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Income Tax Increases in the President's American Family Plan

Proposed Income Tax Rate Hike and Capital Gains Change Would Affect Less than 1 Percent of Taxpayers

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President Biden's American Families Plan includes revenue-raising proposals that would affect only very high-income taxpayers.[1] The two most prominent of these proposals would restore the top personal income tax rate to 39.6 percent and eliminate tax breaks related to capital gains for millionaires. As this report explains, these proposals would affect less than 1 percent of taxpayers and would be confined almost exclusively to the richest 1 percent of Americans. The plan includes other tax increases that would also target the very well-off and would make our tax system fairer. It would raise additional revenue by more effectively enforcing tax laws already on the books.

A month ago, the President announced his American Jobs Plan, which would use corporate tax increases to finance investments in physical infrastructure.[2] In contrast, his American Families Plan (AFP) would use personal income tax increases on very well-off individuals to finance investments in people—in childcare, education, higher education, reducing child poverty and other related measures.

The revenue-raising proposals in the American Families Plan are the following:

Restore the top personal income tax rate to 39.6 percent.
The tax law enacted by Congress and President Trump at the end of 2017 cut the top personal income tax rate from 39.6 percent to 37 percent. It also raised the taxable income threshold (the floor of the top income tax bracket) at which the top rate applies, but the President apparently is not proposing to reverse that change.

For those with taxable income exceeding $1 million, eliminate the special, low personal income tax rate for capital gains and stock dividends.[3]
Currently, capital gains (profits from selling assets) and stock dividends are subject to the personal income tax at much lower rates than other types of income, with a top rate of just 20 percent. Most of the benefits of the special rates for capital gains and dividends go to the richest 1 percent. As a result, some very well-off individuals pay a lower effective tax rate than taxpayers whose incomes are much smaller. Taxable income exceeding $1 million that is capital gains or stock dividends would be subject to the same 39.6 percent rate that would apply to other income under Biden's plan.

End the exclusion of capital gains on assets left to heirs for gains exceeding $1 million ($2 million for married couples).

In the eyes of economists, any increase in the value of assets is income to the owner of those assets. But the tax code only taxes that income when assets are sold and the increase in value becomes a "realized" capital gain. Under current law, if a taxpayer dies and passes assets to heirs, the "unrealized" capital gains on those assets is excluded from income and will never be taxed. This break is also called the "stepped-up basis." To calculate a capital gain after selling an asset, the "basis," which is usually the price the taxpayer paid to purchase the asset, is subtracted from the sale price they received for the asset. For heirs, the basis is "stepped up" to the asset's value on the day they inherited it.

Make permanent the limit on pass-through business losses.

Under rules enacted in 2017, when business owners report losses, they cannot use these losses to offset more than $250,000 of their non-business income (or $500,000 of non-business income in the case of married couples). This prevents high-income taxpayers from deducting losses that exist on paper only to reduce the income they report to the IRS.[4] One of the rare provisions in the Trump tax law that looks good in retrospect, the limit on pass-through losses was set to expire with most of the other personal income tax changes after 2025. The CARES Act controversially suspended it for 2020 and retroactively for 2018 and 2019.[5] The American Rescue Plan Act extended it for one year, through 2026.

Eliminate the carried interest loophole.

The preferential rates for capital gains unfairly benefit the wealthy, as already explained, but proponents usually argue that they somehow encourage investment. While that argument is always weak, it does not apply at all in the case of highly compensated people who find technical ways to disguise their earned income as capital gains in order to benefit from the lower rate. One example is the loophole allowing fund managers to report their "carried interest," which is the money they earn for managing someone else's investments, as capital gains income. The carried interest loophole would be less important anyway if Congress enacted the President's proposal to eliminate the preferential capital gains rate for millionaires. But lawmakers would be wise nonetheless to remove the loophole entirely from the tax code.

End the benefits of "like-kind exchanges" of real estate for gains exceeding $500,000.

Capital gains on property sales can be the main type of income received by large-scale real estate investors but they can avoid paying taxes on this income by structuring their transactions as "like-kind" exchanges, in which one property is traded for another similar property. This policy was originally intended as an administrative convenience in situations where farmers traded land or livestock without any money changing hands. Today, the definition of like-kind is extremely generous, "allowing a retiring farmer from the Midwest to swap farmland for a Florida apartment building tax-free" according to the Congressional Research Service.[6] The New York Times reported that Jared Kushner, who is heavily invested in real estate, avoided paying income taxes for several years, partly by using like-kind exchanges.[7]

Close a loophole in the 3.8 percent taxes high-income people pay related to healthcare.

Before the Affordable Care Act (ACA) was enacted, the United States had one tax devoted to health care, the Medicare payroll tax, but it was not very progressive. It had a flat rate of 2.9 percent (half paid by employers and half paid directly by employees) and it entirely exempted investment income. The ACA sought to correct this in two ways. First, it increased the Medicare payroll tax to 3.8 percent for those with earnings above $200,000 ($250,000 for married earners). Second, it created a comparable 3.8 percent tax on investment income. This tax is called the Net Investment Income Tax (NIIT) and it applies to whatever part of a taxpayer's adjusted gross income above $200,000 ($250,000 for married couples) is investment income. The general idea was that the rich would pay 3.8 percent on their income (excluding retirement income) regardless of what form it takes. But a loophole allows certain income from pass-through businesses, particularly S corporations, to avoid being subject to either the Medicare payroll tax or the investment tax. The Obama administration proposed to close this loophole.[8] The Biden administration proposes to close it only for those with incomes exceeding $400,000.

Figure 1 lists the revenue-raising proposals in the American Families Plan. Assuming the proposals would go into effect in 2022, Figure 1 provides the revenue impact of the two most prominent proposals (increasing the top rate and ending capital gains breaks for millionaires). We cannot yet determine the revenue impacts of the other proposals.

Closing the carried interest loophole, while important as a matter of policy, may have a small revenue impact because many of the taxpayers using carried interest are millionaires who would no longer benefit from the preferential rate for capital gains anyway under the President's plan. Like-kind exchanges are projected to reduce revenue by $41 billion over five years according to the Joint Committee on Taxation.[9] But it is difficult to know how much of that revenue would be recouped under the President's plan, which would leave the break in place for the first $500,000 of gains included in a taxpayer's like-kind exchanges.

The proposal to close the loophole in the 3.8 percent taxes related to health care could have a more significant revenue impact. The Obama administration projected that its proposal to close this loophole would raise $272 billion over a decade but it is not clear if the Biden proposal is as comprehensive as the Obama proposal.[10]

FIGURE 1

Revenue Impact of Personal Income Tax Increases in American Family Plan in Tax Year 2022

Figures in billions of dollars

Provision	Revenue
Restore top income tax rate to 39.6%	$25.9
Eliminate the low personal income tax rate for capital gains and dividends for taxable income exceeding $1 million and limit the exemption for capital gains on assets left to heirs	$142.5
Behavioral effects of higher taxes on capital gains	$79.9
Make permanent the business loss limit (no revenue effect until after 2026)	$0.0
Total Impact of Top Rate Increase and Capital Gains Changes	**$88.4**

Revenue Provisions with Uncertain Impact

Close carried interest loophole

End like-kind exchanges gains over $500,000

Close loophole in 3.8% taxes related to health care

SOURCE: Institute on Taxation and Economic Policy tax model, April 2021

Figure 2 shows that the total tax increase on individuals from the proposals on the top rate and on capital gains combined would be $168 billion in tax year 2022. But Figure 1 shows that the combined revenue impact would be less, $88 billion. The difference exists because the revenue impact of the rate increase on capital gains would be reduced by taxpayers' use of various techniques to avoid the rate increase. ITEP generally follows the approach of Congress's official revenue estimator, the Joint Committee on Taxation (JCT) in modeling this behavioral response.[11] This analysis also takes into account how this behavioral response would be significantly reduced by Biden's related proposal to end the exemption for capital gains on assets left to heirs.[12]

As illustrated in Figure 2, only 0.7 percent of taxpayers would be affected by these two provisions and virtually all of the tax increase would fall on the richest 1 percent.

FIGURE 2

Impacts of President's Proposal to Restore the Top Personal Income Tax Rate to 39.6% and Remove Capital Gains and Dividends Breaks for Millionaires in Tax Year 2022 in the United States

Income Group	Income Range	Average Income	Tax Change 1000's	Average Tax Change	Tax Change as % of Income	Share of Tax Change	Share with Tax Hikes	Avg. Change for Those w/ Tax Hikes
Poorest 20%	Less than $22,400	$11,800	$0	$0	0.0%	0%	0.0%	$0
Second 20%	$22,400 to $42,500	$32,200	$0	$0	0.0%	0%	0.0%	$0
Middle 20%	$42,500 to $69,900	$55,000	$0	$0	0.0%	0%	0.0%	$0
Fourth 20%	$69,900 to $122,400	$92,300	$ +4,100	$0	0.0%	0%	0.0%	$0
Next 15%	$122,400 to $276,200	$174,000	$ + 900	$0	0.0%	0%	0.0%	$0
Next 4%	$276,200 to $681,600	$404,000	$ +147,200	$ +20	0.0%	0%	0.8%	$ +2,690
Richest 1%	$681,600 or more	$2,167,700	$ +168,180,500	$ +104,130	4.8%	100%	65.5%	$ +159,010
ALL		**$101,400**	**$ +168,353,100**	**$ +1,040**	**1.0%**	**100%**	**0.7%**	**$ +151,240**
Bottom 60%	Less than $69,900	$33,000	**$0**	**$0**	**0.0%**	**0%**	**0%**	**$0**

SOURCE: Institute on Taxation and Economic Policy tax model, April 2021

Figure 3 lists the states from most affected to least affected by these tax increases. The share of the population affected by the tax increases exceeds 1 percent only in the District of Columbia and five states—New Jersey, Massachusetts, New York, California and Connecticut. In every other state, less than 1 percent of the population would be affected.

FIGURE 3

Share of Taxpayers with a Tax Increase in Tax Year 2022, by state

State	Share	State	Share	State	Share	State	Share
District of Columbia	1.2%	New Hampshire	0.6%	Missouri	0.5%	Alabama	0.4%
New Jersey	1.2%	Arizona	0.6%	Rhode Island	0.5%	Vermont	0.4%
Massachusetts	1.2%	Kansas	0.6%	Tennessee	0.5%	Hawaii	0.4%
New York	1.1%	Florida	0.6%	Delaware	0.5%	Wyoming	0.4%
California	1.1%	Utah	0.6%	Michigan	0.4%	Kentucky	0.4%
Connecticut	1.1%	Virginia	0.6%	Idaho	0.4%	South Carolina	0.3%
Washington	0.9%	Wisconsin	0.5%	Oregon	0.4%	Louisiana	0.3%
Minnesota	0.8%	Iowa	0.5%	Nebraska	0.4%	Arkansas	0.3%
Nevada	0.8%	Alaska	0.5%	Ohio	0.4%	Mississippi	0.3%
Texas	0.8%	South Dakota	0.5%	Montana	0.4%	Oklahoma	0.3%
Colorado	0.7%	Pennsylvania	0.5%	Georgia	0.4%	New Mexico	0.3%
Maryland	0.7%	North Dakota	0.5%	Indiana	0.4%	West Virginia	0.1%
Illinois	0.7%	North Carolina	0.5%	Maine	0.4%	**United States**	**0.7%**

SOURCE: Institute on Taxation and Economic Policy tax model, April 2021

The American Families Plan Would Also Increase Revenue by Improving Tax Enforcement

Even lawmakers who disagree on how our tax laws should be written ought to agree that the government should enforce the tax laws currently on the books. Funding for tax enforcement is one type of government spending that truly does pay for itself in obvious ways.

And yet Congress could not even agree on this after Republicans took control of Congress in 2010. A July 2020 report from the Congressional Budget Office found that from 2010 through 2018, lawmakers cut the IRS budget by 20 percent in inflation-adjusted dollars, resulting in a 22 percent staff reduction, including 30 percent of the IRS's enforcement staff.[13] Natasha Sarin and Larry Summers point out that the cuts are even worse than that. When measured as a share of GDP or tax collections, the IRS has been cut 35 percent over the past decade. To undo those funding cuts, they suggest the IRS budget would need to be increased by more than $100 billion over the next decade.[14]

A proposal in the President's American Families Plan appears to achieve most of that. It would provide $80 billion in additional dedicated funding over ten years to the IRS, which apparently is in addition to the increased annual discretionary funding the administration is also requesting. The dedicated funding stream would allow the agency to make long-term investments and lure the most capable staff without fear that a change of power in Congress would cause a sudden reversion to draconian budget cuts. The proposal would also provide the IRS with better tools, including automatic reporting by banks of money flowing in and out of certain bank accounts.[15]

The IRS has estimated that the tax gap—the difference between federal taxes owed and federal taxes paid—averaged $381 billion from 2011 through 2013.[16] Using the same methods to analyze the tax gap today, the IRS would likely conclude it has risen to nearly $600 billion.[17] IRS Commissioner Charles Rettig recently said it could be as high as $1 trillion a year.[18] About a third of the tax gap is thought to be owed by the richest 1 percent.[19]

The Biden administration projects that its proposal would only retrieve a fraction of that total amount each year and eventually raise revenue by $700 billion over a decade.

ENDNOTES

1 White House, “Fact Sheet: The American Families Plan,” April 28, 2021. **https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/**

2 White House, ”FACT SHEET: The American Jobs Plan,“ March 31, 2021. **https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/**

3 Congress’s official revenue estimator, the Joint Committee on Taxation (JCT) assumes that capital gains income is very elastic in its relationship with the tax rate imposed on it. The higher the tax rate on capital gains, the more people with assets will use various techniques to avoid paying the increased rate. One of those techniques is to simply hold onto an asset until the end of one’s life and pass it on to heirs. The tax rules currently exempt any capital gains on assets owned by a taxpayer at the time of death. But the President’s plan would repeal this tax break as well. The plan would include unrealized capital gains on assets as taxable income on the final personal income tax return filed for a taxpayer after he or she dies. This analysis does not include any revenue or distributional impact of taxing gains at death (which is uncertain in the short-run) but takes into account how taxing gains at death would reduce the ability of taxpayers with assets to avoid the rate increase on capital gains.

4 Steve Wamhoff, “The CARES Act Provision for High-Income Business Owners Looks Worse and Worse,” Institute on Taxation and Economic Policy, April 24, 2020. **https://itep.org/the-cares-act-provision-for-high-income-business-owners-looks-worse-and-worse/**

5 Steve Wamhoff, “Partying Like It’s 2017: How Congress Went Overboard on Helping Businesses with Losses,” Institute on Taxation and Economic Policy, Updated April 24, 2020. h**ttps://itep.org/partying-like-its-2017-how-congress-went-overboard-on-helping-businesses-with-losses/**

6 Gregg Esenwein, “The Sale of a Principal Residence Acquired Through a Like-Kind Exchange,” 2005, Congressional Research Service. **http://congressionalresearch.com/RS22113/document.php?study=The+Sale+of+a+rincipal+Residence+Acquired+Through+a+Like-Kind+Exchange**

7 Jesse Drucker and Emily Flitter reported that “Developers might have to pay capital gains taxes if they sell their properties. But the Kushners, like others in the real estate business, often avoid that tax, too, by using the proceeds of sales to buy more properties within a certain time window. At least in part because of that perk, the Kushners’ property sales in the period covered by the documents—totaling about $2.3 billion, according to Real Capital Analytics, a research firm—generated little or no taxable income for Mr. Kushner.” Jesse Drucker and Emily Flitter, Jared Kushner Paid No Federal Income Tax for Years, Documents Suggest, New York Times, October 13, 2018. **https://www.nytimes.com/2018/10/13/business/jared-kushner-taxes.html**

8 Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals,” February 2016, page 169. **https://home.treasury.gov/system/files/131/General-Explanations-FY2017.pdf**

9 Joint Committee on Taxation, ”Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024,” November 5, 2020, JCX-23-20, page 29. **https://www.jct.gov/publications/2020/jcx-23-20/**

10 The Obama administration proposed to close two loopholes allowing business owners to escape these taxes and it is not clear if the Biden administration would close one or both. One allows certain active income of businesses to avoid either tax. The other would crack down on business owners who claim that most of their income is not compensation, thus avoiding payroll taxes. Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals,” February 2016, page 169. **https://home.treasury.gov/system/files/131/General-Explanations-FY2017.pdf**

11 Following the approach of JCT, we take the behavioral response to capital gains tax rate changes into account when estimating revenue impact but not when estimating distribution.

12 According to a review of JCT’s methods by the Congressional Research Service (CRS), at current tax rates, capital gains income has an elasticity of 0.68 in the long-term. (See “Capital Gains Tax Options: Behavioral Responses and Revenues,” updated May 20, 2020. **https://fas.org/sgp/crs/misc/R41364.pdf**) For a very small rate increase this means that the amount of capital gains income realized will drop by 0.68 times the increase in the tax rate. Revenue raised would therefore be (1-0.68) times the static revenue estimate, or just 32 percent of the static revenue estimates. For a more significant rate increase such as the one Biden proposes, the math is more complicated. It is not entirely clear how much this elasticity would be reduced by taxing gains at death. The Tax Policy Center assumes that taxing gains at death would reduce the elasticity to 0.4. We adopt this assumption for our analysis. JCT assumes that the short-term elasticity for capital gains is even more dramatic than the long-term effect. This analysis uses the long-term elasticity (as reduced by the proposal to tax gains at death) in order to present a more representative example of the likely impact in a typical year.

13 Congressional Budget Office, “Trends in the Internal Revenue Service’s Funding and Enforcement,” July 2020. h**ttps://www.cbo.gov/publication/56467**

14 Natasha Sarin and Lawrence H. Summers, “Understanding the Revenue Potential of Tax Compliance Investment,” University of Pennsylvania Institute for Law & Economic Research, September 21, 2020. **https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3695215**

15 Richard Rubin, “Biden to Seek $80 Billion to Bolster IRS, Tax Enforcement,” Wall Street Journal, updated April 27, 2021. **https://www.wsj.com/articles/biden-to-seek-80-billion-to-bolster-irs-tax-enforcement-11619539465**

16 Internal Revenue Service, “Tax Gap Estimates for Tax Years 2011–2013,” September 2019. **https://www.irs.gov/pub/irs-pdf/p5364.pdf**

17 Charles O. Rossotti and Fred L. Forman, “Recover $1.6 Trillion, Modernize Tax Compliance and Assistance: The How-To,” Tax Notes Federal, September 14, 2020. **http://58w.aaf.myftpupload.com/wp-content/uploads/2020/10/tax-notes-published-article-9142020.pdf**

18 John McCormick, “IRS Chief Says $1 Trillion in Taxes May Go Uncollected Each Year,” Wall Street Journal, April 13, 2021. **https://www.wsj.com/articles/irs-chief-says-1-trillion-in-taxes-may-go-uncollectedeach-year-11618337765**

19 John Guyton, Patrick Langetieg, Daniel Reck, Max Risch, Gabriel Zucman, “Tax Evasion at the Top of the Income Distribution: Theory and Evidence,” Washington Center for Equitable Growth, March 2021, page 4. **https://equitablegrowth.org/working-papers/tax-evasion-at-the-top-ofthe-income-distribution-theory-and-evidence/** “We estimate that 36% of federal income taxes unpaid are owed by the top 1% and that collecting all unpaid federal income tax from this group would increase federal revenues by about $175 billion annually.”