End the Break On Capital Gains

Leonard E. Burman

The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders.

Document date: July 30, 2007
Released online: July 30, 2007

The Washington Post, July 30, 2007 -- Lawmakers continue to profess shock that super-rich investment managers dodge millions of dollars in taxes on their enormous earnings. But much like the cynical Captain Renault in "Casablanca," who excoriated gambling while slyly pocketing his own winnings, their shock is disingenuous.

Congress created the giant loophole that fuels these windfalls. Capital gains -- profits on sales of such assets as stock, land or a business -- are taxed at a maximum rate of 15 percent. In contrast, ordinary income -- such as wages and interest -- is taxed at rates up to 35 percent. High-income people have a huge incentive to make income look like capital gains rather than wages. Such alchemy can cut tax bills in half.

For private equity firms, which amass capital to restructure businesses or invest in new ones, exploiting the capital gains loophole is a cinch. Their general partners, who make the deals and manage the investments, earn an annual fee plus a hefty share (typically 20 percent) of any future profits. The fee, less expenses, gets taxed as ordinary income, but the profit share is taxed at capital gains rates.

Do the math: A general partner earning $100 million in gains on a deal can save $20 million in taxes compared with what he'd pay if the income were taxed at the top rate, 35 percent.

The fund manager's return is clearly compensation for services rendered. Sure, it comes with risk, but many other employees take risks unsweetened by massive tax windfalls. For example, most stock options are taxed as ordinary income.

Defenders of the status quo argue that the general partners in private equity deals are not employees but entrepreneurs who identify the projects, raise the capital and, importantly, get their fifth only if a project succeeds. Fairness dictates that they be taxed like other entrepreneurs, who invest their sweat equity in return for future capital gains.

The lobbyists have a very small point. The solution, however, is not to continue cut-rate taxes for those who can game the system but, rather, to eliminate the lower capital gains tax rates entirely.

Yes, conventional wisdom holds that we need low tax rates on capital gains to encourage investment and risk-taking. And, some will say, doesn't taxing capital gains on corporate stock amount to double taxation because profits were already subject to the corporate income tax?

In fact, the tax break on capital gains does more harm than good. The overall level of saving responds little to tax rates. And enough investment is financed from sources unaffected by individual income taxes -- such as pension funds, insurance companies and foreigners -- that the direct taxation of capital gains of U.S. stakeholders doesn't matter much.

What's more, entrepreneurs would get a significant tax break even without the low rate on gains. Unlike employees who pay as they earn, entrepreneurs can postpone their tax until they sell a business. In the case of private equity, for example, a large portion of the general partner's compensation is deferred until the assets are sold. Delaying his tax bill for many years amounts to an interest-free government loan -- a powerful incentive to earn income that way.

It is true that some corporate capital is taxed twice -- once under the corporate income tax and again as capital gain or dividend -- but the best response to that problem is a credit against individual income taxes for taxes already paid at the company level, not capital gains tax breaks for private equity, land and oil wells, which are all untouched by the corporate tax.

What the low tax rate on capital gains does is spur a huge amount of unproductive tax sheltering. Wealthy individuals invest enormous sums in schemes to convert ordinary income into capital gains, often making investments that would make no sense absent the tax savings. Capital is drawn away from productive

investments, hurting the economy. Similarly, the highly talented people who dream up tax shelters could, in a better world, do productive work.

Finally, the capital gains tax break undermines progressivity. In 2005, for example, the richest 10 percent of households got more than 90 percent of the tax benefits.

If Congress doesn't want to see this problem come back in another guise, it should close the giant capital gains loophole once and for all. That would make the tax system fairer and more efficient.

Or, like Captain Renault, lawmakers can feign indignation, shut down the current operation and prepare to be shocked all over again when they see smart billionaires playing the same game tomorrow.

Leonard Burman directs the Tax Policy Center and is a senior fellow at the Urban Institute. He is the author of "The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed." The views expressed are those of the authors and should not be attributed to the Urban Institute, its sponsors, staff, or trustees.

Other Publications by the Authors

- Leonard E. Burman

Usage and reprints: Most publications may be downloaded free of charge from the web site and may be used and copies made for research, academic, policy or other non-commercial purposes. Proper attribution is required. Posting UI research papers on other websites is permitted subject to prior approval from the Urban Institute—contact publicaffairs@urban.org.

If you are unable to access or print the PDF document please contact us or call the Publications Office at (202) 261-5687.

Disclaimer: *The nonpartisan Urban Institute publishes studies, reports, and books on timely topics worthy of public consideration. The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Copyright of the written materials contained within the Urban Institute website is owned or controlled by the Urban Institute.*

Source: The Urban Institute, © 2012 | http://www.urban.org