NATIONAL CENTER FOR POLICY ANALYSIS

# Hillary Clinton's Capital Gains Tax Proposal

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*Presidential candidate Hillary Clinton has vowed to raise taxes on the wealthy if she becomes president. Taxing the wealthy is politically popular since it is assumed that few people will be affected. However, many people who are deemed wealthy are actually small business owners or self-employed professionals whose business income is taxed at personal income tax rates.*

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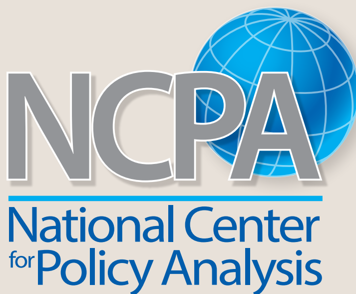


Hillary's plan generally targets most of those who fall into the current top marginal income tax rate. Filers in the top income bracket — with taxable incomes of at least $415,051 (single) or $466,951 (married filing jointly) — pay a marginal income tax rate of 39.6 percent on wage income and nonqualified dividends. Qualified dividends on stock that has been held at least 60 days are currently taxed at 20 percent for high-income earners, whereas ordinary (nonqualified) dividends and interest are taxed at regular income tax rates. Furthermore:

- An additional 0.9 percent Medicare tax applies to any wage income exceeding $200,000 (single) or $250,000 (married filing jointly).
- A 3.8 percent surtax on unearned income — such as capital gains, dividends, rent and royalties — applies to any unearned income above the $250,000 (married filing jointly) and $200,000 (single) thresholds.
- Capital gains on the sale of stocks held less than one year are taxed at the taxpayer's income tax rate, while assets held more than one year are generally taxed at a lower rate, depending on income level.

Capital gains are the amount by which an asset's selling price exceeds its purchase price. Hillary's plan calls for raising the capital gains tax rate for households earning $500,000 or more. However, her plan would change the capital gains tax to a multi-tiered system that depends on how long the assets are held. For households earning more than $5 million, a 4 percent surtax would also be imposed. How would these changes affect wealthy households? Let us take a look.

**Capital Gains' Return on Investment under Current Law.** For earners in the highest tax bracket, the current capital gains rate is 20 percent. However, unearned income that surpasses the $250,000 adjusted gross income ceiling for couples ($200,000 for singles) is subject to the additional 3.8 percent Medicare tax.

- The tax rate for an asset held less than a year or on nonqualified dividends is 43.4 percent.
- The tax rate for an asset held more than one year or on dividends paid on qualified investments is 23.8 percent.

**Return on $100,000 Initial Investment**
**(assuming 8 percent annual capital gain and 3 percent annual dividend)**

| Holding Period | Proposed Capital Gains Tax Rate | Actual Capital Gains/Qualified Dividends Rate (includes 3.8% Medicare tax) | Total Taxes Paid | After-tax Annual Rate of Return | Effective Tax Rate over Holding Period |
|---|---|---|---|---|---|
| 1-2 years | 39.6% | 43.4% | $4,878 | 6.12% | 44.3% |
| 2-3 years | 36% | 39.8% | $9,422 | 6.67% | 40.7% |
| 3-4 years | 32% | 35.8% | $13,449 | 7.08% | 37.1% |
| 4-5 years | 28% | 31.8% | $16,913 | 7.49% | 33.6% |
| 5-6 years | 24% | 27.8% | $19,722 | 7.86% | 30.0% |
| More than 6 years | 20% | 23.8% | $21,776 | 8.20% | 26.5% |

Note: Under Hillary's plan, an additional 4% surtax would be imposed for households earning $5 million or more.

Source: Sean Williams, "Hillary Clinton's Income Tax Brackets: How Much Would You Owe?" Motley Fool, February 28, 2016, and author's calculations.

Consider a $100,000 asset that earns a 3 percent dividend payment and an 8 percent capital gain:

- Assuming that the asset is held more than one year and the dividend is qualified, the after-tax rate of return is 8.3 percent and the effective tax rate is 23.8 percent.
- However, for an asset held less than one year and its nonqualified dividend (subject to the ordinary income tax rate of 39.6 percent), the after-tax rate of return would be only 6.23 percent and the effective tax rate would be 43.4 percent.

**Capital Gains Return on Investment under Hillary's Plan.** Under Hillary Clinton's plan, assets for earners in the top tax bracket would be taxed at different rates not just prior to and after one year, but for up to six years [see the table].

How would these proposed rates affect the return on assets? If a $100,000 asset earns an 8 percent capital gain and 3 percent dividend (assuming a qualified dividend) after five years, the rate of return would fall from the current 8.4 percent yield for assets sold within the one-year to five-year range, to 7.86 percent under Hillary's plan. However, selling the asset prior to holding it for at least six years would produce a much lower rate of return compared to current law [see the table]. For example:

- If the asset were sold after four years, it would yield 7.49 percent, after taxes, 12 percent less than under current law.
- After three years, it would yield a 7.09 percent after-tax return, or 19 percent less.
- After two years, it would yield 6.7 percent, 27 percent less.
- Finally, if the asset were sold after one year, it would yield a 6.12 percent after-tax rate of return, 38 percent less than under current law.

Households that earn more than $5 million would be subject to an additional 4 percent surtax. Thus, the return on their investment would be even smaller; an asset sold after one year would face a 47.4 percent effective tax rate and a 5.7 percent rate of return. This is a 49 percent reduction in the rate of return compared to current law!

**Conclusion.** Increasing the capital gains tax could lower government tax revenues, because people will hold on to assets in order to avoid the tax. While Hillary's intent is to encourage long-term investing, the arbitrary nature of the tiered tax system reduces the efficiency of the capital market. This "lock-in" effect has been noted when capital gains tax rates increased in the past. Moreover, the lower rate of return resulting from higher taxes and the arbitrary holding period may discourage people from investing in certain capital assets in the first place.

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