President Obama Targets The 'Angel Of Death' Capital Gains Tax Loophole

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The President plans to announce in Tuesday’s State of the Union Address[new proposals](http://www.whitehouse.gov/the-press-office/2015/01/17/fact-sheet-simpler-fairer-tax-code-responsibly-invests-middle-class-fami%20)that would raise taxes on capital gains for the wealthiest Americans. The proposal would raise the top tax rate on long-term gains and qualifying dividends to 28-percent (including the Affordable Care Act’s 3.8 percent investment income surtax on high-income taxpayers). The president also proposes to tax capital gains at death rather than allow them to pass income-tax free to heirs as under current law.

All told, the proposal amounts to a substantial tax increase for wealthy people. The top rate on investment income (including ACA surtax) goes up by about 18 percent (from 23.8 to 28 percent). But the more significant change for the very wealthy is elimination of the “angel of death loophole,” as Michael Kinsley [famously called it](http://www.slate.com/articles/briefing/articles/1997/02/eight_reasons_not_to_cut_the_capitalgains_tax.html).

Under current law, heirs of appreciated property benefit from so-called “stepped up basis,” which is a wonky way of saying that past capital gains or losses are ignored. If grandpa leaves you shares of stock that he bought for $10 and are now worth $100, you never have to pay tax on the $90 of appreciation. Under the proposal, grandpa’s estate will be taxed on the $90 profit on his final tax return.

There would be several exceptions: No tax is due until the surviving spouse dies. The first $100,000 in gains is exempt for singles ($200,000 for couples). Special rules would protect small businesses. Finally, gifts to charity would be exempt (though other gifts would be subject to the levy).

Taxing gains at death is a big deal. It would eliminate what is arguably the biggest loophole in the tax code for high-wealth households. Postponing realization of capital gains until death is the holy grail of tax planning because a taxpayer can escape millions of dollars in taxes on a substantially appreciated asset.

This tax avoidance takes a toll on the economy. People hold onto businesses because they don’t want to sell and take the tax hit– even when someone else could run them better. The lawyers, accountants, and finance experts who come up with clever schemes for their clients to extract the cash from highly appreciated assets without technically selling them could otherwise apply their talents to socially productive work.

The angel of death loophole is unfair for at least two reasons. The person who sells an asset just before death can owe millions of dollars in tax that someone who holds until death can avoid. And, of course, capital gains are hugely concentrated among the rich (see chart). Only the richest of the rich can afford to hold onto substantial shares of their wealth until they die.

Taxing gains at death also makes the Administration’s proposed rate hike work better. If taxes on gains go up, taxpayers have a stronger incentive to avoid selling assets. But taxing gains at death reduces this “lock-in effect” and mean that the tax rate increase will produce much more revenue (and fewer economic distortions).

While Congress won’t approve the President’s proposal, it will surely provoke a lot of heated discussion. It’s a religious issue for both sides of the political divide, with conservatives equating capital gains tax preferences with growth and liberals with unfairness.