Taxes on Risk Taking and Wealth

Taxation and Risk Taking

→ If tax structure is linear (one rate), and there is "full loss offset," then taxation of the return to risky investments won't deter risk taking.

Problem: Very partial analysis.
Bui Taxes still affects savings versus consumption.

More important, government's expected revenue is zero. A real analysis would make the expected revenue positive.

His illustration:

Invest \$100, probability .5 it is worth \$120, .5 it is worth \$80.

Zero expected return:

$(.5)(\$20) + (.5)(-\$20) = 0$

Now government says it will tax return 50%, but you can deduct the loss, too.

If project goes well, keep \$10; if goes badly, deduct \$20, reduces tax liability (from other income) by \$10.

So, .5 prob. get $10 or lose $10 (government shares your loss because of the deduction).

We would expect the individual to increase her investment to $200, so once again I keep $20 or lose $20.

Prob. of .5, worth $240, or $160.
Gain/Loss of $40.
If gain, keep $20.
If loss, government tax deduction reduces the loss to $20.

More generally, symmetric treatment of gains and losses by the tax code minimizes the distortions in behavior created by taxes.
(Won't raise revenue with pure symmetry, though.)

Comprehensive View of Gift Tax, Estate Tax, Capital Gains Tax, Income Tax.

I.

Time 0: You buy an asset worth $1000.

Time 1: This asset is now worth $11,000, you die, you give it to an heir.

Time 2: This asset is worth $16,000, and they sell it.

1) Between time 0 an 1, capital gain is developing, but you pay no income or capital gains tax on that. Tax on realization, not accrual.

2) Think of this $11,000 as part of an amount subject to estate tax. 15% to 45% of the $11,000.

What about the basis of the asset; This is the number you subtract from market value to compute a capital gain on realization?

The basis for you (the "giver") was always $1000.

The basis for your heir becomes the market value at the time you died. "Step-up" in basis.

3) When heirs sell asset, have capital gain of $5000 only, pay tax on just that.

* The asset appreciation from $1000 to $11,000 [$10,000] was only taxed by the estate tax; no income or capital gains tax.
* The original $1000 investment was income net of tax, and it's also taxed by the estate tax.
* The asset appreciation from $11,000 to $16,000 [$5000] was only taxed by the capital gains tax. No income tax.

Add in gifts:

At time 0, you also give $15,000 to A, $15,000 to B, $10,000 to C.

This creates ($3000+$3000+$0) $6000 in value that will be considered part of your estate when you die, and on which estate tax may be due.

Note: The recipients do not owe income tax on this money, or any true gifts.

Why Tax Wealth?

Arguments for the estate tax.

1) Extremely progressive.
Also raised $21.5 billion in 2004, a lot of money from very few estates.
About 6343 estates in 2006.

2) Avoid excessive concentration of wealth.
-- We have a lot of wealth concentration, estate tax didn't stop it.
-- This isn't a zero sum game, next generation can become rich and be rich with the heirs of this generation's rich.

3) Carnegie claim about excessive wealth given to children.
-- Why is that a rationale for public policy? Parents would seem to be relevant party here.

[Gruber saves some important arguments for the estate tax to use to rebut arguments against the estate tax.]

Arguments Against The Estate Tax.

1) A "death tax" is cruel.

2) Estate tax amounts to double taxation.

Already addressed. Note point that paying a second tax because you die is different from paying a second tax (sales tax) when you consume.

Step-up in basis means this isn't true for some important part of wealth.

3) Administrative difficulties: to pay the tax, may need to sell the asset.

Selling the family farm! [or business].

Special rules for farms.

4) Compliance and Fairness.

With sufficient estate planning, can avoid the tax.

What's unfair? Some people are more proactive about this than others? Tax on procrastination? Hiring experts no matter what.

Are we comparing this against some more transparent (better compliance) way of raising the money?

<u>Status quo</u>: estate tax with basis step-up.

<u>Alternative</u>: eliminate estate tax and eliminate basis step-up.

Not just eliminate estate tax!

That might work: gov't gets revenue, keeping <u>one</u> tax on capital gain (capital gains tax instead of estate tax), left with <u>one</u> tax on the other part of estate (paid when earned).

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