

# The future of capital gains

What the expiration of the current capital gains tax rates really means **Interviewed by Leslie Stevens-Huffman**

**T**he clock is ticking toward the 2010 expiration of the favorable capital gains taxation laws enacted under the Bush administration in 2003. This portends huge implications for individuals and small businesses alike because small businesses are often structured as sole proprietorships or pass-through entities, so capital gains are passed along to the owners, and because stock ownership is now commonplace among Americans. In 1980, only 13 percent of Americans owned stock, but by 1998, that number had grown to 52 percent. One thing is certain, the next president must deal with the issue, and the options include everything from maintaining the more favorable rates to treating capital gains as ordinary income.

"The sunset on the Bush legislation is nearing," says John M. Wyson, tax partner with Haskell & White LLP. "The capital gains tax now affects so many of us that when politicians argue that the capital gains tax is a tax on the rich, they are painting with an increasingly broad brush. Business owners should be more interested than ever to hear what the candidates are proposing."

*Smart Business* spoke with Wyson about what business owners should know about the expiration of the capital gains tax rates and the current positions of the leading presidential candidates.

## How do capital gains and ordinary income differ in terms of rates?

The most common form of ordinary income is salary and wages, and it is taxed at progressively tiered rates with brackets ranging from 10 to 35 percent. If capital gains become taxed as ordinary income, it will be taxed at those same rates, and there's some historic precedent for that because, prior to 1921, capital gains were generally taxed at the same rates as ordinary income. Then in 1921, Congress enacted favorable tax rates for sales of long-term capital assets. Since that time, the tax rate on capital gains has vacillated. In the mid-1980s, the maximum tax rate on long-term capital gains was set at 28 percent until 1997 when it was lowered to 20 percent. It was reduced to the present day 15 percent in 2003. Although the rates have varied, Congress generally remained consistent by encouraging longer-term investments.



**John M. Wyson**  
Tax partner  
Haskell & White LLP

Short-term capital gains, sales of capital assets held less than 12 months, are still generally taxed at the less favorable ordinary income rates.

## Will the political party controlling the White House impact the new tax rate?

It's perceived that Republicans generally want to lower taxes and Democrats want to raise them. However, the capital gains rate was raised in 1986, during President Reagan's term, and lowered in 1997, during President Clinton's term. So, the political party of the president does not always dictate which way the rate will go.

## What can we expect from the likely candidates we see today?

John McCain has indicated a desire to extend the 15 percent rate on capital gains. Barack Obama, as part of his 'Tax Fairness for the Middle Class' plan, supports a return to the 28 percent maximum rate on capital gains. Hillary Clinton has expressed her intention to raise taxes on capital gains either through a proactive change in the enacted rate or by simply allowing the Bush tax cuts to expire.

## Who will be affected by changes in the capital gains tax rates?

Those affected may include the rich, middle class and even working class families; basically, anyone who holds and sells stock or other capital assets at a gain. The tax also widely affects small businesses. Large corporations are generally unaffected by changes in the capital gains rates because a corporation's regular income and capital gains are each taxed at corporate rates.

It's worth mentioning that the capital gains tax does not apply if you don't sell. As Warren Buffett has said, 'The capital gains tax is not a tax on capital gains; it's a tax on transactions.' As a result, wise investors, like Buffett, who are really in it for the long-term, can end up with very low effective tax rates.

## What action should business owners take in advance of the election?

Most experts agree that, regardless of which party is in the White House next year, capital gains rates will likely remain at 15 percent through 2010. So, there doesn't appear to be any urgency to trigger gains by selling capital assets between now and the election. However, if taxpayers have a significant amount of 'gain' property, they should discuss the various options of minimizing capital gains taxes with their tax adviser.

## How will California capital gains tax rates be impacted?

Unfortunately, California has no favorable tax rate for capital gains. Rather, capital gains are taxed as ordinary income. With the top individual tax rate in California at 10.3 percent, the extra state tax paid on capital gains can be significant, particularly when a taxpayer is in an alternative minimum tax position and is unable to get a federal deduction for the state taxes paid. While the expiration in 2010 won't affect California's rates, taxpayers always have the opportunity to express their opinions and perhaps influence rates that nurture long-term investments. <<

**JOHN M. WYSON** is a tax partner with Haskell & White LLP. Reach him at [jwyson@hwcpa.com](mailto:jwyson@hwcpa.com) or (949) 450-6200.

**Insights Accounting** is brought to you by Haskell & White LLP

© 2008 Smart Business Network Inc. Reprinted from the May issue of *Smart Business Orange County*.