Sensible Taxation of Investment Returns

by Gideon Magnus

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In this article, Magnus proposes an alternative system of rules for investment returns to combat the distortions created by the current system.

The tax rules for investment returns are highly complex, create a number of distortions, and encourage people to spend vast amounts of time and effort minimizing their tax liabilities. In this article, I will describe an alternative system that I believe would work significantly better.

Today, capital gains are taxed differently based on whether they are short-term or long-term, that is, whether the asset was held for less or more than a year. Short-term gains, as well as interest and dividend income, are taxed at ordinary income tax rates — 10, 12, 22, 24, 32, 35, or 37 percent — whereas long-term gains are taxed at 0, 15, or 20 percent, depending on one's tax bracket. Qualified dividends, which are dividends from stocks held longer than 60 days, also enjoy the lower long-term rates. Some taxpayers also face a 3.8 percent surcharge: the so-called net investment income tax.[1]

Our current system creates two main distortions: (1) the incentive to engage in "tax loss harvesting" and (2) the "lock-in" effect. I will now discuss each in turn.

Distortion 1: Tax Loss Harvesting

When people die, the cost basis of their asset holdings is reset. In other words, when a deceased person's portfolio is liquidated, any realized gains are tax free. This creates an incentive to hold on to positions that have a (sizable) gain, while selling positions that are worth less than their cost; the latter is called "tax loss harvesting." These losses can be used to offset realized gains on other assets and can, to some degree, be deducted against other sources of income.

This can lead to people holding portfolios that are unlikely to be sensible as an investment strategy. For instance, people will hold on to positions that have increased a lot in value, simply to avoid realizing a costly gain.

Figuring out how to minimize taxes while keeping a portfolio somewhat sensible is no easy task. This takes time, effort, and money, all of which is wasteful. Moreover, wealthier Americans are more able to bear these costs, which creates a perception that they are unfairly gaming the system.

Distortion 2: The Lock-In Effect

Taxing gains upon realization creates a well-known distortion: the so-called lock-in effect.

Suppose, for instance, that someone has an asset they bought for $100 and then earned a 10 percent return. Suppose they then sold it, paid taxes on the gain, invested in another asset that also earned a 10 percent gain, and then sold that asset. How much would they end up with? Let's assume a tax rate of 20 percent.

Starting with $110, they would pay a tax of 20 percent * $10 = $2, and would then have $108 to invest. This $108 would then grow by 10 percent, to $118.80. They would then pay a 20 percent tax on the gain of $10.80, that is $2.16, and would end up with $118.80 - $2.16 = $116.64.

Suppose, instead, that they would not need to pay a tax after selling the asset when it was worth $110. In this case, they would end up with 110 percent * $110 = $121. They would pay a 20 percent tax on the gain of $21 and would end up with $116.80.

[1] IRS, "Questions and Answers on the Net Investment Income Tax" (last updated Oct. 23, 2023).

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We thus see another incentive to hold on to assets with unrealized gains instead of selling them and reinvesting the proceeds, even if these holdings are not sensible as an investment strategy.

For the same reason, assets that pay dividends or interest are less attractive than those that grow in value. Taxes are due when dividends and interest are received, even if you were planning to reinvest these.

Conversely, for an investment with an unrealized loss, there is an incentive to realize this loss as soon as possible. Why? Consider, for instance, an example where an asset was bought for $100 but is trading at $80. Compare these two options:

- Sell the asset, realize a $20 loss today, rebuy it (for $80), and sell it later after it has grown in value to $100, then realizing a gain of $20.
- Hold on to the asset, wait until it has grown to $100, then sell it, incurring zero gain.

The first strategy is more profitable than the second, as the present value of a cash inflow today and an equal outflow in the future (assuming a positive interest rate) is positive.

This benefit disappears if losses may only be used to offset gains. In that case, the net gain (and thus the tax benefit) today would be zero. Why? If one reinvests the freed-up funds, there is no improvement in the *aggregate* cost basis: The cost basis decline of the "loser" exactly equals the cost basis increase of the "winner."

Abolish or Reform?

Given these considerations, one might argue that it is best to simply abolish all taxes on investment returns. There are, indeed, compelling arguments against any form of capital taxation. However, abolition is highly unlikely, so I will assume that the taxation of capital returns is here to stay. But, as I will show, there is a way to reform the system that eliminates its current deficiencies.

An Alternative System

In a nutshell, I propose the following: (1) people are taxed when they sell their investments in order to consume the proceeds, but not if they reinvest the proceeds; (2) people can make tax-free withdrawals up to the point when they have recouped the cost basis; and (3) investment losses can only be used to offset investment gains, but are otherwise not tax deductible.

Let us now go into further detail, starting with a simple example: someone who wishes to invest in a portfolio of financial assets in a brokerage account.

When they open the account, the amount invested is recorded as the "aggregate cost basis." When they withdraw money, this cost basis is reduced by the amount withdrawn, and when they contribute additional outside funds, the cost basis is increased by the amount contributed. Additional contributions will come primarily from one's salary (that is, labor earnings).

The following rules apply:

- They are allowed to withdraw money from the account tax free, but only up to the amount of the remaining cost basis.
- Any withdrawals beyond the cost basis are taxed at a flat rate.
- Any transactions *within* the account, like purchases, sales, or receipts of dividends or interest payments, do not constitute a taxable event.

If a person owns multiple accounts, the criterion for whether a withdrawal is taxable or not is based on the *total* of the remaining cost bases of all accounts combined.

If a person's overall asset holdings reach zero before their cost basis is depleted, then the remaining cost basis may not be deducted. Put differently, losses on one's investment portfolio can only be used to offset gains and are not deductible against other sources of income.

When a person dies, their accounts are transferred to their heirs, and the remaining total cost basis is transferred. Thus, in contrast with today, there is no "cost basis reset" upon death.

I believe this system eliminates the two distortions discussed above.

First, given that there are no consequences to buying and selling assets, there is no lock-in effect, and people can freely rebalance their portfolios with no tax consequences.

Second, because there is no cost basis reset at death, there is no incentive to sell losing positions while holding on to winners.

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Third, given that the criterion for whether a withdrawal is taxable or not is based on one's *total* cost basis, there is no incentive to split holdings over various accounts and then withdraw first from accounts with the highest remaining cost basis.

Finally, given that losses can only be used to offset gains, there is no incentive to liquidate one's entire portfolio if it is trading at a loss.

I will now discuss some further issues to consider.

Gifts

Suppose someone wishes to donate some assets to another person. If the recipient is an individual, then the donor can decide how much of their cost basis to transfer to the recipient. From the recipient's perspective, the more cost basis they receive, the better. If the recipient is a charitable organization, then the donor's cost basis remains unchanged, and they may use this to offset any future gains. This is because charities are tax-exempt entities.

Estate Taxes

The elimination of the cost basis reset at death strengthens the case for eliminating the estate (and gift) tax, not just for economic reasons but also for political reasons. But this issue is arguably beyond the scope of this article.

Debt

If someone takes out a loan, they will receive a cash inflow into their bank account. This should not, however, increase their aggregate cost basis. Similarly, any rental payments do not decrease their cost basis. More generally, *any investment-related cash in- or outflows do not change one's aggregate cost basis*.

Transition From Current System

I propose the following. People will need to calculate the aggregate cost basis of all assets they own. This amount is the amount that can be withdrawn tax-free. I use the cost basis, and not total net contributions, as people have already paid taxes on any realized gains in the past. Following this, there will no longer be a need to keep track of the cost basis of individual asset holdings within accounts. Instead, each bank or brokerage account will simply need to track total annual inflows minus outflows.

Small Businesses

Small private businesses should be taxed the same way as large public corporations, namely twice: first with a tax at the entity level (the corporate tax), and second, with a tax on each shareholder (the personal tax on investment returns, described here). When someone invests money into his business, this amounts to a portfolio rebalancing, and therefore does not change their aggregate cost basis. Similarly, when someone sells a share of their business, this does not change their aggregate cost basis.

Inflation Adjustment

Every year, one's remaining aggregate cost basis is adjusted upward to account for inflation. This way, their cost basis does not lose real value over time. It has long been argued that investors should not be taxed by inflation; this adjustment accomplishes exactly that.

Conclusion

The current system for taxing investment returns is needlessly complex and creates a number of bad incentives. I believe there is a better way. My proposal will allow people to invest in a portfolio that best meets their needs, and not spend effort, money, and time trying to minimize their tax liabilities. ■

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