PENN WHARTON
UNIVERSITY of PENNSYLVANIA
Budget Model

How Are Capital Gains and Dividends Taxed?

Summary: This post is part of a series that explains tax concepts. The highest 1 percent of earners are responsible for 71 percent of capital gains realizations. President Trump has proposed lowering the top rate on income from capital gains and dividends, while former Vice President Joe Biden has proposed increasing the top rate for taxpayers with more than $1 million in income.

Income from the sale of a capital asset, capital gains income, is included in the calculation of a taxpayer's individual income tax. Any capital asset sold during the year is reported on Schedule D of the 1040. A capital asset refers to most property owned and used for investment or personal purposes. This includes, but is not limited to, stocks, bonds, residential real estate, vehicles, and even furniture and antique items of value.[1]

In order to calculate the capital gain (or loss) from the sale of a capital asset, the asset's basis must be reported. The asset's basis typically equals its cost (purchase price plus commissions and fees), plus costs of improvements, less depreciation.[2]

The 'holding period,' the length of time the asset was owned, defines the tax treatment of the capital gain. *Short-term* capital gains refer to the gains on assets held for less than one year. These gains are treated as ordinary income and taxed at ordinary rates. *Long-term* capital gains refer to the gains on assets held for longer than one year. These gains are given "preferential treatment" and as such, are taxed at lower rates than ordinary income.[3]

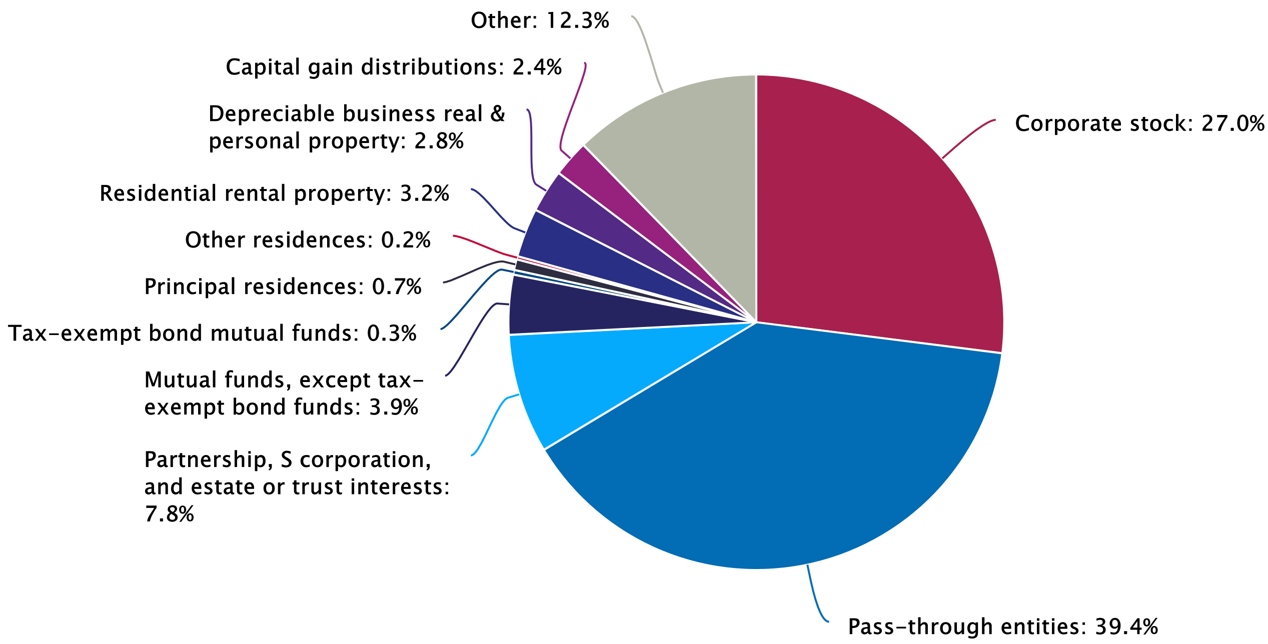
The preferential tax rates for capital gains and dividends are determined by level of taxable income. Under current law in 2020, no tax is owed on capital gains (or qualified dividend income) if taxable income is below $40,000 for single filers ($80,000 for joint filers). Single (married) filers with taxable income between $40,000 ($80,000) and $441,450 ($496,600) face a 15 percent rate while income above that amount faces a 20 percent rate.[4]

Capital gains asset composition & capital losses

As discussed above, income from the sale of a capital asset that was held for longer than a year qualifies for preferential rates. Figure 1 displays each type of capital asset as a percentage of total reported capital gains from 2012, the most recently available data. While a capital asset can refer to many types of property, the bulk of taxable capital gains transactions come from pass-through entities (39 percent) and corporate stock (27 percent). Gains from existing principal homes sales make up approximately 0.7% of total taxable capital gains.[5]

Figure 1. Share and Amount of Reported Capital Gains by Asset Type, 2012

DOWNLOAD DATA



A capital loss is realized when a capital asset is sold for less than its basis. Capital losses can offset gains, such that up to $3,000 in capital losses may be used to reduce other taxable income. Losses in excess of the $3,000 limitation can be carried over to future years.

Special treatment of certain assets

While real estate is considered a capital asset, up to $250,000 ($500,000 if married filing jointly) of the *gains* from the sale of one's primary residence is exempt from taxation.[6] For reference, as of August 2020, the median *total* price of existing home sales across the U.S. was $310,600. Home prices vary widely by region, Table 1 displays U.S. median housing prices by region.[7] Just over one percent of all primary residence homes sales generate a taxable capital gain.[8]

Table 1. U.S. Median Housing Prices by Region, August 2020

DOWNLOAD DATA

Region	Median Housing Price
Northeast	$349,500
Midwest	$246,300
South	$269,200
West	$456,100
Entire US	$310,600

Special treatment of other assets, such as collectibles, and exclusions for specific types of assets also apply.[9]

Who has capital gains income?

Capital gains realizations come primarily from the upper end of the income distribution. Table 2 presents PWBM's 2020 estimates on long-term capital gains realizations by income group.[10] We estimate that the percentage of taxpayers in each income group with any capital gains realizations is increasing up the income distribution: under 3 percent of those in the bottom two quintiles have any capital gains realizations, while we project 90 percent of those in the top 0.1 percent to realize capital gains. As a result, just 5.4 percent of capital gains are realized from the bottom 80 percent of the income distribution, while the highest 1 percent of earners are responsible for 71 percent of capital gains realizations. As such, any change to capital gains policy will accrue to high income taxpayers.

Table 2. Distribution of Long-Term Capital Gains Realizations by Income Group, 2020

DOWNLOAD DATA

Income group	Net Long-Term Capital Gains ($ billions)	% of total Capital Gains Realizations	% reporting a capital gain (or loss)
Bottom quintile	0.6	0.1%	2%
Second quintile	2.8	0.3%	3%
Middle quintile	11.5	1.3%	7%
Fourth quintile	34.2	3.8%	15%
80-90%	37.7	4.1%	22%
90-95%	47.4	5.2%	33%
95-99%	129.2	14.2%	52%
99-99.9%	173.4	19.0%	74%
Top 0.1%	473.6	52.0%	90%

Alternate proposals for capital gains taxation

Progressive tax proposals popularly feature capital gains reform as a mechanism for raising tax revenue from the wealthy. Aside from proposals to raise the tax rates on capital gains, other proposals include taxing capital gains annually as they accrue (mark-to-market), and ending step-up basis.

2020 Election

PWBM highlighted in a recent post that President Trump and his advisors have indicated intentions to lower the top rate on income from capital gains and dividends. We estimated that this would cost about $100 billion over the budget window, with 75 percent of the benefit accruing to those tax units in the top 0.1 percent of the income distribution and 98 percent of the benefit accruing to the top 1 percent.

As part of his tax plan, former Vice-President Joe Biden includes raising tax rates on capital gains and dividends for certain taxpayers. His proposal equalizes the tax rate on capital gains and dividends to the rate on ordinary income for taxpayers with more than $1 million in income. This proposal would eliminate the "preferential treatment" that currently applies to income from capital gains and dividends for these high income taxpayers.

This analysis was conducted by Victoria Osorio and Maddison Erbabian under the guidance of Kody Carmody. Prepared for the website by Mariko Paulson.

---

1. Capital assets and stock used in the taxpayer's trade or business, however, are not included in the definition of capital assets used to calculate capital gains income for individual income tax purposes. ↩
2. Under current law, a "step-up" in basis applies when a capital asset is passed off to heirs after the owner's death. Inheritors of the asset receive a "step-up" in basis, as the basis is re-calculated according to its market value when it is inherited. This produces a "lock-in effect," as realization (and therefore taxation) is deferred. ↩
3. The "preferential" rate schedule also applies to qualified dividends in addition to long term capital gains. ↩
4. These rate schedules do not include the 3.8% Net Investment Income Tax (NIIT), which applies to both long- and short-term capital gains income for taxpayers with modified AGI above certain amounts. ↩
5. These calculations are from the most recently available IRS Sales of Capital Assets data from 2012. IRS. 2020. "SOI Tax Stats-Sales of Capital Assets Reported on Individual Tax Returns." *IRS*. https://www.irs.gov/statistics/soi-tax-stats-sales-of-capital-assets-reported-on-individual-tax-returns. ↩
6. Certain minimum ownership and residential requirements apply in order for a property to qualify for this exclusion. For example, the owner must have owned it and used it as their primary residence for at least two years, and the taxpayer cannot have excluded gain on the sale of another main home in the previous two years. ↩
7. National Association of Realtors. 2020. "Existing-Home Sales Hit Highest Level Since December 2006." *National Association of Realtors*. ↩
8. We calculate the share of principal residence home sales that generate a taxable capital gain using data from tax returns and home sales as of 2012.
   IRS. 2020. "SOI Tax Stats-Sales of Capital Assets Reported on Individual Tax Returns." *IRS*.
   https://www.irs.gov/statistics/soi-tax-stats-sales-of-capital-assets-reported-on-individual-tax-returns.
   Rudden, J. 2020. "U.S. Existing Home Sales 2005-2021." *Statista*.
   https://www.statista.com/statistics/226144/us-existing-home-sales/. ↩
9. https://www.irs.gov/pub/irs-pdf/i1040sd.pdf ↩

10. These estimates for 2020 do not take into account the economic effects of the coronavirus pandemic. ↩