A Capital Gain Tax Increase is on the Horizon

During President Obama's State of the Union address on January 24, 2012, he asserted that taxpayers making more than $1 million should pay not less than 30 percent in federal taxes. This is a clear indicator President Obama believes that the federal capital gain rate should be increased to 30 percent for taxpayers with over $1 million of taxable income.

On February 1, 2012 U.S. Senator Sheldon Whitehouse, democrat from Rhode Island, introduced a tax billed named "Paying a Fair Share Act of 2012". This act is known informally as the "Buffett Rule" tax bill. It applies only to taxpayers with income over $1 million. The purpose of the act is to cause taxpayers making over $1 million to pay at least 30 percent in federal tax. Taxpayers would calculate their taxes according to traditional methods and also by the tax calculation required under the Paying a Fair Share Act of 2012. The result of the two calculations would be compared and the taxpayer would then pay the larger of the two calculations. This act will likely gain little traction so its chances of becoming law are extremely low. But it is an indicator that not just President Obama is interested in increasing the capital gain rate.

Rate Impacted By Multiple Items

Notwithstanding that President Obama and certain congressional members want to see the capital gain rate increased, the Bush Tax Cuts, which were originally set to expire on December 31, 2010 and were extended for two years, are going to expire on December 31, 2012. If this happens, the regular top rate on capital gains will rise from 15 percent to 20 percent. In addition, an obscure provision of the tax code dealing with the limitation on itemized deductions will return in full force when the Bush Tax Cuts expire. This provision, known as the Pease limitation, increases effective tax rates on high-income taxpayers by reducing the value of their itemized deductions. For the Pease limitation, by 2013 the inflation-adjusted level of what is considered a high-income earner is expected to approach $170,000. The Pease limitation will add about another 1.2 percentage points to the effective capital gains tax rate for high-income taxpayers.

And that's not all.. The health reform legislation enacted in 2010 imposed a new tax on the net investment income of high-income taxpayers, including capital gains,effective January 1, 2013. That adds another 3.8 percentage points to the capital gain tax rate. Without the repeal or the amending of this legislation, this rate increase will apply even if another tax cut extension occurs.

Put it all together, and unless another tax cut extension occurs, the top tax rate on capital gains is currently scheduled to increase from 15 percent to 25 percent on January 1, 2013.. Additionally, since 1978 the top capital gain rate has been increased to 28 percent on several occasions. So, if history is any indicator, the top capital gain rate does have a chance of going above 25 percent.

Obama and National Debt

Right now it appears President Obama has a better than 50 percent chance of being re-elected, notwithstanding poor approval ratings, a high unemployment rate and a stale economy. If he is re-elected, he has already made it clear that be believes the capital gain rate should be increased.

Even if a Republican is elected, the capital gain rate is likely to be increased, not just because of all the current rhetoric regarding the capital gain tax being considered a "rich people's tax", but because the low rates may have to be sacrificed to achieve other objectives, such as paying down the national debt. History shows this has happened before. In the 11 years from 1922 to 1933 the maximum capital gains rate was 12.5 percent. In 1934-35, it was raised to 31.5 percent and in the following two years it was raised to 39 percent. This was the response Franklin D. Roosevelt (an Obama hero) had to the deficits facing the country after the Depression.

Now or Later

With all the current talk about capital gains tax , the pending expiration of the Bush Tax Cuts and the additional tax associated with the 2010 health care legislation, now is the time to take action by any entrepreneur considering selling his/her business during the next few years. A 15 percent capital gain tax rate is certainly much more appealing than the risk of experiencing a 25 to 30 percent rate.

About the Author:

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