THE ERA OF LOW TAXES IS OVER¹

For investors, happy days are here no more.²  

Richard L. Kaplan*  

Tax reform under President Joseph R. Biden will likely include some of the general proposals made by candidate Joe Biden, many of which focus on increasing taxes owed by upper-income individuals, especially investors. President Biden has been clear that he believes in an activist government and sees federal programs as the preferred solution to most problems, be they the Covid-19 pandemic or various societal deficiencies. To fund this major expansion of government, President Biden will want to raise federal revenues, and tax reform will inevitably play a major part in accomplishing that objective.

President Biden wants to do more, however, than just raise revenue with the U.S. tax system. He also wants to address one of the major economic and social problems of our day—namely, economic inequality across income classes, ethnicities, and generations. Such economic inequality is not a new concern,³ of course, but disparities in available financial resources have clearly increased in recent years, even before certain tax changes made during the preceding Trump Administration exacerbated these tendencies. Accordingly, President Biden seeks to raise tax revenue primarily from those he sees as having not paid their “fair share” in recent years.

In practical terms, this policy thrust is less likely to pre-ordain major increases in federal tax rates and more likely to address existing tax preferences that disproportionately benefit taxpayers who might be variously described as “the rich,” “the wealthy,” or to borrow George Gershwin’s catchy formulation, “the folks with plenty of plenty.”⁴ Accordingly, tax reform under President Biden will focus on three areas that he mentioned during his recent presidential campaign: capital gains, inheritance taxes, and Social Security’s payroll tax. Each of these areas will be addressed in turn.

* Guy Raymond Jones Chair in Law, University of Illinois.


I. CAPITAL GAINS

President Biden’s most far-reaching proposal is undoubtedly his plan to tax long-term capital gains at the same rate as ordinary income. The preferential taxation of capital gains has been controversial since such treatment was first enacted a century ago, but eliminating this treatment has special appeal now because it accomplishes both of President Biden’s major tax objectives. First, taxing capital gains as ordinary income can raise tons of money because the applicable tax rate on such gains would increase from a maximum of 20% currently to 37%, or possibly 39.6% if the tax rate on ordinary income rises as President Biden has suggested. Second, most of that increased tax revenue will come from people who are in the top of the income distribution – precisely the people whom candidate Biden targeted during his campaign last year. Historically, capital gains are concentrated among the very top income-tier of American taxpayers, and President Biden further concentrates the impact of his proposal by limiting its application to taxpayers who have an annual income of at least $1 million.

Whatever merits a tax preference for capital gains may have, limiting its benefits in this manner has significant political appeal. The famous investor Warren Buffet has regularly observed that he pays a lower federal income tax rate than his secretary. How can that be? Quite simply, because Mr. Buffet derives most of his income from long-term capital gains, while his secretary’s salary is taxed as ordinary income. Thus, Mr. Buffet does indeed pay a lower tax rate than his secretary. Similarly, during the 2012 presidential election, former Massachusetts Governor Mitt Romney was pilloried by the press when his tax returns revealed that he had paid tax at an effective rate of 15% or less – again, a result of the much-lower tax rates that apply to long-term capital gains. To put the matter more bluntly, there is simply no way to address income inequality in terms of after-tax income without substantially modifying the tax rate differential between capital gains and ordinary income.

While President Biden has not promoted simplification as a tax policy objective, the fact remains that eliminating the special tax treatment of capital gains would radically simplify the operation of the federal tax code. Indeed, that was partly why President Ronald Reagan agreed to eliminate the preferential treatment of capital gains in 1986 in exchange for lower income tax rates generally. Thus, eliminating the capital gain-ordinary income distinction is clearly viable.

---


8. An additional 3.8% tax on long-term capital gains applies under the Affordable Care Act, and President Biden has not indicated that he intends to eliminate that levy. I.R.C. § 1411(a)(1).

9. In 2018, for example, 69% of capital gains were received by the top 1% of U.S. taxpayers. See Long-Term Capital Gains Highly Concentrated, CTR. BUDGET & POL’Y PRIORITIES (Nov. 13, 2019), https://www.cbpp.org/long-term-capital-gains-highly-concentrated [https://perma.cc/BJK8-8J2D].
as a policy option. In fact, five out of six states that have an income tax apply the same tax rates to capital gains and ordinary income. Finally, the federal government currently taxes such gains as ordinary income when funds are withdrawn from retirement savings arrangements such as individual retirement accounts, 401(k) plans, or any of the other pre-tax variants in the defined contribution retirement universe. 10 On the other hand, the simplification benefits of eliminating the capital gain tax preference would be more fully realized by extending this treatment to all taxpayers, but eliminating it for those with annual incomes exceeding $1 million is an appropriate start.

II. INHERITANCE TAXES

When intergenerational economic inequality is considered, the federal estate tax has historically been the focus of such efforts. After all, addressing such inequality is the raison d’être for this tax. Its role as a revenue raiser has long been more of an after-thought because the estate tax is riddled with escape hatches, some intended and some not. In point of fact, a law review article in 1977 described the estate tax as a “voluntary tax” for this very reason. 11 Indeed, I have heard it surmised that the federal government derives more revenue from the income tax on estate planners than from the estate tax itself! In any case, the estate tax has been fundamentally ineffective in reducing wealth inequality across generations.

That being the case, the estate tax may be due for a top-to-bottom reconsideration in light of the enormous concentration of wealth in this country, especially among newly minted technology titans. But the political reality is that this tax is notoriously unpopular among Americans, including those with no foreseeable financial exposure to it. 12 There is just something about the estate tax that strikes many (most?) people as fundamentally inappropriate. 13 Accordingly, Congress has long provided a substantial estate tax exemption, which presently is $11.7 million per person, 14 or $23.4 million for a married couple. It is possible, of course, for Congress to lower this amount, but President Biden has not made any such proposal along these lines. In this connection, it is worth noting that if the exemption when the estate tax was first enacted – namely, $50,000 in 1916 15 – were adjusted for the change in Gross Domestic Product since then, the current exemption would exceed $21.4 million per person. 16

12. See Michael J. Graetz & Ian Shapiro, Death by a Thousand Cuts: The Fight over Taxing Inherited Wealth 100 (2005) (noting that “64 percent of Californians have voted to abolish their state inheritance tax, paid by only a tiny minority . . .”).
13. See generally id. at 118–30.
16. If the estate tax was intended to apply to a given proportion of the nation’s wealth, divide the Gross Domestic Product for 2020 (4th quarter) of $21,479.5 billion, see BUREAU OF ECON. ANALYSIS, GROSS
Perhaps that is why President Biden has approached the problem of intergenerational inequality by proposing repeal of a tax provision that applies to the “basis” of inherited property. This provision allows an heir to treat such property as if the heir purchased it for its fair market value when the decedent died. The impact of this “reset basis” rule can be seen in the following example: Assume that Jack bought stock at $10 a share when he was a young investor and that it was worth $1,000 per share when he died. His daughter, Jill, inherits this stock and takes as her cost its fair market value when Jack died – namely, $1,000 per share. As a result, the $990 of gain that accrued during Jack’s lifetime is never subjected to the income tax: Jack was not taxed because he never sold his shares when he was alive, and Jill is not taxed on that $990 of appreciation because she starts with a new, so-called “stepped-up,” basis of $1,000.

President Biden proposes to eliminate this method of transferring appreciation between generations tax-free, though he has not specified how he would accomplish this goal. One possibility would treat death as a taxable event, as is done in Canada. In the preceding example, that would mean that Jack’s final income tax return would include his gain of $990 per share. Alternatively, the decedent’s original basis – $10 per share in Jack’s case – could carry forward as the basis of the stock in the hands of Jill, and she would then owe tax on the stock’s appreciation when she sells this stock. Either mechanism would make the accumulated gain taxable to someone, unlike the situation currently.

This change would certainly seem radical to generations of tax planners, but eliminating the step-up-in-basis rule was proposed by President Obama and by President Clinton before him. Moreover, it was actually enacted in the Tax Reform Act of 1976, though it was subsequently repealed retroactively due to anticipated compliance difficulties. But computerization of property records has advanced considerably during the succeeding 45 years, so President Biden’s proposal might be much more feasible now. Moreover, eliminating this powerful, and unlimited, tax incentive to retain appreciated property until death might induce some owners to donate these assets to charitable organizations while they are still alive.

17. I.R.C. § 1014(a).
III. SOCIAL SECURITY TAX

Although most of President Biden’s tax agenda is geared toward financing new programs, he has also expressed concern about one of the Democratic Party’s most cherished programs: Social Security. Much has been written about this program’s projected shortfall and how to address it, but President Biden has highlighted one specific policy option – namely, apply the Social Security payroll tax to more wages.

Since the Social Security program began, its payroll tax has applied to a statutorily limited amount of annual wages and salaries.23 Over the years, this amount has been increased for inflation, and this year, it is $142,800.24 Thus, once an employee earns $142,800 in 2021, any additional wages, salaries, or bonuses bear no Social Security tax. During 2019, the most recent year for which data are available, this wage limit covered 83% of all wages and salaries paid in the United States and only 6% of workers had annual earnings greater than this amount.25 In any case, President Biden seeks to apply Social Security’s payroll tax to wages and salaries over $400,000. Accordingly, this tax would apply to wages and salaries up to the annual cap ($142,800 in 2021) and to such earnings over $400,000, but not to earnings between these two parameters (i.e., $251,200 in 2021). This unusual tax structure would increase tax revenues flowing into the Social Security system, but exclusively from the highest earners, roughly the top 0.4%.26

This change would be fairly easy to implement and could be accomplished with minimal disruption, because employers currently collect Social Security’s payroll tax through payroll withholdings.27 The immediate impact would be greater solvency for the Social Security program, but this apparently painless “easy fix” has a potential hidden cost that has received very limited public policy attention: Will the additional earnings that are subjected to Social Security’s “second tier” of tax be included in the worker’s lifetime earnings record? It is this earnings record, after all, that determines a worker’s retirement benefit when that person retires.28

If these earnings are so included, the current inflow of additional Social Security tax revenue will be offset in the future by higher Social Security retirement benefits when affected workers begin receiving augmented retirement benefits that are attributable to these newly-taxed earnings. And if these earnings are not included in the worker’s earnings record, then the critical link between Social Security...
Security’s taxes and its benefits will be broken – a change of truly historic proportions. In effect, the program’s payroll tax, or at least the extended levy that President Biden has proposed, would then be seen as just another tax, and the connection between taxes and benefits that undergirds Social Security’s near-universal support would be tarnished, if not shattered.

IV. CONCLUSION

President Biden’s tax agenda is foundational to financing his ambitious expansion of the federal government’s role in our society and to moderating some of the economic inequality that has arisen in recent years. These are important and worthy objectives whose time may have come as the Administration grapples with its first 100 days.

29. An alternative approach would include these earnings but lower their contribution to a worker’s retirement benefit significantly. See Social Security 2100 Act, S. 269, 116th Cong. § 202(a)(3), (b) (2019) (including earnings above $400,000 in a worker’s earnings record, but crediting them at only 2%, rather than 15%, which would otherwise apply).