IRET Congressional Advisory

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HOUSE TAX BILL: STRIPPING STRIPPED STOCK OF CAPITAL GAINS TREATMENT

"Strips" are the principal component of bonds stripped of their interest coupons (which are sold separately) and resold at an original issue discount to yield interest via price appreciation. The accruing price appreciation is treated as taxable interest for tax purposes.

The practice has spread to preferred stock. The stock is stripped of its dividend rights (which are sold separately) and the stock is resold at a discount from a fixed redemption price payable at a future date. Current law treats the rise in the stock price as a capital gain. The House tax bill converts the treatment to ordinary income. In doing so, it accentuates the income tax bias against saving.

> ***The House proposal would move the tax code in the wrong direction, i.e., closer to universal double taxation of saving, raise the cost of capital and reduce saving in the United States, and slow the growth of investment, productivity, wages, and employment.***

Current law subjects the returns on saving to double taxation. Income is taxed when earned. If used for consumption, there is little additional federal tax. If used for saving or investment, it is taxed again on the returns. A neutral tax code would either give a deduction for amounts saved and tax the gross returns (akin to a deductible IRA) or give no deduction and tax none of the returns on saving (akin to tax exempt bond treatment). All saving would be given one or another of these treatments.

With no deduction for saving, the correct treatment for either the interest on bonds or the dividends on stock is not to tax them. In the case of the stripped principal sold at a discount, the price appreciation should not be taxable to the holder.

Under current law, dividends are paid from after-tax corporate income. The dividend payments are not deductible by the corporation. Furthermore, dividends on stock (common or preferred shares, whether stripped or not) are taxed as ordinary income to the shareholder, who purchased the stock with after-tax income. Thus, the dividend is subject to repeated taxation, reducing the value of the stock and raising the cost of capital to the company.

If stripped preferred stock can be reissued at a discount and subject to capital gains treatment, it enhances the initial value of the original issue stock, and lowers the cost of capital, making up in some small part for the multiple taxation of the regular dividend.

The correct solution to the stripped preferred stock problem is to stop taxing the regular dividend, or, as a second best answer, to allow the corporation a deduction for the dividends it pays out. Absent such fundamental reform, the

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capital gains treatment of the stripped stock is preferable to the higher tax rates on ordinary income. The House proposal would move the tax code in the wrong direction, i.e., closer to universal double taxation of saving, raise the cost of capital and reduce saving in the United States, and slow the growth of investment, productivity, wages, and employment.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.