Prof. Dr. Lorenz J. Jarass

Hochschule RheinMain, Wiesbaden
MBA in business administration and Ph.D in economics of University of Regensburg, FRG
MS, School of Engineering, Stanford University, USA

MAIL@JARASS.com, http://www.JARASS.com

Wiesbaden, 07. September 2020

Online Workshops on Wealth Taxation

organized by P. HONGLER (Uni St. Gallen) and M. VALTA (Uni Düsseldorf)

Workshop on Wealth Taxes and Property Taxes

by E. PICHET and L.J. JARASS

7. Sept. 2020, 16:00 - 17:30 CEST

Fair and Simple Taxation of Wealth: Taxation of Unrealized Capital Gains

by L.J. JARASS

7. Sept. 2020, 16:30 - 17:00 CEST

1. Unrealized capital gains should be taxed 2
1.1 Non-Taxation of unrealized capital gains produces many problems 2
1.2 Arguments against taxation of unrealized capital gains are not valid 2
2. Gradual taxation of unrealized capital gains 4
2.1 Bring book values more in line with market values 4
2.2 Taxation of capital gains – example 4
3. Conclusion 5

1. Unrealized capital gains should be taxed

1.1 Non-Taxation of unrealized capital gains produces many problems

Unrealized capital gains often remain untaxed forever

According to many national tax regulations (incl. Germany) capital gains count as income and have to be taxed as such. In contradiction to these basic principles of tax law capital gains are taxed in most cases only if capital gains have been realized by sale of an asset. And even after realization national tax laws often allow legal tax planning to avoid taxation. As a result most capital gains stay untaxed forever. On the other hand all capital losses – realized and unrealized – reduce earnings and therefore taxes.

Non-Taxation of unrealized capital gains is unfair

This tax privilege – capital gains remain legally untaxed forever, capital losses reduce taxes – has produced an ever growing untaxed wealth (´hidden reserves´) due to the value increase of many assets, in particular property. Current income such as wages and profits, however get taxed immediately. This produces an unfair tax system. In addition, the exclusion of most capital gains from taxable income has contributed to the growing difference between the taxable and the real income of wealthy people and companies.

Non-Taxation of unrealized capital gains produces a complicated tax system

Many national tax laws, e.g. the German one, have lots of complicated tax rules concerning the transition and deferral of taxation if it comes to the realization of capital gains, e.g. after the sale of property. In addition EU-law requires additional and extremely complicated tax rules if the owner of the assets move to another EU-country. Therefore non-taxation of unrealized capital gains lead not only to an unfair, but also to a very complicated tax system.

Non-Taxation of unrealized capital gains produces lock-in of capital

Finally non-taxation of unrealized capital gains and the resulting permanent untaxed ´hidden reserves´ has an additional, economically very harmful effect, namely the lock-in of capital. Due to the non-taxation of unrealized capital gains productive investments are obstructed. For example, the major reason for the shortage of building land, in particular in metropolitan areas is that capital gains are taxed only if building land is sold. Therefore property owners sit back and wait for further increases in the value of their land because of this tax-induced misallocation of economic resources. Therefore inappropriate tax laws obstruct investments leading to ever increasing rents and property prices in metropolitan areas.

European tax law allows taxation of unrealized capital gains

The European Court of Justice (C164/12, 23 January 2014) "has held that a Member State is entitled to tax the economic value generated by an unrealised capital gain in its territory even if the gain concerned has not yet actually been realized". Therefore taxation of unrealized capital gains is in accordance with EU law.

1.2 Arguments against taxation of unrealized capital gains are not valid

Not taxing unrealized capital gains is jusitified mainly by three arguments:

- Difficulties to determine market prices,
- resulting liquidity problems,
- heritage tax on untaxed capital gains instead of current taxation of unrealized capital gains.

1 **Market values are available in most cases**

2 Capital gains occur particularly in property, financial and business assets:

3 • Market value of property can be estimated using standard values for land and building (already
4 used in Germany for heritage tax).

5 • Market value of financial assets (money, shares etc.) is determined by its nominal value.

6 • Market value of a business is available if the business is listed on the stock exchange. In other
7 cases the part of market values not associated to property or financial assets, i.e. the capitalized
8 value of future earnings, can be estimated by standard estimation methods (already used in Ger-
9 many for heritage tax).

10 As shown, market values are available in most cases. In rare cases estimates can be given only in a
11 wide range. In these cases valuation haircuts are appropriate and necessary. If unrealized capital
12 gains are gradually taxed as proposed later, these haircuts can be gradually adjusted.

13 Heavy fluctuations of market values can be taken into account by valuation haircuts and a gradual
14 taxation of unrealized capital gains.

15 **Liquidity problems can be avoided**

16 Taxation of unrealized capital gains may create liquidity problems as taxes had to be paid without
17 the tax payer having enough liquidity. Therefore advocates of non-taxation of unrealized capital
18 gains demand that only those earnings which increase the liquidity of the tax payer should be taxed
19 (German ´realization principle´). In addition those advocates demand that all capital losses – real-
20 ized and unrealized – should reduce the taxable income and therefore the taxes (German ´imparity
21 principle´ to protect creditors).

22 In order to find an adequate solution we should distinguish whether assets are necessary or not
23 for the business in question:

24 • Taxation of assets necessary for the business could endanger the liquidity of the business if all
25 capital gains would be immediately taxed. The problem is increased if those capital gains had not
26 been taxed for many years. But, as proposed, taxation should be gradually imposed. If liquidity
27 problems may still arise, tax deferrals should be implemented.

28 • Taxation of assets **not** necessary for the business could not endanger the liquidity of the business
29 because such assets could be sold. Taxation of unrealized capital gains would not only enable a
30 fair taxation, but also increase the overall economic welfare, as unused resources would be in-
31 cluded in the economic production process.

32 **Heritage tax on untaxed capital gains can be circumvented**

33 The basic principle behind taxation of individuals is their economic performance. Therefore advo-
34 cates of non-taxation of unrealized capital gains demand that all untaxed capital gains should be
35 taxed when the taxable person dies. But this final taxation can be avoided by change of residence.
36 For example, the Müller milk family and many other such super rich moved from Germany to Swit-
37 zerland to avoid heritage taxes. This tax-induced expulsion of economically very active people is
38 counterproductive for Germany. Therefore every tax proposal should be independent of residence
39 thereby ensuring that taxation cannot avoided by a change of residence.

1
2. Gradual taxation of unrealized capital gains

2
2.1 Bring book values more in line with market values

3 Gradual taxation of unrealized capital gains would bring taxation again in line with basic principles
4 of income taxation. In the following a practical procedure for bringing in line book values with market
5 values is proposed which leads to a gradual taxation of unrealized capital gains.

6 Taxation of unrealized capital gains could finance improvements of depreciation conditions. Addi-
7 tional depreciations in the first years would – in the long run – not produce additional unrealized
8 capital gains, if – as proposed below – all unrealized capital gains would be taxed gradually. Im-
9 proved depreciation conditions in this case result only temporarily in a reduction of tax revenues.

10 Book values should be brought gradually in line with market values, e.g. increasing the book value
11 annually by 10% of the difference between book value and market value.

12 For the valuation of assets haircuts should be used to decrease valuation problems and heavy
13 fluctuations of tax values. For example, market value is estimated to be 100, using a valuation
14 haircut of 30% the respective tax value is 70. A tax payer who does not accept this tax value has to
15 show that the market value is below 70.

16
2.2 Taxation of capital gains – example

17 The example in table 1 illustrates the procedure:
18 (1) Market value is assumed to be 100 at the beginning of year 1, stays constant in year 2, doubles
19 in year 3 and goes back to 100 in year 4.
20 (2) Valuation haircut is assumed to be 30% of market value.
21 (3) Book value is assumed to be 20 at the beginning of year 1, increasing annually by the capital
22 gains taxable in the previous year.
23 (4) Capital gains are the difference between haircut market value and book value.
24 (5) Capital gains taxable in the current year are assumed to be 1/10 of capital gains.
25 (6) Tax rate for taxable capital gains is assumed to be 20%.

26 **Table 1: Taxation of capital gains – example**

year	(1) market value	(2) market value minus 30% hair cut	(3) book value	(4) capital gains	(5) 1/10 of capital gains taxable in current year	(6) capital gains tax at a tax rate of 20%
		=(1)-30%*(1)		=(2)-(3)	=1/10*(4)	=20%*(5)
1	100	70	20	50	5	1
2	100	70	25	45	4,5	0,9
3	200	140	29,5	110,5	11,05	2,21
4	100	70	40,55	29,45	2,95	0,59

27

28 **Year 1:**
29 (1) Market value = 100.
30 (2) Haircut market value = market value (100) minus 30% valuation haircut (30) = 70.
31 (3) Book value = 20.

(4) Capital gains = haircut market value (70) minus book value (20) = 50.

(5) Capital gains taxable in current year = capital gains (50) * 1/10 = 5.

(6) Capital gains tax = 5 * 20% = 1 (i.e. 1% of market value).

Year 2:

(1) Market value = 100.

(2) Haircut market value = market value (100) minus 30% valuation haircut (30) = 70.

(3) Book value = book value of previous year (20) plus
taxable capital gains in previous year (5) = 25.

(4) Capital gains = haircut market value (70) minus book value (25) = 45.

(5) Capital gains taxable in current year = capital gains (45) * 1/10 = 4.5.

(6) Capital gains tax = 4.5 * 20% = 0.9 (i.e. 0.9% of market value).

Year 3 (market value doubles to 200):

(1) Market value = 200.

(2) Haircut market value = market value (200) minus 30% valuation haircut (60) = 140.

(3) Book value = book value of previous year (25) plus
capital gains taxable in previous year (4.5) = 29.5.

(4) Capital gains = haircut market value (140) minus book value (29.5) = 110.5.

(5) Capital gains taxable in current year = capital gains (110.5) * 1/10 = 11.05.

(6) Capital gains tax = 11.05 * 20% = 2.21 (i.e. 1.1% of market value).

Year 4 (market value comes back to 100):

(1) Market value = 100.

(2) Haircut market value = market value (100) minus 30% valuation haircut (30) = 70.

(3) Book value = book value of previous year (29.5) plus
capital gains taxable in previous year (11.05) = 40.55.

(4) Capital gains = haircut market value (70) minus book value (40.55) = 29.45.

(5) Capital gains taxable in current year = capital gains (29,45) * 1/10 = 2.95.

(6) Capital gains tax = 2.95 * 20% = 0.59 (i.e. 0.59% of market value).

Result: The difference between market value and book value is gradually decreased, every year a small capital gains tax has to be paid.

3. Conclusion

Non-taxation of unrealized capital gains create many problems:

- Unrealized capital gains often remain untaxed forever.
- Non-Taxation of unrealized capital gains is unfair, produces a complicated tax system and a lock-in of capital.

Gradual taxation of untaxed capital gains would ease these problems thereby enabling a simple and fair tax system.

Taxation of unrealized capital gains is necessary for a simple and fair tax system.