

Taxation of Capital Gains Income and Distortion of Individual Investment Choices

Executive Summary

Income from capital gains is given preferential treatment by the IRS code and by many state income tax laws, and policy makers are frequently confronted with proposals to either expand or repeal existing preferences. One justification for preferential treatment would be if, without it, the tax system would bias investors against making investments that promise part or all of their return as capital gains income. This paper examines conditions where an income tax biases investors towards or away from capital gains assets.

Capital gains income is the difference between the realized sales price of an asset and its basis, or book value. Basis usually equals the purchase price or other original cost of the asset less accumulated depreciation or depletion. If price is greater than basis, the taxpayer has positive income. If price is less than basis, the taxpayer has a loss.

Capital gains income comes from three types of processes. Capital gains income can arise when the price of an asset changes due to a change in underlying fundamentals. Asset prices may change due to new information or to changes over time in supply and demand conditions. Capital gains income also can arise when the book value of an asset diverges from its market value. This may happen when accounting rules for depreciation do not reflect the true changes in an asset's value due to use and the passing of time, such as when the law allows accelerated depreciation. It also happens when accounting rules do not correctly reflect the owner's equity in a business, as happens when a corporation retains and re-invests earnings or a small business owner puts in sweat equity. The third process that can produce capital gains income is inflation. When the general price level rises, asset prices generally rise in step. If basis is not adjusted for inflation, this will result in capital gains income.

An income tax will not bias investors' choice between assets that yield part or all of their return as capital gains income and assets that yield all of their return through a string of payments treated as ordinary income if it follows this rule: Capital gains must be taxed and losses deducted as they accrue, at the same rate as ordinary income, with basis calculated using economic depreciation and adjusted for inflation.

This rule can be approximated for financial assets that are traded on active secondary markets. Mark-to-market rules applying to some financial derivatives are an attempt to do so.

On the other hand, the rule is difficult, if not impossible, to implement for gains and losses on many assets. Most nonfinancial assets and some financial assets are not traded on active secondary markets where prices are set on a regular basis. For these assets, gains or losses can only be measured when there is a sale. Even then, it may be impossible to say when a change in value occurred. In addition, policy makers have been reluctant to impose a tax except when a gain or loss is converted to money.

In the U.S., capital gains income and losses generally are taxed when they are realized, which usually is when the assets sells. This defers taxes from the time when income is earned to a later year when the income is recognized for tax purposes. This deferral reduces the present value of taxes from an investment. On the other hand, if a taxpayer has a loss, it can be recognized and deducted immediately by selling the asset. Taxing capital gains income on realization allows taxpayers to recognize losses immediately and defer taxation of gains, which reduces the present value of taxes. Thus, if two investments promise the same returns, but the returns on one will be paid as dividends or interest while the other will be received through appreciation of an asset, taxing on realization biases investors' choice in favor of the capital gains asset.

U.S. accounting rules and tax law do not call for adjusting basis for inflation. When asset prices rise because of general inflation, nominal gains realized on the sale of an asset will over-state the seller's real economic gains. In some cases, a taxpayer with a real economic loss will have a taxable nominal gain. This biases investors' choice against assets that promise part of their return through capital gains.

Net income from a business is receipts less expenses, including depreciation. When accounting depreciation exceeds economic depreciation, current income is understated and the book value of the depreciating assets is understated. If the assets are later sold, there can be capital gains income equal to the difference between the sales price and the understated basis. When a corporation retains and reinvests earnings, they are not counted as income for the shareholders and the shareholders' basis in their shares is not adjusted for this investment. When a small business owner does unpaid or underpaid work for the business, the owner's basis in the business is not increased to reflect the value of this unpaid work. In both cases, when the owner sells the shares or the business, there will be capital gains income equal to the difference between the sales price and the understated basis. Excess depreciation, retained earnings, and sweat equity all result in deferred recognition of income and can convert ordinary income to capital gains income. This biases investors' choice in favor of assets where excess depreciation, retained earnings, or sweat equity can produce capital gains.

Aspects of U.S. tax law and accounting conventions produce biases both in favor of and against assets yielding capital gains income. In some cases, the biases in favor of capital gains assets will be dominant and in others the biases against them will be dominant. It is not clear which bias has the larger effect overall. Preferential rates or partial exemptions for capital gains income would increase the distortion of investors' choices if the biases due to deferring taxes and converting ordinary income to capital gains income are stronger than the bias due to inflation. If the bias from inflation is stronger, some sort of adjustment may be called for, but preferential rates and partial exemptions are blunt tools, which have different effects on gains from assets held for different periods.

Adopting mark-to-market rules to more financial assets would make the tax system more neutral, but would create a problem for some taxpayers who would owe tax on unrealized gains but not have cash flow to pay the tax.