Cutting the Capital Gains Tax When a Rate Cut Isn't in the Cards

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All conservatives agree that capital gains should be excluded from a consumption tax base (the tax base which is used in all conservative tax reform plans, from the FAIR Tax to the flat tax to everything in between). This takes two forms ideally–either new savings is deducted from personal income, or (as is more common), the yield on savings is excluded from personal income.

Taxing income this way makes sense, because it isolates consumed income (as opposed to saved or invested income) and only consumed income to taxation. This leaves the maximum amount of productive income untouched from taxation so that it can increase productivity, grow wages, create jobs, augment nest eggs, etc. Eventually, even this income is consumed and subject to taxation, so there are no loopholes.

Cutting the Capital Gains Tax Directly

In the real world, movement toward this consumption base ideal is halting, unsteady, and uneven. A key policy goal of incremental progress toward a consumption base is cutting the tax rate on capital gains (and dividends, distributed after-tax corporate earnings) to zero. We're a long way from that today.

Thanks to the fiscal cliff (as mitigated by subsequent legislation) and Obamacare, the top capital gains rate today stands at 23.8 percent. That's up from a nadir of 15 percent as recently as a few years ago. Cutting this tax rate is going to be difficult.

First, it involves eliminating one of the twenty new or higher taxes in Obamacare. The Affordable Care Act slapped a 3.8 percentage point surtax on investment income in households

that earn more than $200,000 per year (not indexed to inflation, incidentally). That's hard enough.

Then we have to start chopping down the remaining rate from 20 all the way down to 0. If history is any guide, the Democrats on Capitol Hill will fight conservatives every step of the way, screaming class warfare rhetoric and deficit crocodile tears as they do so. That's no reason not to try, but it is a cold, hard look at the task before us.

Alternate Ways to Cut the Capital Gains Tax

Fortunately, there are several policy alternatives we have at our disposal should cutting the capital gains rate (or cutting it below a certain level) be prohibitive. None of these are as economically powerful as a straight-up rate cut, but they do exempt more and more capital in the economy from the crippling double taxation of capital gains.

1. **Simplify, consolidate, and expand existing tax-advantaged savings accounts.** There are more tax-advantaged savings accounts out there than one can count (almost). On the employer provided side, you have the 401(k), 403(b), 457, SIMPLE IRA, SIMPLE 401(k), and the federal employee TSP.

Self-employed people have "solo" or "owner only" or "self-directed" 401(k) plans and simplified employee pensions (SEPs).

People with earned income can choose from among IRAs, Roth IRAs, and KBH IRAs for non-working spouses.

Want to save for college? You'll have to look at 529 plans and Coverdell education savings accounts (ESAs).

How about healthcare? Well, there's the use-it-or-lose-it flexible spending account (FSA), the use-it-or-keep-it health savings account (HSA), and the endangered species plan, the health reimbursement arrangement (HRA).

There's even a tax-advantaged savings account for fisherman, the "capital construction fund" (CCF) account.

It's enough to make your head spin. And it causes most Americans to under-save. Study after study has shown that most people, when giving a dizzying amount of options like this, will choose to do nothing and instead consume what could have been saved. That's not good for them, and it's certainly not good for economic growth.

Back in the middle 2000s, the Treasury Department came up with a proposed three-account system to replace everything seen above. Here's how it would work:

Employer Retirement Savings Accounts (ERSAs). These would replace all the employer options from above. The accounts would work much like Safe-Harbor 401(k) plans do today, where

employers make sure that all employees benefit in exchange for a waiver of onerous non-discrimination testing. The current 401(k) elective deferral limit ($18,000 in 2015, plus a $6000 catch-up for older workers) would apply. Deferrals could be either pre-tax or after-tax, depending on participant wishes.

Retirement Savings Accounts (RSAs). These would replace all the personal IRA-type products that exist today. Anyone could save up to $10,000 per year into an RSA. The money would be deposited after tax, but would grow tax-free if used for retirement after age 55. There would be no income limits on contributions, so they would be very easy to understand.

Lifetime Savings Accounts (LSAs). These would work just like RSAs, but there would be no requirement that the funds be used for retirement. In addition to retirement, they could be used for healthcare, education, a first home, to start a small business, etc. Importantly, there would be no earned income requirement, so even the parents of children could make annual LSA contributions on their behalf. LSAs would replace HSAs, FSAs, HRAs, 529s, and Coverdells.

When given these simpler options, it's very likely more Americans would save more than today, and it would certainly be easier for the financial services industry to market savings products more easily.

2. One account to rule them all

Another take on the above is to create an additional account (not displacing what's already there), but which is done in the simplest possible way.

Chris Edwards of the Cato Institute has done the most writing on this. These type of accounts already exist in Canada and the United Kingdom, and they are doing very well.

In Canada, the government created "Tax Free Savings Accounts" (TFSAs) in 2009. Any adult can contribute up to $10,000 per year (with rollover of contribution eligibility if you skip or partially skip a year). The money grows tax-free, and can be used for any purpose, including but not limited to retirement. The accounts can be opened at any bank or brokerage firm, online or in person. This is as simple as it gets. The British version is called an "Individual Savings Account" (ISA), and there you can sock away an amazing $23,000 per year with tax-free growth.

These accounts are working. According to Edwards, 40-50 percent of adults in Canada and the U.K. own these accounts, compared to only 38 percent of Americans who have an IRA.

The accounts are dominated by the middle class–80 percent of participants in Canada make less than $80,000 per year, and a majority of British participants make less than $30,000 (and a majority are women).

Edwards thinks this is a good model for what he calls a "Universal Savings Account" (USA) here in America. It would not replace any existing tax-advantaged product, but it would be much simpler. To avoid repetition, read what an LSA above would do to get the idea.

3. Tax free exchanges of property

Another way of avoiding taxes on capital gains is to allow owners of assets with unrealized capital gains to sell those assets and roll them into new investments, tax deferred.

We already have a limited version of this, called a "Section 1031 exchange" or "Starker exchange." Suppose you own a rental real estate property and you want to sell it. However, you don't want to pay all the capital gains tax on your profit. Section 1031 allows you to "buy up" and roll the profits into a new rental property at least as expensive as the one you just sold. The capital gains tax is thereby deferred until you ultimately sell your asset and realize the gain in your pocket.

Why can't all capital gains work this way? Why can't people buy an asset (buildings, mutual funds, artwork, stocks, etc.) and then roll gains into new investments when they sell? As it stands now, Uncle Sam takes a bite every time a transaction is made.

Even worse, sometimes capital gains tax is owed even if you haven't sold anything. Suppose you have a mutual fund, which is really just a collection of stocks. The mutual fund manager buys and sells stocks throughout the course of the year. You don't sell any shares of the fund, but you have to pay taxes on the gains earned within the fund from all the manager's sales. A common sense way of extending 1031 would be to allow for deferral of capital gains inside mutual funds until you actually sell shares.

There's no reason why 1031 cannot apply to buying stocks or mutual funds. If you could roll gains into new purchases, every brokerage account in America would be very close to an IRA.

Getting rid of the tax (actually a double-tax) on capital gains is a necessary part of moving to a consumption base. If it's not politically feasible to walk through the front door and cut the rate, policymakers should keep in mind these additional side door options.