How are capital gains taxed?

Q. How are capital gains taxed?

A. Capital gains are profits from the sale of a capital asset, such as shares of stock, a business, a parcel of land, or a work of art. Capital gains are generally included in taxable income, but in most cases, are taxed at a lower rate.

A capital gain is realized when a capital asset is sold or exchanged at a price higher than its basis. Basis is an asset's purchase price, plus commissions and the cost of improvements less depreciation. A capital loss occurs when an asset is sold for less than its basis. Gains and losses (like other forms of capital income and expense) are not adjusted for inflation.

Capital gains and losses are classified as long term if the asset was held for more than one year, and short term if held for a year or less. Short-term capital gains are taxed as ordinary income at rates up to 37 percent; long-term gains are taxed at lower rates, up to 20 percent. Taxpayers with modified adjusted gross income above certain amounts are subject to an additional 3.8 percent net investment income tax (NIIT) on long- and short-term capital gains.

The Tax Cuts and Jobs Act (TCJA), enacted at the end of 2017, retained the preferential tax rates on long-term capital gains and the 3.8 percent NIIT. TCJA separated the tax rate thresholds for capital gains from the tax brackets for ordinary income for taxpayers with higher incomes (table 1). The thresholds for the new capital gains tax brackets are indexed for inflation, but, as under prior law, the income thresholds for the NIIT are not. TCJA also eliminated the phaseout of itemized deductions, which had raised the maximum capital gains tax rate above the 23.8 percent statutory rate in some cases.

TABLE 1

Tax Rate on Long-Term Capital Gains

2018

Prior law	Tax Cuts and Jobs Act
Zero rate for taxpayers below the 25 percent tax bracket; 15 percent rate for taxpayers in the 25 to 35 pecent tax brackets; 20 percent rate for taxpayers above the 35 percent tax bracket.	Zero rate if taxable income is below $38,600 (single), $77,200 (joint); 15 percent rate if taxable income is between $38,600 and $425,800 (single), $77,200 and $479,000 (joint); 20 percent rate if taxable income is above $425,800 (single), $479,000 (joint).
3.8 percent NIIT at AGI above $200,000 (single), $250,000 (joint).	3.8 percent NIIT at AGI above $200,000 (single), $250,000 (joint).

AGI = adjusted gross income; NIIT = net investment income tax

There are special rules for certain types of capital gains. Gains on art and collectibles are taxed at ordinary income tax rates up to a maximum rate of 28 percent. Up to $250,000 ($500,000 for married couples) of capital gains from the sale of principal residences is tax-free if taxpayers meet certain conditions including having lived in the house for at least 2 of the previous 5 years. Up to the greater of $10 million of capital gains or 10 times the basis on stock held for more than five years in a qualified domestic C corporation with gross assets under $50 million on the date of the stock's issuance are excluded from taxation. Also excluded from taxation are capital gains from investments held for at least 10 years in designated Opportunity Funds. Gains on Opportunity Fund investments held between 5 and 10 years are eligible for a partial exclusion.

Capital losses may be used to offset capital gains, along with up to $3,000 of other taxable income. The unused portion of a capital loss may be carried over to future years.

The tax basis for an asset received as a gift equals the donor's basis. However, the basis of an inherited asset is "stepped up" to the value of the asset on the date of the donor's death. The step-up provision effectively exempts from income tax any gains on assets held until death.

C corporations pay the regular corporation tax rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.

MAXIMUM TAX RATE ON CAPITAL GAINS

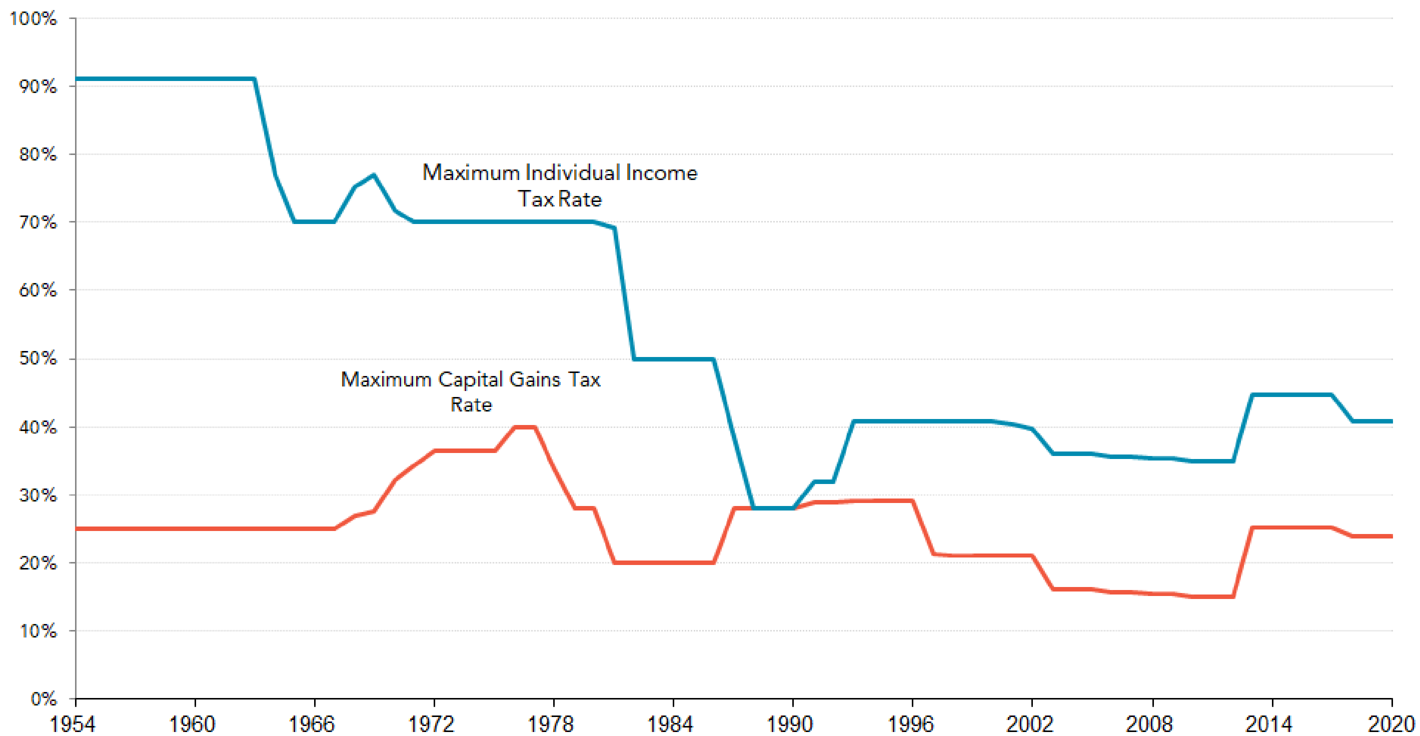
For most of the history of the income tax, long-term capital gains have been taxed at lower rates than ordinary income (figure 1). The maximum long-term capital gains and ordinary income tax rates were equal in 1988 through 1990. Since 2003, qualified dividends have also been taxed at the lower rates.

How are capital gains taxed?

FIGURE 1

Maximum Capital Gains and Individual Income Tax Rate

Tax years 1954–2020



Sources: US Department of the Treasury, Office of Tax Analysis (2016); Urban-Brookings Tax Policy Center calculations.
Note: The maximum rates include the 3.8 percent tax on net investment income (2013-) and adjusts for the phaseout of itemized deductions (1991–2009, 2013–2017).

Updated May 2020

Key Elements of the U.S. Tax System

How are capital gains taxed?

Data Sources

US Department of the Treasury, Office of Tax Analysis. 2016. "Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954–2014." Washington, DC: Department of the Treasury.

Further Reading

Auten, Gerald. 2005. "Capital Gains Taxation." In *Encyclopedia of Taxation and Tax Policy*, 2nd ed., edited by Joseph Cordes, Robert Ebel, and Jane Gravelle, 46–49. Washington, DC: Urban Institute Press.

Burman, Leonard E. 1999. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. Washington, DC: Brookings Institution Press.

Kobes, Deborah, and Leonard E. Burman. 2004. "Preferential Capital Gains Tax Rates." *Tax Notes*. January 19.

Q. What is the effect of a lower tax rate for capital gains?

A. It does not appear to spur economic growth significantly. But lower rates foster tax avoidance strategies and complexity.

Throughout the history of the income tax, capital gains generally have been taxed at lower rates than ordinary income. In 1988, 1989, and 2000, the top tax rate on capital gains was the same as the top tax rate on ordinary income. Since 2003, qualified dividends have also been taxed at the same lower rates as capital gains. Proponents of the tax preference argue that lower tax rates for capital gains and dividends offset taxes already paid at the corporate level, spur economic growth, encourage risk taking and entrepreneurship, offset the effects of inflation, prevent "lock-in" (the disincentive to sell assets), and mitigate the tax penalty on savings under the income tax. Critics, for their part, complain that the lower tax rate disproportionately benefits the wealthy and encourages tax-sheltering schemes.

The double-taxation argument goes only so far. Capital gains from the sale of stock are only about half of all capital gains. And even when a gain arises from the sale of corporate stock, corporate profits can often escape full taxation through business tax preferences.

ECONOMIC GROWTH

Do lower taxes on capital gains spur economic growth? By reducing the disincentive to invest, a lower capital gains tax rate might encourage more investment, leading to higher economic growth. Many factors determine growth, but the tax rate on capital gains does not appear to be a major factor, as evidenced in figure 1, which shows the top tax rates on long-term capital gains along with real economic growth from 1954 to 2019.

Capital gains may arise from risky investments, and a lower capital gains tax rate might encourage such risk taking. Even without a tax preference, taxing gains while allowing full current deductions for losses on a symmetric basis would reduce risk by reducing after-tax variance of returns. However, deductibility of losses is limited, which limits the risk-reduction benefit of capital gains taxation for some taxpayers. Under current law, taxpayers can use capital losses to offset capital gains and, for noncorporate taxpayers, up to $3,000 of additional taxable income other than capital gains. Noncorporate taxpayers also can carry any remaining capital losses forward to future years indefinitely.

It is true that inflation causes part of almost any nominal capital gain. But inflation actually affects the returns on currently taxed assets (interest, dividends, rents, and royalties) more than it affects capital gains, which are taxed when an asset is sold.

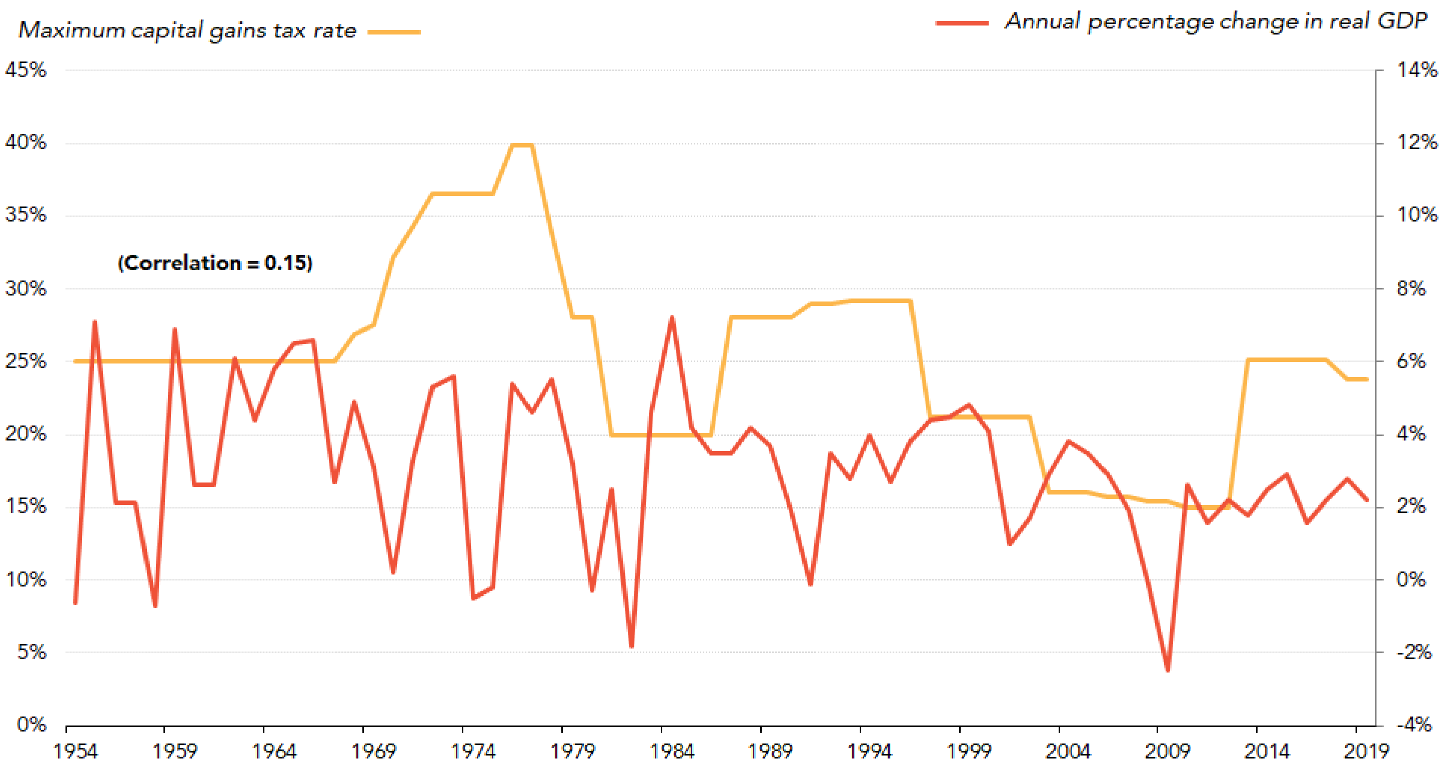
Key Elements of the U.S. Tax System

What is the effect of a lower tax rate for capital gains?

FIGURE 1

Maximum Capital Gain Tax Rate and Economic Growth

Tax years 1954–2019



Source: Urban-Brookings Tax Policy Center calculations; US Bureau of Economic Analysis, "National Economic Accounts"; and US Department of the Treasury, Office of Tax Analysis, "Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains 1954–2014.".
Note: The maximum capital gains tax rate includes the 3.8 percent tax on net investment income (2013–) and adjusts for the phaseout of itemized deductions (1991–2009, 2013–2017).

BENEFICIARIES OF A LOWER TAX RATE

Critics are correct that low tax rates on capital gains and dividends accrue disproportionately to the wealthy. The Urban-Brookings Tax Policy Center estimates that in 2019, more than 75 percent of the tax benefit of the lower rates went to taxpayers with income over $1 million (table 1).

What is the effect of a lower tax rate for capital gains?

TABLE 1

Benefit of Lower Tax Rates on Long-Term Capital Gains and Qualified Dividends

Current law, 2019

Cash income level	Share of returns with tax benefit	Benefit as share of after-tax income	Share of total tax benefit	Average tax savings
Less than $10,000	0.0%	0.0%	0.0%	$0
$10,000 – $20,000	0.4%	0.0%	0.0%	*
$20,000 – $30,000	1.5%	0.0%	0.1%	$10
$30,000 – $40,000	2.5%	0.0%	0.1%	$10
$40,000 – $50,000	5.1%	0.1%	0.2%	$20
$50,000 – $75,000	8.5%	0.1%	0.8%	$60
$75,000 – $100,000	16.2%	0.2%	1.2%	$120
$100,00 – $200,000	23.3%	0.2%	4.3%	$230
$200,000 – $500,000	41.4%	0.4%	8.1%	$940
$500,000 – $1,000,000	72.5%	1.5%	8.2%	$7,570
More than $1,000,000	86.7%	7.2%	76.8%	$155,580
All	**12.4%**	**1.2%**	**100.0%**	**$960**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0319-2).
* Nonzero value rounded to zero.

Low tax rates on capital gains contribute to many tax shelters that undermine economic efficiency and growth. These shelters employ sophisticated financial techniques to convert ordinary income (such as wages and salaries) to capital gains. For top-bracket taxpayers, tax sheltering can save up to 17 cents per dollar of income sheltered. The resources that go into designing, implementing, and managing tax shelters could otherwise be used for productive purposes.

Finally, the low rate on capital gains complicates the tax system. A significant portion of tax law and regulations is devoted to policing the boundary between lightly taxed returns on capital assets and fully taxed ordinary income.

Updated May 2020

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0319-2."

US Bureau of Economic Analysis. "Current-Dollar and Real Gross Domestic Product." 2018.

———. "National Economic Accounts." Last modified August 7, 2018.

US Department of the Treasury, Office of Tax Analysis. "Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954–2014." December 20, 2016.

What is the effect of a lower tax rate for capital gains?

Further Reading

Burman, Leonard E. 1999. The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed. Washington, DC: Brookings Institution Press.

———. 2007. "End the Break on Capital Gains." Washington Post. July 30.

———. 2018. "Should Treasury Index Capital Gains?" TaxVox (blog). May 10.

Q. How might the taxation of capital gains be improved?

A. Taxing capital gains at the same rates as ordinary income would simplify the tax system by removing major incentives for tax sheltering and other attempts to manipulate the system. This could be accomplished by taxing accrued capital gains on an annual basis.

The Tax Reform Act of 1986, signed by President Ronald Reagan, raised tax rates on capital gains and lowered rates on ordinary income but set the same 28 percent top rate for both. The goal: reducing tax planning devoted to converting ordinary income to capital gains. The policy worked—briefly. Successive congresses raised the top rate on ordinary income (now 40.8 percent) and reduced the top rate on capital gains (now 23.8 percent). As the gap between the two rates grew, so did the incentives to manipulate the system. Now might be a good time to once again tax capital gains and ordinary income at the same rate, which could be higher than today's rate on capital gains but lower than the current rate on ordinary income.

In the 1980s, taxpayers exploited the ordinary income/capital gain gap by making investments that generated ordinary deductions—such as interest, lease payments, and depreciation—to reduce their current income tax liability. These taxpayers got their money back (and presumably more) in the form of long-term capital gains. The Tax Reform Act targeted these arrangements by limiting passive loss, interest, and accelerated depreciation deductions. Most importantly, it also eliminated the ordinary income/capital gain gap, thus making many tax shelter schemes unprofitable.

With the return of the ordinary/capital income tax differential, schemes to convert ordinary income into capital gains have followed. The Senate investigated one such scheme, basket options, which used the tax alchemy of derivatives to convert short-term into long-term capital gains. Private equity and other investment managers are often compensated with "carried interest," which allows them to claim long-term gains rather than salaries.

These planning opportunities are available only to the well-off, who hold the vast majority of capital assets and face the highest tax rates, thus deriving the most benefit from lower tax rates on capital gains (figure 1).

Annually taxing accrued capital gains, rather than realized gains, has been proposed as a method to equalize tax rates. This method, sometimes called "mark-to-market", is currently used to tax financial institutions and some financial products. By preventing "lock in"—holding property to defer tax liability (perhaps until death, when the heirs can completely avoid taxation of accrued gains on inherited assets) it could raise substantial revenue that would make it possible to reduce tax rates or the deficit.

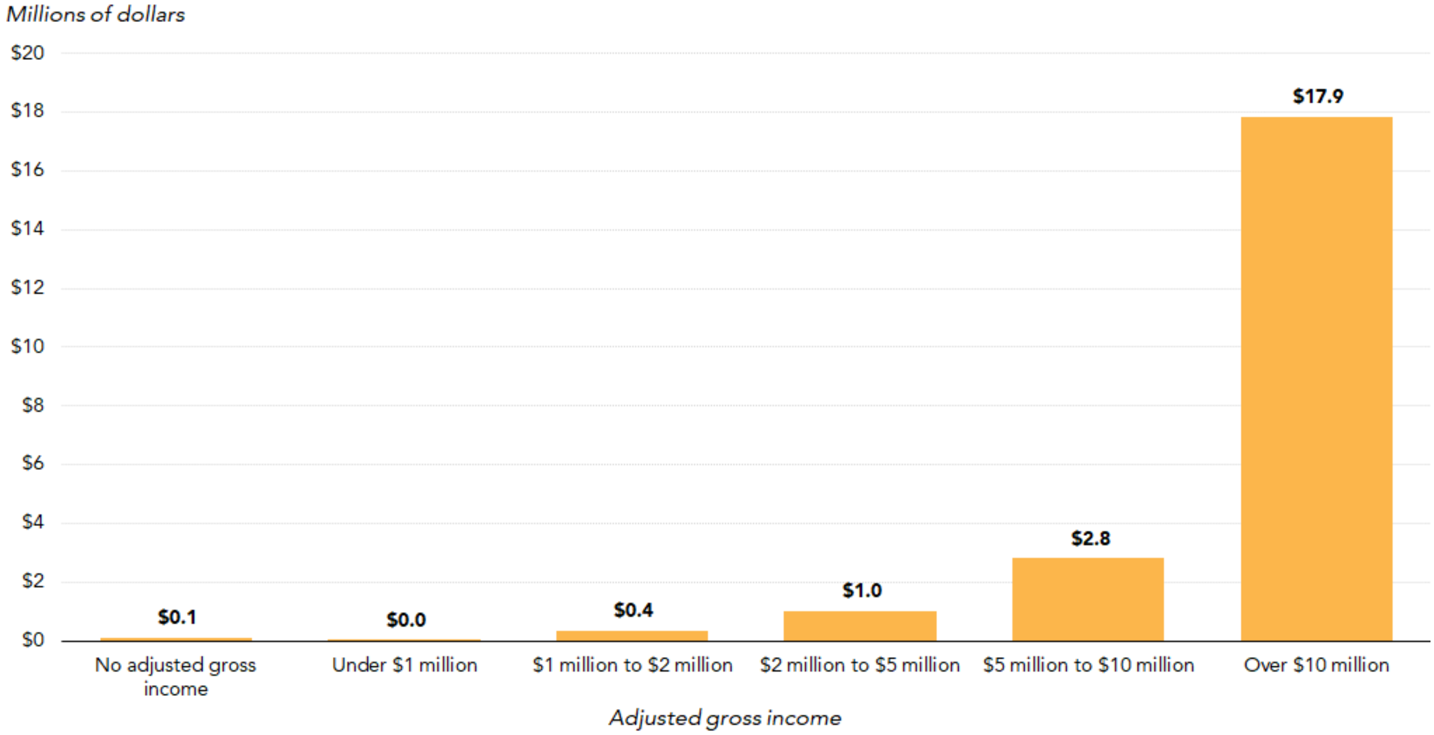
Key Elements of the U.S. Tax System

How might the taxation of capital gains be improved?

FIGURE 1

Average Taxable Net Gain from Sales of Capital Assets

Tax year 2017



Source: Internal Revenue Service. *Statistics of Income. Basic Tables: Returns Filed and Sources of Income.* Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," Tax Year 2017.

Alternatively, Congress could either tax capital gains at death or instate carryover basis so that heirs retain the lower basis of inherited assets. Either step would also reduce the tax incentive to keep assets until death, and could raise revenue.

Finally, if Congress is concerned about the potential double taxation of corporate earnings, it might integrate the two levels of taxes on corporate income. That is, Congress could tax corporate earnings only once, taxing the corporation or its shareholders but not both. The US Department of the Treasury (1992) has laid out several options for such integration.

Updated May 2020

Data Sources

Internal Revenue Service. *Statistics of Income. Basic Tables: Returns Filed and Sources of Income.* Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," Tax Year 2017.

Further Reading

Batchelder, Lilly L, and David Kamin. 2019. "Taxing the Rich: Issues and Options."

How might the taxation of capital gains be improved?

Burman, Leonard E. 1999. *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*. Washington, DC: Brookings Institution Press.

———. 2012. "Tax Reform and the Tax Treatment of Capital Gains." Testimony of Leonard E. Burman before the House Committee on Ways and Means and the Senate Committee on Finance, Washington, DC, September 20.

Rosenthal, Steven M. 2014. "Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits." Testimony before the US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, Washington, DC, July 22.

US Department of the Treasury. 1992. "Integration of the Individual and Corporate Tax Systems." Washington, DC: US Department of the Treasury.

What is carried interest, and how is it taxed?

Q. What is carried interest, and how is it taxed?

A. Carried interest, income flowing to the general partner of a private investment fund, often is treated as capital gains for the purposes of taxation. Some view this tax preference as an unfair, market-distorting loophole. Others argue that it is consistent with the tax treatment of other entrepreneurial income.

Carried interest is a contractual right that entitles the general partner of an investment fund to share in the fund's profits. These funds invest in a wide range of assets, including real estate, natural resources, publicly traded stocks and bonds, and private businesses. Hedge funds, for example, typically trade stocks, bonds, currencies, and derivatives. Venture capital funds invest in start-up businesses. And private equity funds invest in established businesses, often buying publicly traded companies and taking them private.

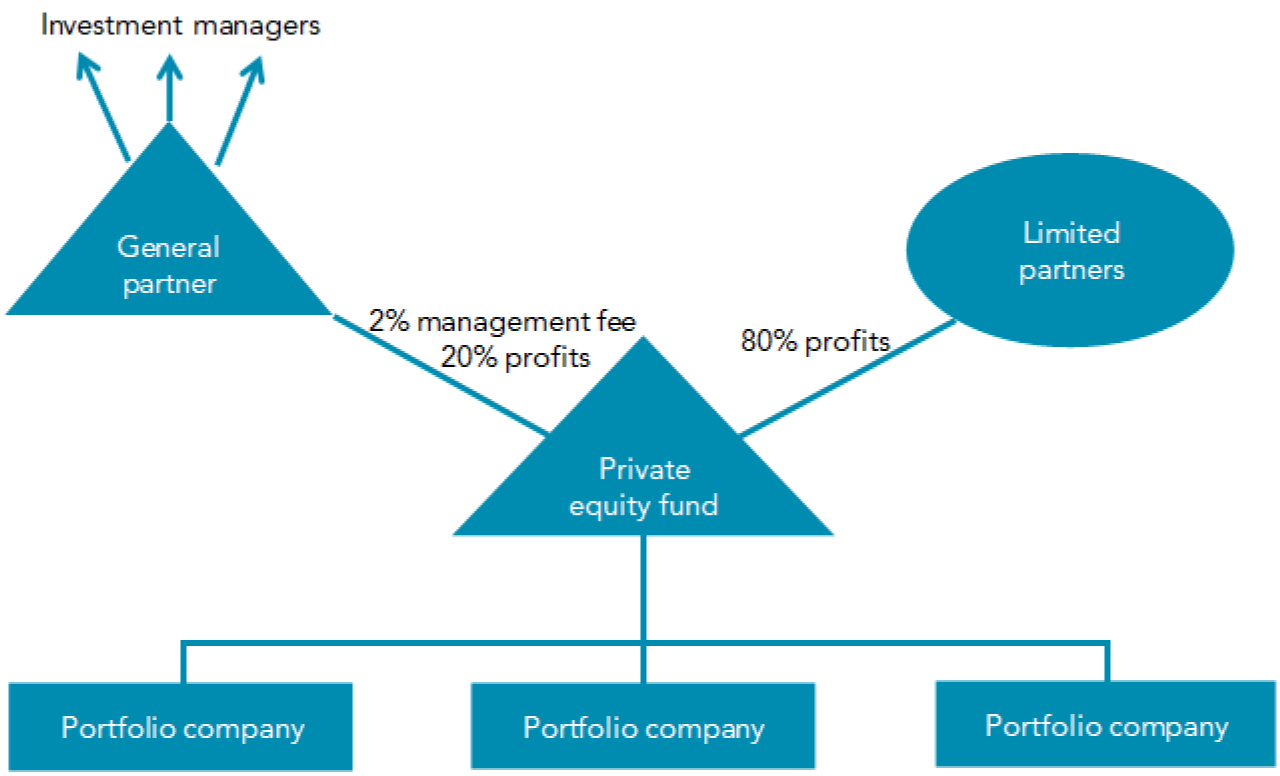
Depending on the investment, the general partner's share of the profits can take a variety of forms: interest, royalties, long- or short-term capital gains, and dividends. There is ongoing debate about whether partners receiving long-term capital gains and qualified dividends as carried interest should receive the preferential tax rates accorded to regular investors.

The preferential tax rate is especially important for a private equity fund and its managers. A private equity fund typically uses carried interest to pass through a share of its net capital gains to its general partner which, in turn, passes the gains on to the investment managers (figure 1). The managers pay a federal personal income tax on these gains at a rate of 23.8 percent (20 percent tax on net capital gains plus 3.8 percent net investment income tax).

What is carried interest, and how is it taxed?

FIGURE 1

A Typical Private Equity Fund



The general partner receives its carried interest as compensation for its investment management services. (Typically, the general partner also receives a separate annual fee based on the size of the fund's assets.) The limited partners receive the balance of the fund's profits in proportion to their capital investment. A typical division for a private equity fund is 20 percent of the profits to the general partner and 80 percent to the limited partners.

Private equity funds managed $4.1 trillion in 2019, a massive increase over the $100 billion managed in 1994. They use their capital to buy companies and improve their operations, governance, capital structure, and market positioning. Then they sell the companies and pass any profits to the partners.

Many commentators argue that it would be fairer and more efficient economically to tax carried interest like wage and salary income, which is subject to a top rate of 37 percent. They draw an analogy between the general partners and investment bankers, who pay tax at ordinary rates on their wages, salaries, and bonuses. They also object that most service providers are not able to treat their income as capital gains. Some commentators add, if we treat carried interest like wage and salary income for the general partners, we also should allow the limited partners to deduct the carried interest as an ordinary expense.

But others believe that the general partners are more like entrepreneurs who start a new business and may,

What is carried interest, and how is it taxed?

under current law, treat part of their return as capital—not as wage and salary income—for their contribution of "sweat equity." Our tax system largely accommodates this conversion of labor income to capital because it cannot measure and time the contribution of the sweat equity.

The Tax Cuts and Jobs Act slightly curtailed the tax preference for carried interest, requiring an investment fund to hold assets for more than three years, rather than one year, to treat any gains allocated to its investment managers as long term. Gains from the sale of assets held three years or less would be short term, taxed at a top rate of 40.8 percent. However, most private equity funds hold their assets for more than five years, so the longer holding period requirement may not affect them much.

Updated May 2020

Data Sources

Preqin. 2020. *2020 Preqin Global Private Equity Report: Sample-Pages*. London: Preqin.

Further Reading

Fleischer, Victor. 2008. "Two and Twenty: Taxing Partnership Profits in Private Equity Funds." *New York University Law Review* 83 (1): 8–15.

Gergen, Mark. 1992. "Reforming Subchapter K: Compensating Service Partners." *Tax Law Review* 48: 69–111.

Marron, Donald J. 2016. "Goldilocks Meets Private Equity: Taxing Carried Interest Just Right." Washington, DC: Urban-Brookings Tax Policy Center.

Rosenthal, Steven M. 2013. "Taxing Private Equity Funds as Corporate 'Developers.'" *Tax Notes*. January 21.

Steuerle, C. Eugene. 2007. "Tax Reform, Tax Arbitrage, and the Taxation of 'Carried Interest.'" Testimony before the US House of Representatives Committee on Ways and Means, Washington, DC, September 6.

Viard, Alan D. 2008. "The Taxation of Carried Interest: Understanding the Issues." *National Tax Journal* 60 (3): 445–60.

Weisbach, David A. 2008. "The Taxation of Carried Interest in Private Equity." *Virginia Law Review* 94: 715–64.