IRET Congressional Advisory

July 13, 1999 No. 84

CUT TAXES ON CAPITAL GAINS AND DIVIDENDS TOO

Representative Bill Archer (R-TX), Chairman of the House Ways and Means Committee, announced that a key element of his tax relief plan this year will be lower capital gains tax rates for individuals. He would cut the top rate from 20% to 15%, and the rate for individuals in the 15% ordinary income tax bracket from 10% to 7.5%. Senator Connie Mack (R-FL) would similarly reduce the capital gains rate, and would extend the same rate reductions to dividends received by individuals. Cutting the capital gains tax would reduce the anti-saving bias in the tax system. The bias could be reduced further by extending similar tax relief to dividends received by individuals and to capital gains and dividends received by corporations.

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Individual capital gains tax rates were last lowered in 1997. At that time, the maximum rate dropped from 28% to 20%, and the rate for individuals in the 15% ordinary income tax bracket dropped from 15% to 10%.[1] There is clear evidence that the 1997 capital gains tax cut benefitted the economy.[2] The 1997 legislation did not lower the tax rate corporations pay on their capital gains (it is still 35% for large corporations).

Although it may appear that the direct beneficiaries of capital gains tax relief are capital owners, most of the total economic benefits go to labor. Workers gain because people are paid according to their productivity, and a lower capital gains tax leads to more capital formation (by reducing the cost of capital) and higher productivity. When investment increases GDP by $1, labor receives almost 50 cents of the added income on an after-tax basis; capital owners receive only about 5 cents, net, after paying taxes and setting aside about 10 cents to replace capital; and federal, state, and local governments take about 35 cents in taxes.

Some opponents of capital gains tax relief would raise the "fairness" issue; the majority of capital gains are taken by upper income taxpayers, although people in all tax brackets report some gains, and stock and small business ownership is much more widespread than a generation ago. Fairness is actually on the side of the tax cut. The tax on capital gains is triple taxation; in fact, it is one of **several** added layers of tax imposed on income that is saved (taxes that are not imposed on income used for consumption). This excess taxation is unfair to savers, and when the result is reduced investment, productivity and wages, it is unfair to workers too. Because the capital gains tax is unfair to begin with, the fairest action would be to eliminate it. If it is not eliminated, it should at least be reduced.

Institute for Research on the Economics of Taxation

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Tax Biases Against Saving

Most income is taxed when first earned (except limited amounts deferred in pension or IRA contributions). If it is used for consumption, it is free of additional federal income taxes. If it is saved, however, the returns on the saving are taxed again, often repeatedly. Personal taxes on returns on bank and bond interest, rent on real estate, and earnings of unincorporated businesses, constitute a second round of taxation — double taxation — of income that is saved. Personal saving invested in corporate stock is also subject to a second round of taxation — the corporate income tax on the corporate earnings on that saving. A third round of income tax — triple taxation — is imposed if the corporation distributes its after-tax income as dividends to individuals. If the corporation retains its after-tax earnings for reinvestment, the resulting increase in the share price constitutes a capital gain, and triggers a third layer of tax on the retained earnings if the shares are sold. Note that corporate dividends and retained earnings are both subject to this added layer of tax. In its latest study of corporate tax integration, the Treasury Department pointed out the advisability of dealing evenhandedly with this excess layer of tax on dividends and capital gains.[3]

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Capital gains may also occur when a business's earnings outlook improves for reasons other than reinvestment. A new product or patent, a rise in sales, anything that would lead to a jump in anticipated income (income that the business has not even received yet) may boost the current valuation of the shares or business. If the higher expected business earnings come to pass, they will be taxed as corporate income and/or personal business or dividend income. To also tax the increase in the current value of the business, either upon sale, gift, or bequest, is to triple-tax the future income.

Additional layers of tax arise if one corporation owns shares in another. Corporations are taxed on the capital gains they receive if they sell shares in another company, and on a portion of any dividends they receive from non-subsidiaries.[4] Shareholders of the receiving corporation then face additional tax as the dividends are passed on to them, and on the gains when they sell their shares in the receiving company.

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If the saving outlives the saver, the federal unified transfer (estate and gift) tax may impose yet another layer of tax on the saving. Every dollar in an estate has already been, or will be, subjected to one or more layers of individual or corporate taxation. Insofar as the transfer tax exceeds the transfer tax credit, the saving is triply or quadruply taxed.

Income that is either tax-deferred in pensions, or free from tax at withdrawal, as in a Roth IRA, escapes one of the layers of multiple taxation. This generally ends the tax bias against saving that earns interest. However, double taxation of corporate income at both the business level and again at the individual level as dividends and capital gains generally remains.

In addition to the federal income and transfer taxes, state and local income, estate, and gift taxes impose multiple layers of tax on saving and its returns. There are property taxes as well. These multiple layers of tax on saving and capital increase the cost of saving, leading to a smaller stock of capital than would otherwise prevail. A smaller capital stock means a lower level of labor

productivity, which means lower real wages, employment, and total income than could otherwise have been achieved.

Tax Rates on Corporate Equity Income Under the Archer and Mack Proposals

The table shows that the combined tax rates imposed by the current corporate and personal income taxes on corporate earnings paid as dividends exceed 60% for some savers, leaving the highest-taxed shareholders less than $0.40 in after-tax return on each dollar of corporate earnings paid as dividends. This would not change under the Archer proposal, but the tax rate on dividends would fall to 44.75% under the Mack plan.

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When earnings are retained, they tend to raise the value of the stock. If a capital gains tax is part of the tax system, there will be a double tax on the retained earnings upon sale of the stock. The tax rate on retained earnings resulting in a long term capital gain reaches 48%. Representative Archer's and Senator Mack's plans would both help in this case. They would cut the total tax rate to 44.75%, leaving the individual investor $0.5525 per dollar of reinvested earnings, up from $0.52 under current law. (Neither plan would lower the tax rate on short term gains. There is no good reason to double-tax short term gains at punitive ordinary tax rates either. Either all gains should receive long-term treatment, or the current one-year holding period should be reduced. Between Jun 23, 1984 and December 31, 1987, the holding period was 6 months.)

Representative Archer and Senator Mack could achieve a greater reduction in the capital gains case by also cutting the corporate capital gains tax rate or by introducing a corporate capital gains received exclusion similar to the dividends received exclusion. The dividends received deduction for corporations should also be increased.

Since a large part of individual saving, especially for retirement, is invested in corporate equities (either through direct ownership of stock or indirectly through mutual funds, pension plans, and annuities), the additional layer of tax on corporate income is particularly hard on the private provision of retirement income.

Integration of Individual and Corporate Taxes

Complete elimination of the additional layer of tax imposed by the corporate income tax could be achieved through the *integration of the corporate and individual income taxes*. Under one method, corporate income would be attributed to

Combined Top Corporate and Individual Tax Rates on Corporate Income			
Dividends		Retained Earnings Resulting in Long Term Capital Gain	
Current	Mack	Current	Archer & Mack
60.74%	44.75%	48%	44.75%
35% corporate rate, 39.6% individual rate	35% corporate rate, 15% individual rate	35% corporate rate, 20% individual rate	35% corporate rate, 15% individual rate

shareholders for tax purposes and taxed at the individual's tax rate, with no tax at the corporate level. Under another, individuals would receive a tax credit for the tax paid by the corporation, and a basis adjustment for retained earnings.[5]

Most countries employ a modified approach to reducing the double taxation. Many allow corporations to deduct dividends paid from the company's taxable income, resulting in a tax on dividends only at the personal income tax level. This still leaves a double tax on retained earnings that raises the value of corporate stock, which most countries lessen through reduced taxation of capital gains.

Senator Mack's added step of reducing the tax on dividends provides a more balanced approach... Either plan would be improved by extending the same relief to corporate capital gains and dividends received.

Conclusion

By reducing the capital gains tax at the individual level, Representative Archer's and Senator Mack's plans would reduce tax penalties on capital formation. That would result in a stronger, more productive economy, boost wages, and improve the competitive position of American businesses in the world marketplace. Senator Mack's added step of reducing the tax on dividends provides a more balanced approach to reducing the double taxation of corporate income, and would further strengthen investment and the economy. Either plan would be improved by extending the same relief to corporate capital gains and dividends received.

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Endnotes

1. The rates are scheduled to drop further to 18% and 9% for assets bought after the year 2000 and held for five or more years.

2. Rep. Archer cites a just-released study done by David Wyss of Standard & Poor's DRI for the American Council on Capital Formation (ACCF). Wyss found that the 1997 tax rate cut reduced the cost of capital and stimulated investment, which raised productivity and boosted people's wages and incomes. The rate cut also encouraged people to realize more of their gains. Wyss estimated that the higher income and the additional realizations generated enough added taxes to pay for the rate cut.

3. Department of the Treasury, *Integration of the Individual and Corporate Income Tax Systems, Taxing Business Income Once*, Washington, D.C., Jan. 6, 1992. In the introduction, p. 13, the study states: "Integration should distort as little as possible the choice between retaining and distributing earnings. The U.S. corporate system discourages the payment of dividends and encourages corporations to retain earnings..." Also see the section entitled "Bias Against Corporate Dividends Distributions", pp. 116-118.

4. Suppose Corporation B owns shares in Corporation A. When Corporation A earns money, it pays tax. Then Corporation B, the recipient, pays tax when it receives a dividend from A or sells its shares in A. Corporation B obtains some relief if it is paid in dividends: the dividends received deduction excludes from tax 70% of inter-corporate dividends. (The exclusion becomes 80% if B owns at least 80% of A and 100% if the companies are affiliated.) Corporation B obtains no relief, though, if it is paid via capital gains; it is then taxed at the full corporate tax rate, which is 35% for large companies. To lessen the multiple taxation of income at the corporate level, the corporate capital gains tax rate should be reduced and/or corporate capital gains realized when one company sells shares in another should qualify for an exclusion analogous to the dividends received deduction. Also, the dividends received deduction should be increased.

5. See Treasury, *op. cit.*, for a full discussion.

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.