Capital gains, estate taxes dominate debate at Ways and Means Select Revenue Measures hearing

House Democratic and Republican taxwriters squared off over President Biden's proposals to increase the tax rate on capital gains and modify the tax treatment of inherited assets during a May 12 Ways and Means Select Revenue Measures Subcommittee hearing to consider perceived income and wealth inequities in the tax code.

President Biden's American Families Plan, which he unveiled on April 28, calls for increasing the top individual income tax rate and the capital gains tax rate, taxing carried interests as ordinary income, eliminating stepped-up basis for certain inherited assets, and other tax hikes focused on upper-income taxpayers to offset the cost of enhancements to family-focused tax incentives such as the earned income tax credit, the child tax credit, and the child and dependent care credit, and to pay for spending initiatives generally benefiting lower- and middle-income taxpayers. The president has said his plan is intended to rebalance the tax code in an effort to "reward work, not wealth."

Progressive enough?

Select Revenue Measures Subcommittee Chairman Mike Thompson, D-Calif., and the subcommittee's Democrats argued at the hearing that the federal tax system as it operates today exacerbates economic inequality, with its benefits accruing primarily to more affluent taxpayers.

"For a generation, the bulk of the gains in our economy have been concentrated in the wealthiest Americans," Thompson said in his opening statement. "Middle-class families have seen real incomes stagnate while those at the top grow richer. …A tax system that favors financial assets and dynasty trusts over working families won't support the investment we need to build a more prosperous future."

But subcommittee ranking member Adrian Smith, R-Neb., along with the panel's Republican members, disputed the contention that the tax code's benefits are skewed to the wealthy. Citing an analysis prepared by the nonpartisan Joint Committee on Taxation (JCT) staff, Smith noted in his opening statement that in 2018, "a taxpayer earning $20,000 to $30,000 dollars per year pa[id] 3.1 percent of their income in federal taxes. Someone earning between $75,000 and $100,000 paid an average rate of 15.8 percent, and a taxpayer over $1 million pa[id] 31.5 percent on average." Moreover, he said, middle-class taxpayers made significant gains under the 2017's Tax Cuts and Jobs Act (P.L. 115-97), which doubled the standard deduction and significantly expanded the child tax credit.
URL: https://www.jct.gov/publications/2021/jcx-24-21/

"If we want a tax code where the burden of taxation is largely paid by upper-percentile workers, we have it," Smith said.

Capital gains

The American Families Plan proposes to tax income from long-term capital gains and certain dividends at ordinary rates for "households making over $1 million," although the White House has not specified how the threshold would be calculated. (Presumably, taxpayers in this income bracket would see their capital gain and dividend income taxed at the president's proposed top ordinary rate of 39.6 percent. That rate, combined with the 3.8 percent Medicare tax on net investment income that was enacted 2010 as part of the Patient Protection and Affordable Care Act, would bring the maximum tax rate on capital gain and dividend income to 43.4 percent.)

Democrats on the panel argued that this proposal would help level the playing field between wealthier taxpayers, who tend to hold higher levels of capital assets and have the flexibility to decide when to recognize gain, and lower- and middle-income taxpayers, whose income primarily is derived from wages and is subject to current taxation.

Suppressing growth?: Republican taxwriters contended that the president's proposal is excessive and would not achieve its intended results because, rather than generating revenue, it would simply encourage holders of capital assets to avoid a taxable event by deferring sales.

"Economists tell us there is a revenue-maximizing capital gains rate, and if you exceed that rate people won't sell assets and the government collects zero revenue," ranking member Smith said. "This lock-in doesn't benefit government, and it's even worse for our economy."

In an exchange with Smith, Chris Edwards, director of tax policy studies at the Cato Institute and the GOP's sole invited witness at the hearing, agreed that the president's proposal would discourage holders of capital from selling assets and seeking out new investments. He also contended that the "revenue-maximizing rate" on capital gains is closer to 28 percent. (It's worth noting that two Democratic members of the Senate Finance Committee – Robert Menendez of New Jersey and Mark Warner of Virginia – recently commented that while the gap between capital gains and ordinary income tax rates needs to be narrowed, they believe the president's proposal could be an overreach. For prior coverage, see *Tax News & Views*, Vol. 21, No. 23, Apr. 30, 2021.)
URL: https://dhub.blob.core.windows.net/dhub/Newsletters/Tax/2021/TNV/210430_1.html

Subcommittee Republican Tom Rice of South Carolina argued that preferences such as a lower capital gains rate are included in the tax code precisely because Congress wants to encourage certain types of behaviors that grow the economy.

Edwards agreed that favorable tax treatment of capital gains encourages entrepreneurs to invest, which in turn leads to increased innovation and worker productivity.

Republican taxwriter Dave Schweikert of Arizona asked Edwards whether eliminating specific tax and spending subsidies – such as federally subsidized flood insurance and tax incentives for electric vehicles – that tend to be used more heavily by wealthier individuals would be more effective than making broad changes to the tax treatment of capital assets.

Edwards replied that there is value in eliminating “unfair” subsidies on both the tax and spending sides of the federal budget. In addition to the ones Schweikert cited, Edwards commented that the tax exemption for municipal bond income and the tax incentives related to Opportunity Zones also should be excised from the code.

Mark-to-market: One of the Democratic witnesses, Jason Oh, a tax law professor at the UCLA School of Law, told the panel that Congress should consider adopting an annual mark-to-market tax on capital assets in conjunction with a higher capital gains tax rate as a way to eliminate the issue of deferred sales. (President Biden has not included such a proposal in his American Jobs Plan; however, Senate Finance Committee Chairman Ron Wyden, D-Ore., has called for implementing an annual mark-to-market regime for assets of high-income households and taxing the resulting gains at higher rates. Legislative text has not been released but is expected in the coming months. For details on Wyden’s proposal, see *Tax News & Views*, Vol. 22, No. 2, Jan. 15, 2021.)
URL: https://newsletters.usdbriefs.com/2021/Tax/TNV/210115_3.html

Del. Stacey Plaskett, D-V.I., asked Oh how a mark-to-market regime would work in a recession when asset prices fall.

Oh replied that this is a “primary design issue” that would have to be addressed in crafting legislation. Lawmakers would need to include a rule that does not allow for unlimited deductibility, he said, adding that such a system may need to be limited to publicly traded assets.

Estate tax

There was a similar partisan split among taxwriters over the president’s proposal to eliminate the current-law step-up in basis on inherited assets. Democrats on the panel argued that repealing stepped-up basis would prevent wealthier taxpayers from indefinitely deferring tax on appreciated capital assets. Republicans, for their part, countered that the president’s proposal amounts to a “tax on success” and contended that it would have dire consequences for heirs of family farms and closely held businesses, who might be forced to sell those operations just to pay the taxes due.

The notion of protecting family farms and small businesses also has its supporters among House Democrats, however. Chairman Thompson, whose district includes agricultural regions in California’s wine country, cautioned that lawmakers “need to keep in mind how the tax system affects working small-business and farm owners,” and a group of House Democrats raised a similar concern in a recent letter to House Speaker Nancy Pelosi, D-Calif., and Ways and Means Committee Chairman Richard Neal, D-Mass.
URL: https://axne.house.gov/sites/axne.house.gov/files/5.6.21%20Stepped%20Up%20Basis%20Final.pdf

Thompson asked witness Henry L. Gutman whether it is possible to eliminate the basis step-up in a way that protects closely held businesses and family farms.

Gutman, a former chief of staff at the JCT, argued that the best approach would be to allow for deferral of tax on nonmarketable assets until those assets are actually sold and require immediate taxation of marketable assets such as stocks, bonds, and mutual funds.

Ways and Means Committee member Bill Pascrell, D-N.J., (who is not on the subcommittee but was permitted to speak at the hearing) asked Gutman about a proposal (H.R. 2286) he recently introduced that would eliminate the basis step-up but also provide a $1 million exemption for net capital gains, with any remaining tax deferred over seven years at a low rate of interest.
URL: https://pascrell.house.gov/uploadedfiles/pascre_003_xml_deemed_realization_final_signed.pdf

Gutman replied that the proposal would address the issue of closely held businesses "very responsibly."

Ranking member Smith, however, was doubtful that any proposed carve-outs would be effective.

"I don't trust that exemptions will help these folks," Smith said in his opening statement, "because at the end of the day, either the exemptions won't work or the capital gains tax increase won't raise any revenue."

Audit and enforcement

Several of the panel's Democrats argued that congressionally mandated cuts to the Internal Revenue Service's budget over the past decade have eroded the agency's enforcement resources and made it more attractive for the Service to audit lower-income taxpayers, whose returns are relatively simple, rather than wealthy individuals, who often employ sophisticated tax strategies and can afford expensive legal resources to prolong litigation. The resulting drop in audit rates among affluent taxpayers, Democrats contended, has led to an increase in tax-avoidance strategies and contributed to the widening "tax gap" – the difference between the amount of tax owed to the government and the amount actually collected.

Chairman Thompson noted that audit and enforcement issues will be "closely examined" by the Select Revenue Measures Subcommittee and the Ways and Means Oversight Subcommittee in June.

Biden's American Families Plan proposes to boost the IRS's enforcement budget by $80 billion over 10 years to expand its audits of high-income individual taxpayers and corporations, an effort that the administration suggests would net the fisc an additional $700 billion over that period.

Witness Chye-Ching Huang, executive director of the New York University Tax Law Center, said in reply to a question from Thompson that audits of higher-income taxpayers require a greater commitment of enforcement personnel with expertise in examining complex financial arrangements. Huang later told Rep. Suzan DelBene, D-Wash., that increased, sustained funding for IRS enforcement efforts would make it easier for the Service to rebalance its audit priorities. And in an exchange with Rep. Linda Sanchez, D-Calif., Huang commented that although the size of the tax gap is difficult to estimate precisely, an audit program that recovers even a fraction of unpaid taxes would "raise revenue in a very equitable way."

(See separate coverage in this issue for details on a Senate Finance Subcommittee on Taxation and IRS Oversight hearing this week that focused on taxpayer compliance issues and the tax gap.)

Expanded family tax credits

Several Democrats on the subcommittee, along with their invited witnesses, focused on the economic benefits of the president's proposals to extend – and in some cases make permanent – enhancements to the child tax credit and the earned income tax credit that were recently enacted under the American Rescue Plan (P.L. 117-2).

Among other things, the president has called for extending the increased child tax credit amount through 2025 and making full refundability of the credit permanent, as well as permanently extending provisions that expanded eligibility for and increased the amount of the earned income tax credit for taxpayers with no qualifying children. Without further action by Congress, these changes will expire at the end of this year. (Speaker Pelosi and Ways and Means Chairman Neal have expressed support for making all of the family tax credit enhancements in the American Rescue Plan permanent.)

In an exchange with California Democrat Linda Sanchez, witness Jason Oh said that Biden's family tax proposals (as well as his spending proposals to expand access to affordable child care and make pre-kindergarten programs universal) promote economic opportunity by addressing the issue of "how expensive it is to work when you have a family."

Responding to a question from Rep. Terri Sewell, D-Ala., Oh also noted that expanding the earned income tax credit encourages workforce participation by providing a wage subsidy.

Chye-Ching Huang commented to Washington Democrat Suzan DelBene that the president's proposed changes – particularly his proposal to make full refundability of the child tax credit permanent – would be a significant step forward in reducing childhood poverty and "increasing opportunities for the next generation to become productive workers."

— Michael DeHoff
Tax Policy Group
Deloitte Tax LLP