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Since 1937

Talking Tax Reform:

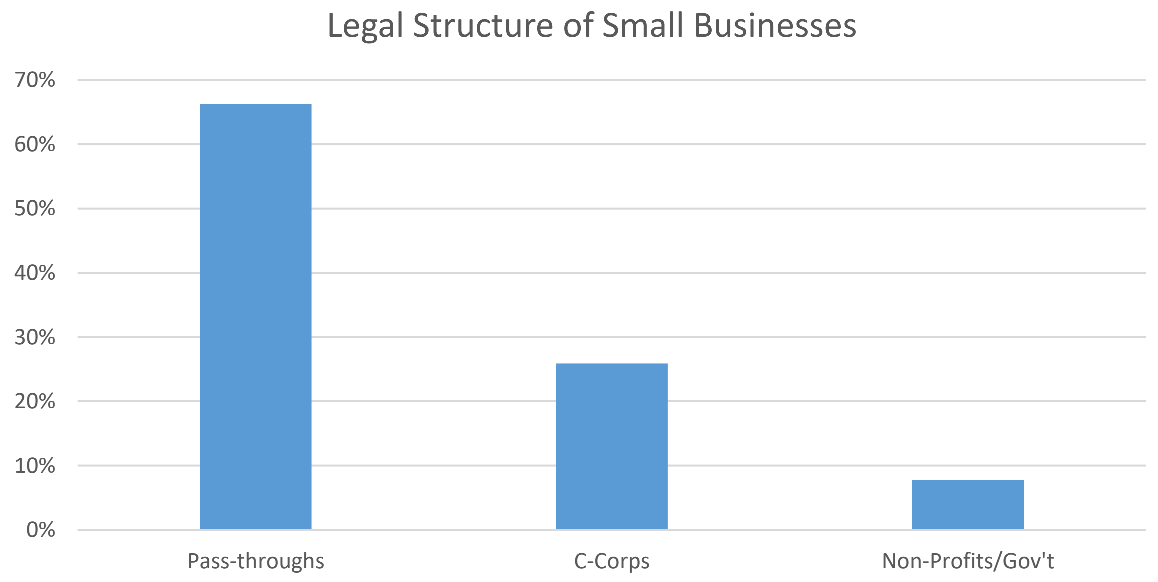
Understanding President Biden's and Congressional Democrats' Tax Plans: Individual and Pass-through Business Taxes

Major Individual and Pass-through Business Tax Proposals by Biden Administration

- Raise the top marginal income tax rate from 37 percent to 39.6 percent, which would apply to income over $452,700 for single filers, $481,000 for head of household filers, and $509,300 for joint filers. These thresholds are indexed for inflation after 2022.
- Tax long-term capital gains as ordinary income for taxpayers with adjusted gross income above $1 million, resulting in a top marginal rate of 43.4 percent when including the 3.8 percent Net Investment Income Tax (NIIT).
- Tax unrealized capital gains at death for unrealized gains above $1 million ($2 million for joint filers, plus current law capital gains exclusion of $250,000/$500,000 for primary residences). This excludes gains on tangible personal property and the existing exclusion for capital gain on certain small business stock.
- Apply the 3.8 percent NIIT to active pass-through business income for those earning over $400,000.
- Make permanent the 2017 tax law's limitation on excess losses that applies to non-corporate income.
- Limit Section 1031 Like-Kind Exchanges above $500,000 in deferred capital gains.
- End the preferred treatment of carried interest for those earning over $400,000.

Understanding Small Business in America

- Census definition: A business with fewer than 500 employees
- Census data shows that 99.7% of businesses in America are small, and responsible for 77% of total employment.
- Most small businesses are structured as pass-throughs (sole props, partnerships, S corps), but some are also structured as small C corporations.



Small Business Impact of Biden's Tax Proposals

- The Biden administration argues that only 3 percent of small businesses would be impacted by these proposals.

- A few limitations with the Treasury analysis:
  - Only looks at "filers," not businesses specifically
  - Many filers at the bottom of distribution report some pass-through income, sometimes in addition to employment
  - Not necessarily what we think of as a traditional business that makes capital investments, employs workers, and generates significant income
  - Treasury analysis omits impacts of corporate tax proposals on small businesses

A Better Measure of Small Business Economic Impacts

- Using a similar analysis, we found using 2011 data that while only 6% of filers with pass-through net income reported incomes greater than $400,000, they generated more than half (52%) of all pass-through income.

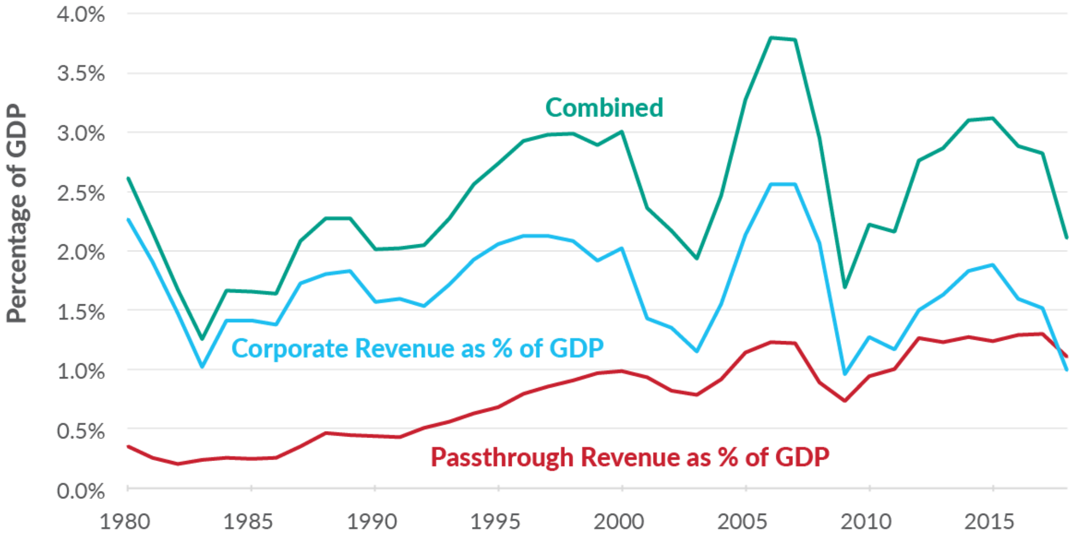
- More recent IRS data from 2018 confirmed these findings as well.

- That such a small group generates such a significant share of pass-through income implies that increasing taxes on this group of filers could impact the economy more than Treasury claims.

Putting Biden's Pass-through Tax Proposals in Context

Combined Business Tax Collections Remained Close to the Historical Norm in 2018

Business Tax Collections as a Portion of GDP, 1980 to 2018



Source: Internal Revenue Service Statistics of Income, "Integrated Business Data," "Partnership Returns Line Item Estimates (Publication 5035)," "S Corporation Statistics," "Nonfarm Sole Proprietorship Statistics," "Individual Income Tax Returns (Publication 1304)," Congressional Budget Office, Tax Foundation calculations.

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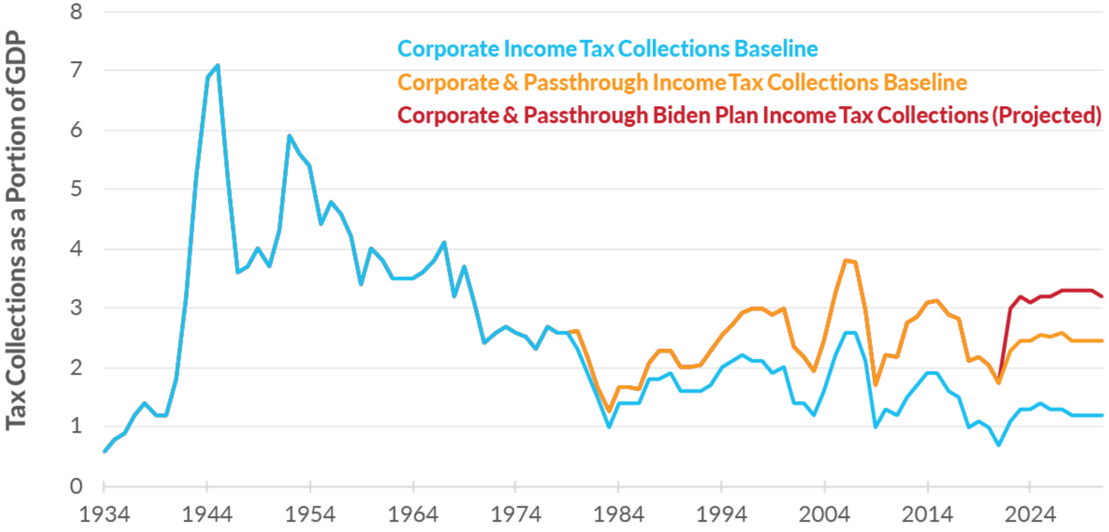
Business Income Tax Collections Would Rise to Highest Level in 40 Years Under Biden Tax Plan

Business Income Tax Collections, 1934 to 2021 and Projected 2021 to 2031



Note: While precise estimates are not available, the limited data we have indicate that pass-through business income tax collections prior to 1980 were relatively small.
Source: Congressional Budget Office, Office of Management and Budget, Internal Revenue Service, Tax Foundation General Equilibrium Model, June 2021, and author's calculations.

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Uncertainties Surrounding Revenue and Administrative Potential of Capital Gains Changes

- Taxing unrealized gains has not been tried in the U.S.

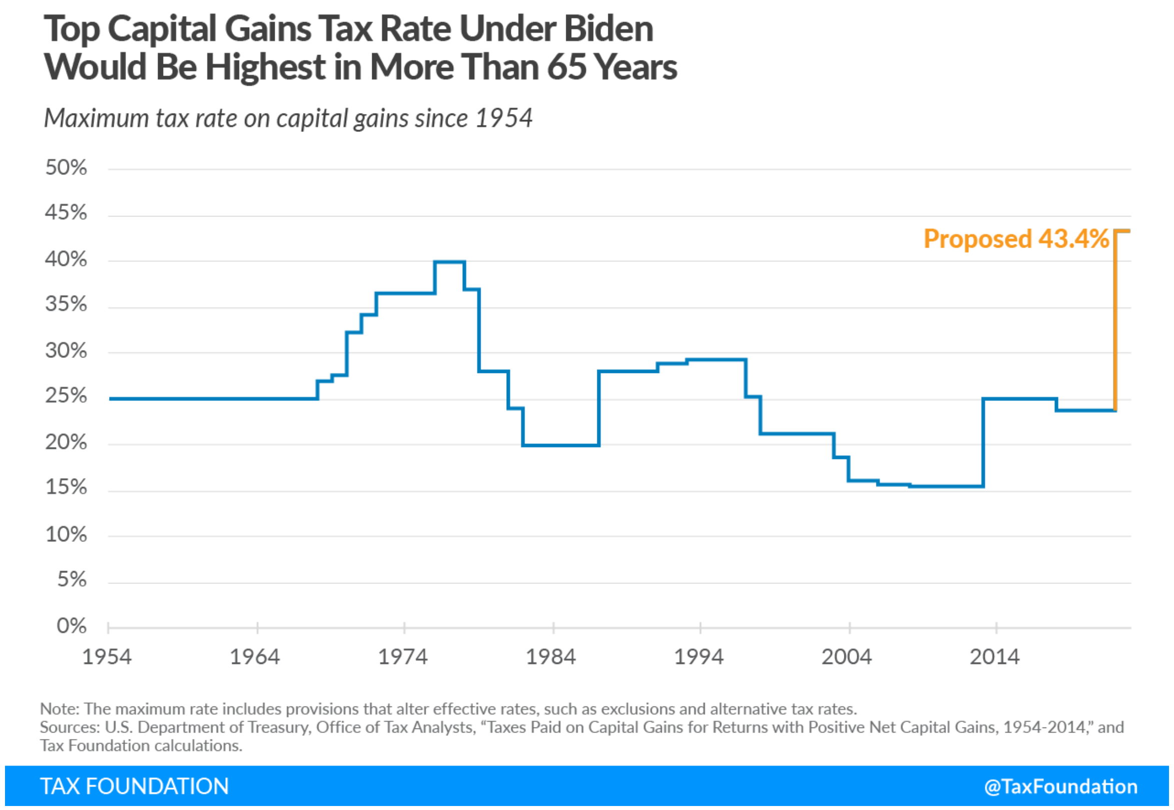
- Questions about durability of the policy over the long term.

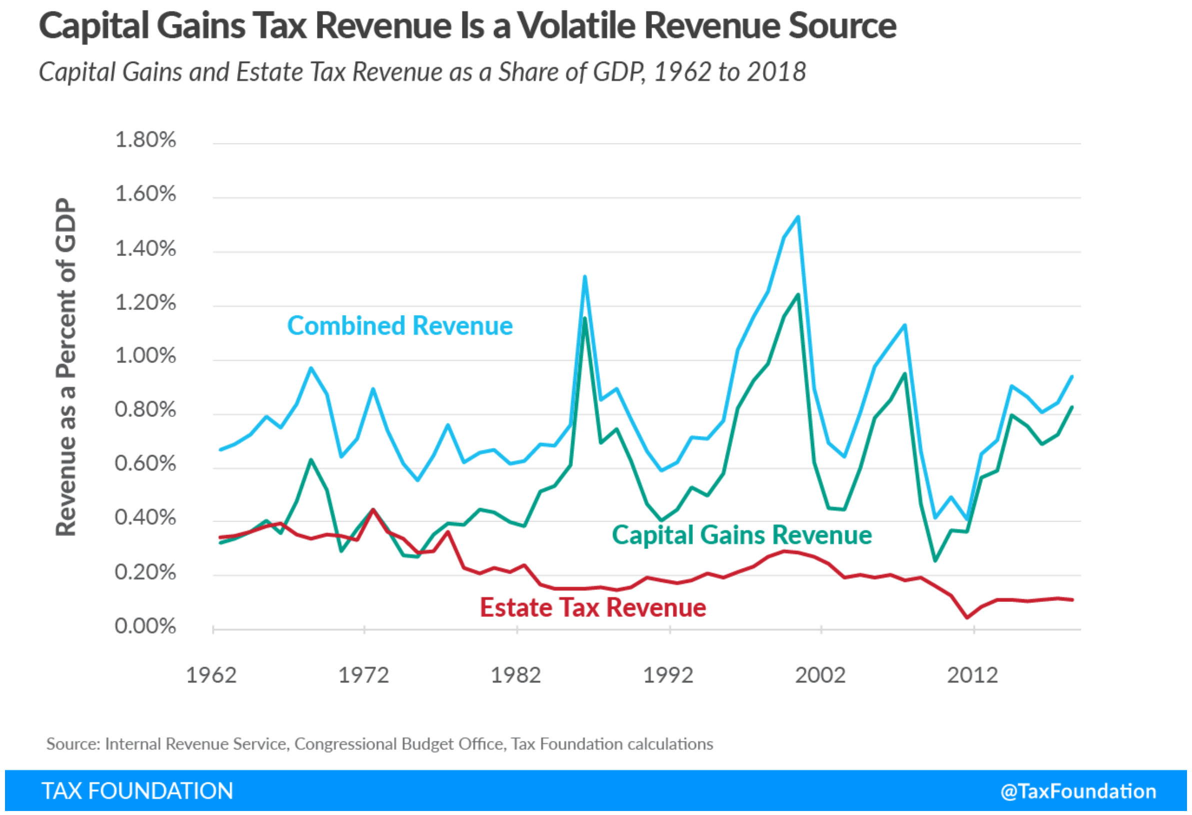
- Design of exemptions for small and family-owned businesses impact revenue potential and create tax avoidance opportunities.

- An increase in capital gains taxes tends to put downward pressure on the value of assets like equities, leading to smaller unrealized gains taxable at death than prior to the tax increase.

- We estimate that Biden's capital gains proposal would raise about $213 billion over 10 years, lower than the $322 billion estimate from Treasury.

Putting Biden's Capital Gains Proposal in Context

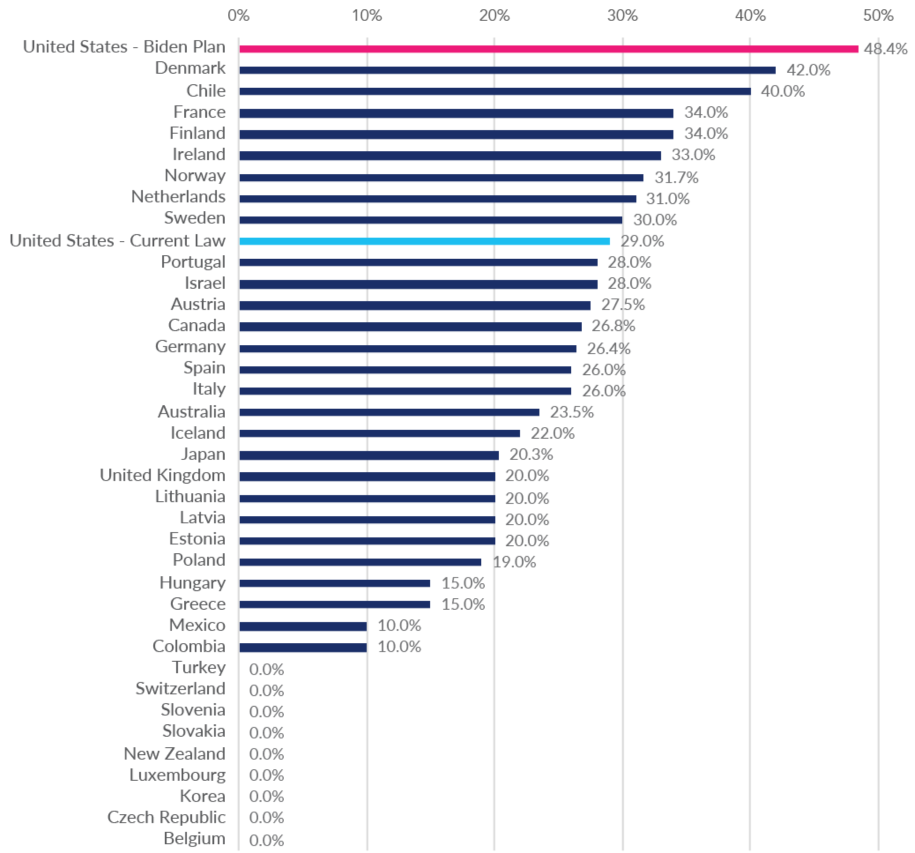




Putting Biden’s Capital Gains Proposal in Context

Top Combined Capital Gains Tax Rate Would be Highest in the OECD under Biden's Plan

Top Marginal Long-term Capital Gains Tax Rates on Individuals in OECD Countries, 2020



Source: Daniel Bunn and Elke Asen, "Savings and Investment: The Tax Treatment of Stock and Retirement Accounts in the OECD," Tax Foundation, May 26, 2021.

Revenue Effect of Biden Individual & Pass-through Tax Proposals

TABLE 3.

Conventional and Dynamic Revenue Effect of the American Families Plan (Billions of Dollars)

Proposal	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2022 - 2031
Raise Top Individual Income Tax Bracket to 39.6 Percent	27.1	28.6	29.3	30.9	0.0	0.0	0.0	0.0	0.0	0.0	115.9
Tax Unrealized Capital Gains at Death Over $1 Million and Impose a 39.6 Percent Tax Rate on Capital Gains on Income Earned over $1 Million	-3.6	5.7	16.2	18.9	19.5	23.6	27.2	30.8	34.7	39.8	212.8
Impose Net Investment Income Tax on Active Passthrough Income	14.5	15.3	15.9	16.8	17.1	18.9	19.8	20.6	21.5	22.8	183.2
Make the Active Pass-through Loss Limitation Permanent	0.0	0.0	0.0	0.0	20.2	21.0	21.8	22.7	23.6	24.5	133.8
Limit 1031 Exchanges to $500K in Gain	0.6	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.9	7.5
Tax Carried Interest as Ordinary Income	0.6	0.7	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	7.4
Total Revenue Raisers	**39.3**	**51.0**	**62.8**	**68.1**	**58.1**	**65.0**	**70.4**	**75.7**	**81.5**	**88.8**	**660.6**
Permanent Full Refundability of Child Tax Credit (CTC) and Extend Expanded CTC Through 2025	-101.6	-101.1	-100.2	-98.8	-3.0	-2.8	-2.7	-2.6	-2.4	-2.3	-417.5
Permanent Expansion of Earned Income Tax Credit (EITC)	-12.0	-12.0	-12.1	-12.1	-15.0	-15.1	-15.2	-15.3	-15.4	-15.4	-139.7
Permanent Expansion of Child and Dependent Care Tax Credit (CDCTC)	-8.0	-8.3	-8.6	-9.0	-9.4	-9.8	-10.3	-10.7	-11.1	-11.5	-96.7
Permanent Expansion of Premium Tax Credits	-22.0	-30.3	-31.6	-33.0	-34.4	-35.7	-37.1	-38.5	-39.9	-41.4	-343.8
Total Tax Credits	**-143.6**	**-151.7**	**-152.5**	**-152.9**	**-61.8**	**-63.5**	**-65.3**	**-67.0**	**-68.8**	**-70.7**	**-997.7**
Total Conventional Revenue	**-104.3**	**-100.7**	**-89.7**	**-84.8**	**-3.7**	**1.5**	**5.1**	**8.7**	**12.7**	**18.1**	**-337.1**
Total Dynamic Revenue	**-119.8**	**-118.6**	**-109.2**	**-105.7**	**-9.2**	**-5.7**	**-3.4**	**-1.0**	**1.5**	**4.6**	**-466.5**

Source: Tax Foundation General Equilibrium Model, May 2021. Items may not sum due to rounding.

Economic Impacts of Biden Individual & Pass-through Tax Proposals

TABLE 2.

Economic Effect of the American Families Plan by Tax Provision

Provision	Long-Run Change in GDP	Long-Run Change in GNP	Long-Run Change in Full-Time Equivalent Jobs	Long-Run Change in Wages	Long-Run Change in Capital Stock
Tax Unrealized Capital Gains over $1 Million at Death and Impose a 39.6 Percent Tax Rate on Capital Gains Realized for Income Earned over $1 Million	-0.1%	-0.3%	-27,000	-0.1%	-0.3%
Impose Net Investment Income Tax on Active Pass-through Income Over $400,000	-0.1%	-0.1%	-12,000	-0.1%	-0.2%
Make the Excess Business Loss Limitation Permanent	-0.1%	-0.1%	-16,000	-0.1%	-0.2%
Limit 1031 Exchanges to $500K in Gain	Less than -0.05%	Less than -0.05%	-1,500	Less than -0.05%	Less than -0.05%
Tax Carried Interest as Ordinary Income	Less than -0.05%	Less than -0.05%	-1,000	Less than -0.05%	Less than -0.05%
Expanded Tax Credits (EITC, CTC, CDCTC, Premium Tax Credits)	Less than -0.05%	Less than -0.05%	-6,500	Less than -0.05%	Less than -0.05%
Total	**-0.4%**	**-0.6%**	**-64,000**	**-0.4%**	**-0.7%**

Source: Tax Foundation General Equilibrium Model, May 2021. Items may not sum due to rounding.

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Congressional Individual Tax Possibilities

- Raising long-term capital gains tax rate up to 25, 28, or 30 percent without changing step-up in basis.
  - Could keep top bracket as is or apply the higher rate over $1M in gains.

- Raising exemption level for taxing unrealized gains and/or providing a more generous exclusion for farms or small businesses.

- Sen. Wyden Tax Proposals
  - Taxing derivatives and carried interest as ordinary income and tax that income using mark-to-market
  - Potential restrictions on IRA contributions for higher earners
  - Section 199A pass-through deduction changes

HOW WOULD CAPITAL GAINS RESPOND TO RECENT TAX PROPOSALS?

September 9, 2021
Robert McClelland

For Some, It Will Be Easy to Escape the Tax Increase

	All gains realized at once	Gains realized over two years
Non-gains income	$700,000	$700,000
Gains	$600,000	$300,000
Total income	$1,300,000	$1,000,000

Research Areas vs Current Proposals

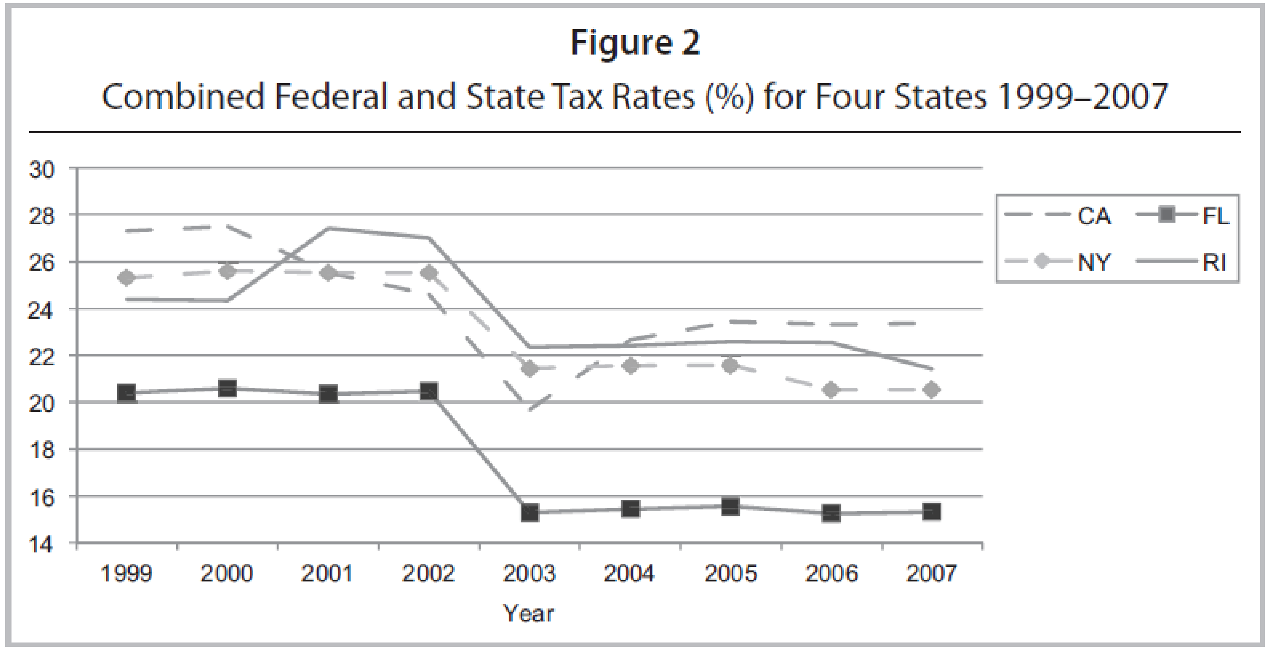
	Small tax change	Large tax change
Assets may be held for more than two years	Research	Current proposals
Assets held for two or fewer years		Research

The Elasticity of Capital Gains with Respect to Taxes

- The percent change in the realizations of capital gains in response to a one percent change in the tax rate
- Example: The tax rate on capital gains realizations increases from 20 percent to 22 percent, or 10%
  - Elasticity = -0.5 → capital gains decrease by 5%
  - Elasticity = -0.3 → capital gains decrease by 3%
- The larger the magnitude of the elasticity, the lower the amount of revenue that will be raised
- An elasticity of -1.0 implies that no new revenue is raised

Small Tax Change, Assets May be Held for More Than Two Years

Elasticity ≈ -0.7



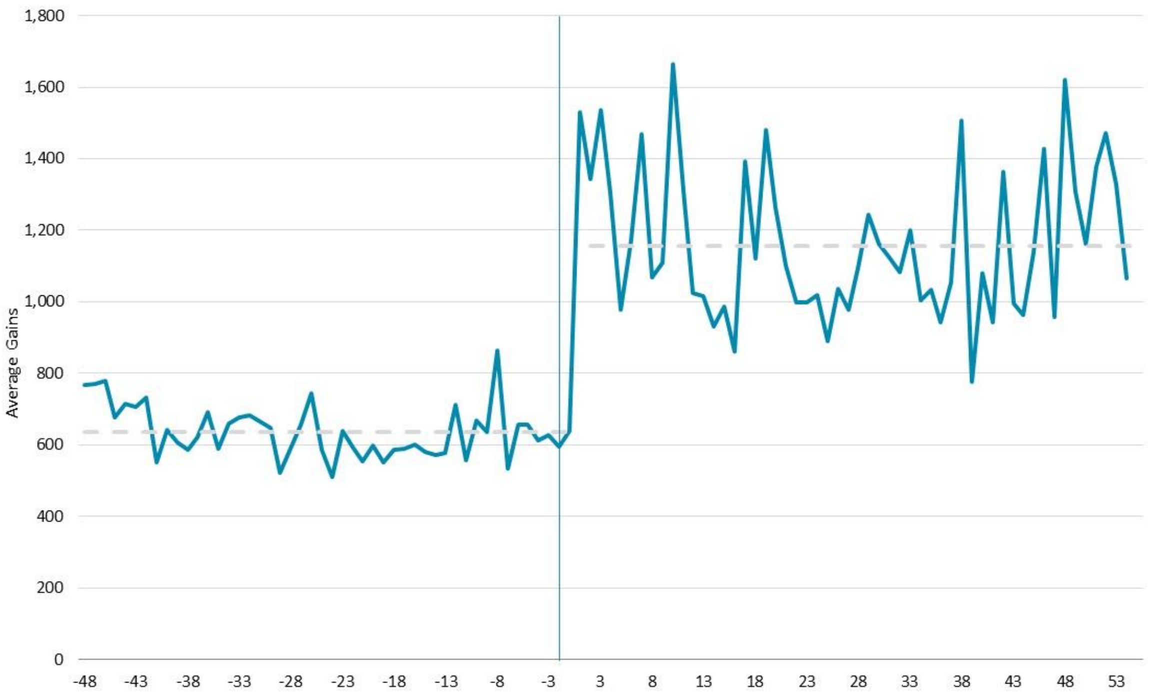
Large Tax Change, Assets Held for Less Than Two Years

Elasticity ≈ -0.8

FIGURE 1

Average weekly gains

2012



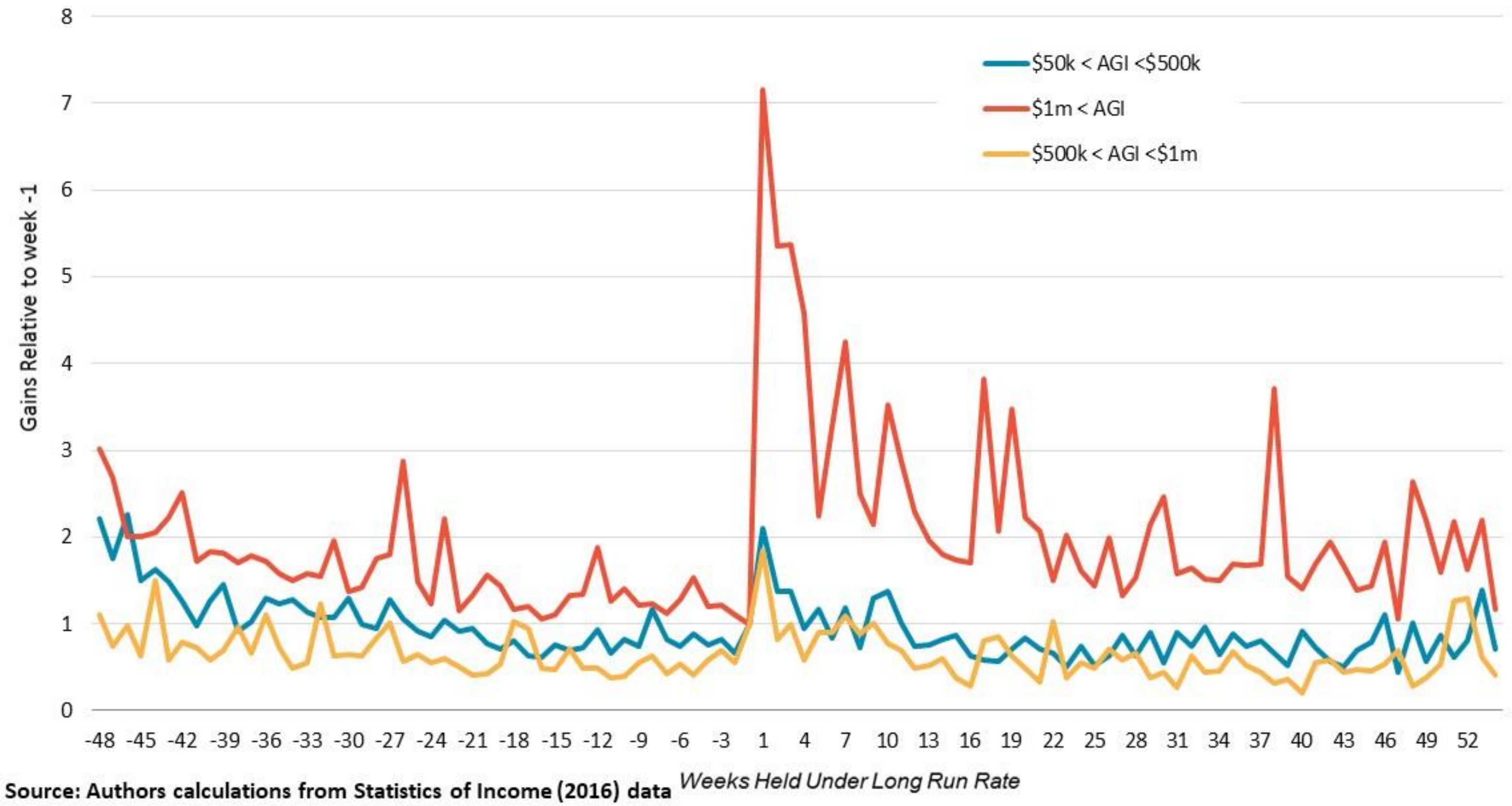
Source: Authors calculations from Statistics of Income (2016) data

Do Millionaires Behave Differently?

FIGURE 2

Gains by income class

relative to week -1, 2012



Source: Authors calculations from Statistics of Income (2016) data

Table 8.

Number of Estates Filing Returns and Number with Insufficient Liquidity to Pay the Estate Tax in 2000, Under Various Exemption Levels

Exemption Amount	Estates Filing Tax Returns	Estates Owing Estate Tax	Estates with Insufficient Liquid Assets to Pay Estate Tax Liability[a]
		All Estates	
Actual[b]	108,322	52,000	2,834
$1.5 Million	33,685	13,771	740
$2.0 Million	20,997	6,337	366
$3.5 Million	9,210	3,676	182
		Estates of Farmers[c]	
Actual[b]	4,641	1,659	138
$1.5 Million	1,005	300	27
$2.0 Million	578	123	15
$3.5 Million	187	65	13
	Estates Claiming Qualified Family-Owned Business-Interest Deduction		
Actual[b]	1,470	485	164
$1.5 Million	692	223	82
$2.0 Million	440	135	62
$3.5 Million	223	94	41

Source: Congressional Budget Office based on data from the Internal Revenue Service's Statistics of Income files.

a. Liquid assets include government and private-sector bonds, bond funds, corporate stock, cash and cash management accounts, and insurance. The number of estates with insufficient liquidity is an upper bound on the actual number because estimates of liquidity do not include money held in some trusts, which could also be used to pay estate taxes.

b. Estate tax returns filed in 2000 could be for people who died in either the last nine months of 1999 or in 2000. The actual estate tax exemption was that in effect on the date of death: $650,000 in 1999 or $675,000 in 2000.

c. Using the narrow sample discussed in Box 3.