



Summary

For over 100 years, with one brief exception (1987-1990), the United States has taxed long-term capital gain at a lower rate than ordinary income. The previous Biden administration proposed raising the capital gains rate to be on par with the top rate on ordinary income. Former President Biden also proposed increasing the tax rate on net investment income and applying it to active business owners, including real estate professionals.

RER encourages Congress to continue to support investment and job creation with a meaningful capital gains incentive.

Key Takeaways

- Unlike other tax policies, such as immediate expensing, the capital gains preference only **rewards smart, productive investments** that generate profits.
- The reduced capital gains rate partially offsets the higher risk that comes with illiquid, capital-intensive real estate projects, as well as **the economic effects of inflation**.
- **High taxes on capital income make it harder** to attract the investment needed to rebuild our urban centers. Opportunity Zone capital gains incentives facilitated **\$75 billion** in new investment in low-income communities in the first two years after enactment.
- A tax on unrealized gains would require the IRS to **police households** as they identify, tabulate, and value all their worldly possessions. The tax would thrust the IRS into a new and unwelcome role. The agency would become a permanent, live-in accountant and watchdog over every aspect of household finances, consumer activity, and economic life.

Background

Proposed Changes to Capital Gains

- Traditionally, the United States has taxed long-term capital gain at a lower rate than ordinary income. Since 1921, the only exception was a brief three-year period after the Tax Reform Act of 1986, when Congress lowered the top ordinary tax rate from 50 percent to 28 percent and created temporary tax parity between ordinary and capital income.
- Long-term capital gain is currently taxed at a top rate of 20 percent.
- However, the rate increases to 23.8 percent if the income is subject to the 3.8 percent tax on net investment income. The net investment income tax applies to real estate gains earned by passive investors and not income earned from the active conduct of professionals in real estate.
- The prior Biden administration proposed raising the capital gains rate to 39.6 percent, which would have brought it to parity with its proposed top rate on ordinary income.
- In addition, former President Biden had proposed to increase the 3.8 percent tax on net investment income to 5 percent and extend it to the income of active business owners, including real estate professionals; the net investment income tax applies to both capital gains and rental income.
- Former President Biden and several key Democratic lawmakers also proposed a mark-to-market regime in which built-in, unrealized gain would be taxed on an annual basis, regardless of whether the asset is sold.

Recommendations

Maintain a Reduced Tax Rate on Capital Gains: The current structure **decreases the cost of capital**, drives long-term investment, encourages productive entrepreneurial activity, draws investment from around the world, and increases U.S. workforce **productivity and competitiveness**.



- The differential tax treatment of liquid and illiquid investments would distort markets and give rise to wasteful new tax shelters and taxpayer games.

Reward Risk-Taking: Current law on capital gains encourages taxpayers to **put capital to work** on projects that won't pay off for many years. By taxing business assets and investments annually, a tax on unrealized gains would remove one of the major incentives for **patient, productive capital investment**.

- Risk capital differs from wage compensation. The entrepreneur who foregoes a traditional job in favor of starting a business forfeits many protections and benefits offered to employees, such as a pre-negotiated salary.
- The capital gains preference **compensates entrepreneurs** for this risk, including the potential complete loss of their time and capital.

Preserve the Integrity of Our Tax System: A proposed tax on unrealized gains is quite possibly **unconstitutional**. Supreme Court jurisprudence has applied a realization requirement to determine whether gains or profits constitute income taxable under the 16th Amendment.

- In addition, taxing unrealized gains would trigger **wasteful disputes and litigation**, detracting from productive economic activity. Annual valuation requirements will require **costly appraisals**. Valuation disagreements will be a constant source of audits and administrative appeals.