IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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December 5, 2005 **Advisory No. 196**

TAX RECONCILIATION: CAPITAL GAINS, DIVIDENDS, AND THE AMT

The Senate and House have yet to complete conference work on the tax portion of Budget Reconciliation. Each has passed bills with the usual old perennial "extenders" of temporary provisions, such as the R&E credit, which have been authorized annually for some time. Two other extenders, one involving the AMT and one involving dividends and long term capital gains, are under dispute between the House and the Senate.

The House has passed a two year extension of the 15% tax rate cap on dividends and capital gains, which is due to expire at the end of 2008. Extending the cap through 2010 would put its expiration date in line with that of the 2001 marginal tax rate reductions and other provisions of the 2001 tax bill. If the cap is allowed to expire, the tax rates on dividends will revert to those on ordinary income (up to 35%), and the top tax rate on capital gains would jump back to 20 percent.

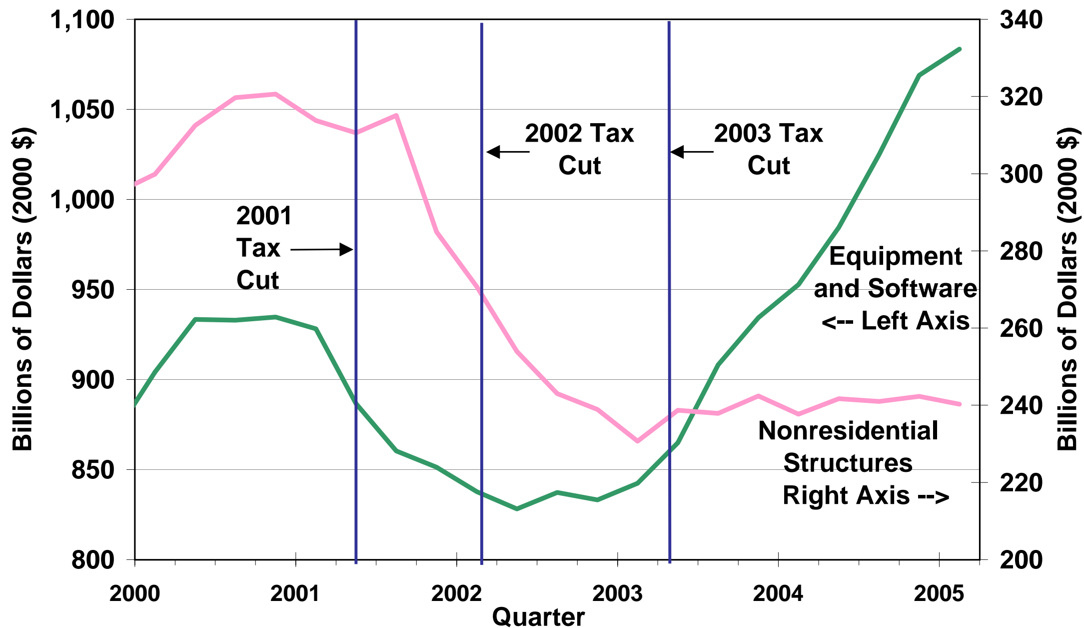
The Senate has passed a one year extension of the expiring "fix" of the Alternative Minimum Tax (AMT). That "fix", adopted for three years in 2001 and extended annually since 2004, provides a temporary increase in the unindexed AMT exempt amounts to $58,000 for joint filers and $40,250 for single filers (in 2005). Without the extension, the exempt amounts would drop back in 2006 to their permanent levels of $45,000 (joint) and $33,750 (single). The number of angry taxpayers subject to the AMT would jump from 3 million to about 21.5 million.

Under the arbitrary Budget Reconciliation limits given to the tax Committees, there isn't room to do both without first passing reconciliation spending cuts or dropping some tax "sweeteners" that were added to the bill. This is a self-inflicted Congressional dilemma. The 15% rate cap on dividends and long term capital gains is more necessary for a strong economy. The AMT fix extension is more necessary to keep angry taxpayers from storming Members' offices, though it too has some economic benefits. What to do? Do both. It would be better to find more entitlement cuts or trim the tax goodies than to delay either extender.

Dividend and Capital Gains Rate Cap

The 15% rate cap on dividends and capital gains lowers the service price of capital, the rate of return that investments in new factories, equipment, and buildings must earn to justify their existence. The dividend and long term gains cap was one of the three provisions in the 2003 tax cut that made it more attractive to create and employ plant and equipment, and that really got the economic recovery moving. (See Chart 1.) The other two items were the moving forward of the remaining marginal tax rate reductions being phased in under the 2001 tax cut, and the temporary 50% expensing provision that has since expired at the end of 2004. The dividend and gains rate cap accounted for over half of the improvement in the treatment of investment. The marginal rate relief was over a third of the effect. The expensing provision contributed less than ten percent. (See Table 1.)

Chart 1 Real Private Investment
And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

The lower service price of capital was what pulled investment in equipment out of the doldrums and got the economy moving. It was a slump in investment that caused the 2001 recession, and it was not until investment began to recover that the economic expansion took on much life, and real GDP growth exceeded four percent per year. Since then, the "jobless recovery" has been a job-creating juggernaut. It has also been a revenue generating juggernaut. The lower prospective tax on capital gains and dividends was capitalized in the prices of stock, and the stock markets rose. The rising markets created more accrued capital gains, and, at the lower tax rate, people were willing to realize more of these gains. Because of the lower tax rate on dividends, many companies introduced or increased their dividend payouts. The added realized gains and dividends were taxed at 15%, and federal revenues got a large boost. Indeed, the dividend and gains cap accounts for much of the unanticipated surge in federal tax receipts in the last two years. That revenue surge would be reversed if the cap were allowed to expire.

The AMT Fix

Failure to adopt the AMT fix would have conflicting effects on the marginal tax rates facing workers, savers and small business investors. The AMT has two statutory tax rates, 26% and 28%, on ordinary income, and a 15% rate on dividends and capital gains. However, the AMT exempt amount is phased out for people with incomes between $250,000 and $382,000; they lose twenty-five cents of exemption per dollar of additional income (including ordinary income, dividends, and capital gains). For each added dollar of income (regardless of the source), taxable AMT income rises by $1.25. This boosts the effective 26% AMT tax rate by a quarter, or by 6.5 points to 32.5%, and boosts the effective 28% AMT tax rate by 7 points to 35%, on ordinary AMT income.

As Congressman Charles Rangel and New York Times writer David Cay Johnston have recently noted, the same 6.5 and 7 point increases apply to dividends and capital gains, which face effective

<table>
<tr><th colspan="5">Table 1 Service Price of Private Business Capital</th></tr>
<tr><th></th><th>2004 Law</th><th>Without 50% Expensing</th><th>Without 15% Rate on Dividends and Capital Gains</th><th>Without Lower Marginal Tax Brackets</th></tr>
<tr><td>Private Businesses</td><td>0.132</td><td>0.134</td><td>0.148</td><td>0.157</td></tr>
<tr><td>Corporate Businesses</td><td>0.165</td><td>0.168</td><td>0.191</td><td>0.202</td></tr>
<tr><td>Equipment & software</td><td>0.301</td><td>0.308</td><td>0.352</td><td>0.373</td></tr>
<tr><td>Nonresidential structures</td><td>0.096</td><td>0.097</td><td>0.110</td><td>0.116</td></tr>
<tr><td>Residential structures</td><td>0.102</td><td>0.102</td><td>0.115</td><td>0.122</td></tr>
<tr><td>Inventories</td><td>0.083</td><td>0.083</td><td>0.094</td><td>0.099</td></tr>
<tr><td>Nonfarm land</td><td>0.083</td><td>0.083</td><td>0.094</td><td>0.099</td></tr>
<tr><td>Farm land</td><td>0.083</td><td>0.083</td><td>0.094</td><td>0.099</td></tr>
<tr><td>Noncorporate Businesses</td><td>0.082</td><td colspan="2">0.083</td><td>0.087</td></tr>
<tr><td>Equipment & software</td><td>0.237</td><td colspan="2">0.243</td><td>0.246</td></tr>
<tr><td>Nonresidential structures</td><td>0.064</td><td colspan="2">0.066</td><td>0.069</td></tr>
<tr><td>Residential structures</td><td>0.082</td><td colspan="2">0.082</td><td>0.086</td></tr>
<tr><td>Inventories</td><td>0.065</td><td colspan="2">0.065</td><td>0.071</td></tr>
<tr><td>Nonfarm land</td><td>0.065</td><td colspan="2">0.065</td><td>0.071</td></tr>
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<tr><td colspan="5">Data Source: Gary Robbins, Heritage Center for Data Analysis</td></tr>
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marginal rates of 21.5% or 22% in the phase-out range so long as there is ordinary income subject to the AMT. Why? An added dollar of dividend or capital gains income is taxed directly at 15 cents, even under the AMT, but it also reduces the exempt amount by 25 cents, which raises the AMT on ***other*** AMT income by 6.5 or 7 cents, raising the total tax by 21.5 or 22 cents. But does that mean that the AMT fix is more important for investment than the 15% dividend/capital gains cap extender? No.

Because of the reduced exempt amount, many more people would be subject to the AMT. Some of them would find the AMT marginal rates lower than their ordinary income tax marginal rates, some higher. Some of them would have income in the phase-out range of the AMT exempt amount. For them, the effective marginal tax rate on dividends and capital gains would be 21.5% or 22%, up from 15% under the ordinary income tax. But because of the reduced exempt amount, the phase-out range would shrink, and some people whose income currently puts them in the phase-out range would pass through it and return to statutory AMT tax rates. For them, the effective marginal tax rate on dividends and capital gains would revert to 15%.

Note, too, that even for people under the AMT the 15% cap on dividends and capital gains is an important improvement over prior law. Before the 15% cap, dividends were taxed at 26% or 28% under the ordinary AMT and 32.5% or 35% under the phase-out. Long term gains were taxed at 20% under the ordinary AMT and 26.5% or 27% under the phase-out. The cap drops the rates for both types of income to 15% under the regular AMT and 21.5% or 22% under the phase-out. The new-law AMT rate is higher than under the ordinary income tax, but nonetheless lower than under the old-law AMT before the cap. Put another way, people under the AMT would lose more incentive to invest if the dividend and capital gains cap were to expire

than if the AMT fix were to expire. Of course, their taxes would go up either way, and the AMT is a disincentive to work and earn business income.

Any tax which requires such complicated explanations is a bad tax, and should not exist! But, in a nutshell, the economic damage to saving and investment from the higher AMT would be less than from failure to extend the dividend and capital gains rate cap.

Boiling It Down to Timing

In theory, Congress could wait to extend the 15% cap on the tax rates on dividends and capital gains until next year, or even 2007 or 2008. If it were a sure thing that the next Congress would be willing to extend the provision at that time, the delay would cause no problems. In that case, do the AMT fix now. However, it is by no means certain that the current Congress will be as friendly to the dividend and gains cap idea in the election year of 2006, or that the new Congress will be as favorably inclined after the 2006 elections. Also, Congress would be faced with the need to extend the expiring AMT fix again next year too. Consequently, delaying the dividend and gains cap extension would create concern in the stock markets, and possibly drive them lower, raising the cost of acquiring funds for business fixed investment and reducing the rate of growth of jobs and GDP.

Note that it is also true, in theory, that the Congress could wait until some time in 2006 to extend the AMT fix (retroactive to January 1), because taxpayers would not be filing their final returns for calendar 2006 until April, 2007. Again in theory, Congress could find some spending cuts or bring itself to lower the revenue floor by the spring Budget Resolution to permit the extension. In fact, if the economic recovery continues to exceed government forecasts, the revenue estimates might provide room by then for whichever of the two provisions is not adopted.

The utter silliness of the current budget process is starkly apparent in this impasse. Both provisions are needed, and both will probably be adopted eventually, but the rules imposed by budget reconciliation make it impossible to proceed in a timely manner. Instead, Congress is forced to wait until the last minute for one of the provisions, and the markets are subjected to needless turmoil. Of course, the issue would not have arisen in the first place if the AMT, a tax travesty if there ever was one, had never been enacted. Nor would it have arisen if the 2001 and 2003 tax cuts had been made permanent, as any sensible tax reforms would be, but the Budget Act limits any net tax cut to a ten year time horizon.

Ideally, spending would be cut to make room for both provisions. Unfortunately, Congress has been on a spending binge unmatched in recent history, and shows no sign of curbing its appetite. The second best solution would be to suspend, or better, repeal, the Budget Act of 1974, and all the futile Resolutions and Reconciliations and Omnibuses that go with it. The only resolve that we really need is the resolve of the Congress to go on a diet, or the resolve of the electorate to call them to account. Without either resolve, no Budget Resolution will restrain spending; it will only ratchet up both taxes and spending over time.

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President and Executive Director

Note: Nothing 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 the Congress.