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Closing Leaky Holes in Capital Gains Taxes



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When you work for your money, taxes come out of every paycheck. When your money works for you, the tax bill can wait—and, in some cases, never arrive. Two aspects of the tax system help make that possible: step-up in basis at death and borrowing against appreciated assets. Together, they can allow investment gains to finance a lifetime of

spending and then pass to heirs without ever facing capital gains tax. Below, we examine how those loopholes work and how policymakers could close them in order to strengthen tax fairness and raise federal revenues.

How Capital Gains Can Escape Taxes

Capital gains are a key form of capital income. They occur when someone sells an asset —such as a stock, bond, home, or painting—for more than they paid for it. Capital gains are taxed differently than income from work: under current law, gains from assets held for more than one year are generally taxed at lower rates than wages and many other forms of "ordinary" income.[1] But lower rates are only part of the advantage. Step-up in basis at death and borrowing against appreciated assets can work together to allow some gains to escape taxation altogether.

Step-up in basis allows increases in an asset's value during the original owner's lifetime to escape capital gains tax when the asset is passed to an heir at death. When an heir later sells the asset, they owe capital gains tax only on the increase in value *after they inherited it*—not on the gain that accrued during the original owner's lifetime.[2] This rule affects taxpayers across the wealth spectrum, from someone inheriting a family home to an heir receiving a major fortune. The Joint Committee on Taxation estimates that step-up in basis will exempt $379.3 billion from taxation over fiscal years 2025-2029.[3]

The second issue is **borrowing against assets** that have increased in value, often described as part of the "buy, borrow, die" strategy. Some very wealthy individuals use their holdings of stock, business interests, or other assets as collateral for loans. This allows them to access cash without selling their assets and triggering capital gains tax. As long as they can keep making interest payments, they may keep these loans outstanding throughout their lifetime and eventually pass their assets to heirs on a stepped-up basis.

These issues are tightly intertwined. Step-up in basis erases gains at death, while borrowing against appreciated assets can let wealthy households access those gains during life without a taxable sale. Together, they can turn a delay in paying capital gains tax into a permanent avoidance.

Directly Patching Step-Up in Basis

Preventing capital gains from escaping taxation at death starts with changing how inherited assets are treated. Policymakers generally have two main options: preserve the original owner's basis so the gains are taxed when an heir sells, or tax the gains at death. A hybrid approach could also combine elements of both options.

1. Replace Step-Up with Carryover Basis

Instead of resetting an asset's basis to its market value when its owner dies, the heir would inherit the original owner's basis—generally, what the owner paid for the asset. Consider stock purchased for $100,000 that was worth $500,000 when the owner died. If the heir later sold it for $600,000, the heir would owe capital gains tax on the full $500,000 gain, not just the $100,000 increase since inheritance.

Importantly, carryover basis would not require the estate or heir to pay capital gains tax immediately at death—the tax would remain deferred until the heir sold the asset. What changes is that the gain accumulated during the original owner's lifetime would stay in the tax system. Gifts made during life generally also receive carryover-basis treatment under current law.[4] In 2024, the Congressional Budget Office (CBO) estimated this policy change would raise about $200 billion over the next ten years.[5]

Design challenges:

- **Tracking basis**: Heirs would need to know what the original owner paid for an asset, which can be difficult for property purchased decades earlier or without good records.
- **Continued deferral**: Preserving the gain does not guarantee that it will be taxed anytime soon. Heirs could hold the asset for the rest of their lives and pass it to another generation, continuing to defer the tax until someone sells.

2. Tax Unrealized Gains at Death

Another approach would treat death as a realization event—making the gains accumulated during the owner's lifetime taxable at that point. For tax purposes, the deceased owner would be treated as having sold the asset at fair market value immediately before death. The heir's basis would then reset to the asset's value at the previous owner's death, so the same gain would not be taxed again.

Policymakers could apply the same rule to gifts made during life. Doing so would prevent taxpayers from avoiding realization at death simply by transferring appreciated assets before they die. Policymakers could exempt some amount of gains or provide different treatment for certain assets rather than applying realization to every transfer. In 2024, CBO estimated this policy change would raise roughly $540 billion over ten years.[6]

Design challenges:

- **Liquidity**: The deceased or their heir would owe capital gains taxes without necessarily having received cash from a sale. Paying the tax bill could require selling assets that heirs would otherwise intend to keep, such as farms, family businesses, real estate, and other illiquid assets.
- **Valuation**: Publicly traded securities are relatively easy to value, but closely held businesses, real estate, art, and other assets may require appraisals and generate disputes over their value.
- **Payment and exemption rules**: Policymakers would need to decide whether to exempt some gains or assets and whether to allow installment payments or deferral for taxpayers who would be unable to pay without selling their assets.

3. Use a Hybrid Approach

Policymakers could also take a blended approach between these systems. They might combine realization at death with carryover basis—or even retain step-up for some taxpayers—depending on the size of the gain, the size of the broader estate, or the type of asset involved. Gains below a substantial exemption could retain step-up or receive carryover basis, while gains above that threshold could be taxed at death.

A hybrid system could also distinguish between assets. Publicly traded stocks and bonds, which are easy to value and sell, could face realization at death, while farms, businesses, or other illiquid assets could receive carryover basis or additional time before tax is due.

Design challenges:

- **Complexity**: Combining multiple systems would create more rules for taxpayers and the IRS to administer than choosing a single treatment for inherited assets.
- **Drawing the lines**: Policymakers would have to determine which taxpayers, gains, and assets qualify for exemptions or preferential treatment.
- **Avoidance**: Differences in treatment across assets or thresholds could encourage taxpayers to restructure asset ownership or shift wealth toward assets receiving more favorable treatment.
- **Erosion through carveouts**: Broad exemptions for favored assets could substantially reduce both the revenue raised and the amount of previously untaxed gains ultimately brought into the tax system.

Reforming The "Borrow" in Buy, Borrow, Die

The reforms above address gains that disappear at death. Policymakers could also address the borrowing that lets some wealthy households access those gains during life through the practice known as buy, borrow, die. The Budget Lab at Yale and the Bipartisan Policy Center have examined several options to address this issue, which we explore below.[7]

1. Treat Borrowing Against Appreciated Assets as Realization

Under this approach, borrowing against appreciated assets would trigger capital gains tax, even though the underlying asset was not sold. For example, borrowing $10 million against assets originally bought for $1 million and now worth $10 million would be treated as the realization of a $9 million gain. The taxpayer would pay capital gains tax

on that gain, and the basis of the asset borrowed against would increase so the same gain would not be taxed again later.

This would reduce the core buy, borrow, die advantage by making borrowing look more like selling for tax purposes. A wealthy investor could still borrow against appreciated stock or other assets, but doing so would no longer allow them to access the value of those gains while avoiding capital gains tax.

Design challenges:

- **Determining the gain**: The IRS would need to know the taxpayer's basis and calculate how much unrealized gain should be treated as realized.
- **Administrative complexity**: Rules would be needed to identify which assets, or what share of assets, are treated as realized and how basis is adjusted afterward.

2. Apply an Excise Tax to Securities-Backed Borrowing

An excise tax would impose additional taxation on certain loans backed by appreciated securities. Rather than calculating the unrealized gain behind the loan, the tax would be based on the amount borrowed or the outstanding loan balance. This policy could be implemented in multiple ways: the Bipartisan Policy Center examined a narrower tax applied specifically to securities-backed lines of credit, while the Budget Lab at Yale modeled a broader 0.5% annual tax on the outstanding balance of covered loans.[8]

This approach would not directly tax any capital gains. Instead, it would reduce the financial advantage of borrowing rather than selling. If borrowing against appreciated assets carried an additional tax, using loans to access those gains would become less attractive relative to simply selling the asset and paying capital gains tax.

Design challenges:

- **Blunt instrument**: The tax would be based on the loan rather than the underlying gain. It may not closely track the amount of tax being avoided.
- **Defining covered loans**: A narrow tax could encourage borrowers to switch to other non-taxed loan products.

- **Setting the rate**: The tax would need to be large enough to reduce the borrowing advantage without imposing excessive costs on transactions unrelated to tax avoidance.

3. Require Prepayment of Capital Gains Tax at Time of Borrowing

A withholding approach would require taxpayers to make an upfront payment toward future capital gains taxes when they borrow against appreciated assets. The Budget Lab at Yale modeled a 10% withholding tax—meaning a $10 million covered loan would trigger a $1 million tax payment regardless of the taxpayer's basis in the underlying assets.[9] The payment would not represent a new tax on borrowing itself; it would be treated as a credit against capital gains taxes ultimately owed.

The actual tax liability would be reconciled later, when the taxpayer sells the asset or at death. If the taxpayer had prepaid more than the eventual capital gains liability, the excess would be refunded; if they had prepaid too little, the remaining tax would be collected before step-up in basis applied. Like realization at borrowing, this approach would collect tax when the taxpayer takes out a loan. But it would postpone the potentially harder work of determining basis and the actual gain until sale or death, rather than requiring that calculation every time someone borrows.

Design challenges:

- **Prepayment may not match the gain**: A flat withholding amount may be too high for some taxpayers and too low for others.
- **Timing of refunds**: Taxpayers who overpay may wait years before receiving a credit or refund.

4. Strengthen Reporting and Anti-Abuse Rules

Some of the most aggressive forms of buy, borrow, die could also be constrained by strengthening rules that already police transactions designed to avoid realizing capital gains. Congress could require more reporting on large loans secured by appreciated assets, tighten existing anti-abuse rules, and authorize Treasury to explicitly target

transactions designed to replicate a sale without technically triggering realization. These changes would not eliminate the underlying tax advantage of borrowing, but they could serve as a backstop to more direct reforms.

Stronger anti-abuse rules would complement the policy designs above. Policymakers could consider:

- Requiring lenders to report large loans secured by appreciated assets, so the IRS can identify taxpayers repeatedly accessing gains without selling.
- Tightening aggregation and related-party rules so taxpayers cannot avoid new requirements by splitting loans across years, lenders, trusts, or controlled entities.
- Expanding existing constructive-sale rules to cover more transactions that effectively allow investors to cash out an appreciated position while technically retaining ownership.

Design challenges:

- **Limited impact**: These options would improve enforcement but would not close the underlying loophole. As a result, they would make limited progress on their own.
- **Whack-a-mole**: Wealthy taxpayers and advisers could find ways around narrowly targeted changes, requiring rules to be updated over time.
- **Drawing the line**: Anti-abuse rules would need to be broad enough to catch transactions designed to mimic a sale without inadvertently discouraging ordinary borrowing or legitimate business transactions.

What About Broader Reforms?

Beyond the targeted reforms outlined above, policymakers have proposed broader reforms to how capital gains—or wealth more broadly—are taxed.

Mark-to-Market

One option is a mark-to-market system, where gains would be taxed annually as assets appreciate, limiting investors' ability to defer taxes indefinitely.[10] It could raise revenue both by collecting taxes sooner and by taxing gains that might otherwise be deferred for decades or avoided at death.

The main difficulty in implementing a mark-to-market system is determining some assets' values annually. While publicly traded assets can be valued relatively easily, many forms of wealth—intellectual property, artwork, or privately held businesses—are harder to value.[11] Requiring annual valuations would create substantial administrative burdens for both taxpayers and the IRS.[12] Additionally, taxpayers may face liquidity challenges if they owe taxes without having sold the underlying assets.[13] Finally, assets can lose value over time. Determining the appropriate refund or credit in those downturns poses practical and political challenges.

Wealth Taxes

Policymakers have also proposed going beyond capital gains and directly taxing the accumulated wealth of wealthy households. Under many of these proposals, households with a net worth above a specified threshold would pay an annual tax on wealth exceeding that threshold. Senator Warren's plan sets an exemption threshold of $50 million, limiting the tax's impact to 0.06% of all households.[14] Taxable wealth would include both financial assets, like bank accounts and stock portfolios, and non-financial assets, like real estate and other property.[15] Revenue raised from a tax design like this could be substantial. One estimate found that a 1% wealth tax with a $50 million exemption threshold would have raised an additional $94 billion of revenue in 2019 alone.[16]

Wealth taxes face some of the same valuation challenges as mark-to-market taxation, particularly for assets that are not regularly traded. Ultra-wealthy households could also seek to reduce their wealth tax liability by shifting assets into foundations and trusts, or by renouncing US citizenship and leaving the country.[17] Many proposals address these avoidance strategies through rules for trust-held assets and exit taxes for individuals renouncing US citizenship.[18] Finally, wealth tax reform efforts are likely to face constitutional challenges.[19]

Taxing Deferral

The realization-based taxation system could be preserved while still reducing the tax benefits of long-term deferral. One approach would apply an additional charge when gains on assets held for long periods are realized—similar to interest owed for delaying payment of a bill. Under this system, taxpayers would still owe taxes only upon the sale of an asset, but the tax bill would include a charge reflecting the benefit of deferring payment.[20]

Compared with mark-to-market taxation, a deferral charge system would be considerably easier to administer because it would not require annual asset valuations.[21] It could also encourage investors to sell assets that they had been holding primarily to defer taxes, unlocking a new source of revenue from gains that are currently being deferred. But a reform like this could influence investment decisions in unintended ways, potentially making high-growth, high-risk assets more appealing because selling them quickly could result in a lower tax burden than holding them for longer.[22]

Conclusion

Policymakers must do more to prevent investment gains from permanently escaping taxation. Beyond the issue of fairness, we have a rising national debt, an aging population, and stagnant federal revenues. There are workable ways to prevent capital gains from escaping taxation through step-up in basis and buy, borrow, die. These targeted reforms offer a starting point before policymakers confront the broader question of whether income from capital should continue to receive preferential treatment compared with income from work.

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