

# THE WALL STREET JOURNAL

## REVIEW & OUTLOOK

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*A 69% Capital Gains Tax Hike . . .*

*Pelosi's 5.4% income surtax would hit capital gains and dividends.*

Our job is to read bad legislation so you don't have to, and on that score we may demand combat pay for plowing our way through the House health-care bill that passed on Saturday. This thing has economic booby traps everywhere, such as favors for the tort bar (see below) and the largest capital gains tax increase in at least a half-century.

House Democrats are funding their new entitlement with a 5.4% surtax on incomes above \$500,000 for individuals and above \$1 million for joint filers. The surcharge is intended to snag the greatest number of taxpayers to raise some \$460.5 billion, and so the House has written it to apply to modified adjusted gross income. That means it includes both capital gains and dividends.

That surtax takes effect on January 1, 2011, or the day the Bush tax rates of 2001 and 2003 expire. Today's capital gains tax rate of 15% would bounce back to 20% because of the Bush repeal and then to 25.4% with the surtax. That's a 69% increase, overnight. The last time investors were hit with anything comparable was 1986, when the capital gains rate jumped to 28% from 20%, a 40% increase, as part of the Reagan tax reform that lowered income tax rates.

### Taxing History

Maximum tax rate on long-term capital gains by statute, and for 2011 as passed in House health-care bill



Source: Treasury Department, Office of Tax Analysis

The 1986 experience was not a happy one. Tax revenues from capital gains surged before the increase took effect in 1987, as investors moved to cash in at the lower rate. Revenues then plummeted. Total realized capital gains didn't again reach their 1985 level of \$172 billion until 1996. By 1992, the federal government was barely getting more in revenue (\$29 billion) at the 28% rate than it did in 1985 (\$26.5 billion) at the 20% rate.

Rate reductions, as in 2003 when Republicans cut the rate to 15% from 20%, have typically had the opposite effect. Treasury receipts from capital gains climbed to an estimated \$117.8 billion in 2006 from \$49 billion in 2002.

While the rising stock market through this period played a role, so did the "unlocking" effect from a lower rate that reduces the friction of taxes on decisions to buy or sell and thus report a capital gain. Both the economy and the Treasury also benefitted when Bill Clinton agreed to reduce the rate to 20% from 28% as part of his budget deal with Newt Gingrich in 1997.

Candidate Obama acknowledged this reality in April of 2007, when he backed away from his original proposal to nearly double the capital gains rate to 28%, and instead suggested 20%. He also promised to eliminate the tax entirely for small business. "I'm mindful that we've got to keep our capital gains tax to a point where we can actually get more revenue," he said at the time.

While families of all income levels realize capital gains, Internal Revenue Service data from 2007 show that 58% of overall capital gains revenue was reported by taxpayers with adjusted gross income above \$1 million—and would be subject to the new 25.4% rate. The actual percentage of revenue subject to the penalty would be higher when counting individuals with income above \$500,000.

Some readers may think that this 5.4% surtax can't possibly make it into a final Congressional bill due to Senate opposition, but we wouldn't be so sure. Mr. Obama hasn't said so much as a discouraging word about the House bill. And we've seen in the past 10 months that when Mr. Obama's campaign promises clash with the priorities of House liberals, the liberals always win.