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Clinton's Start-up Capital Gains Proposal: Build It Up or Shut It Down

President Clinton has proposed a targeted capital gains exclusion for taxpayers who buy newly-issued small business stock and hold it for at least five years. The proposal has so many limitations that it would do very little to generate growth and jobs. It is entirely inadequate to remedy the sharp bias of the tax system against equity financing of investment. It should be expanded to eliminate or reduce the multiple layers of taxation now imposed on capital formation.

Under the Clinton plan, investors who buy original issue stock of a qualified "start-up" small business (either directly or through investment partnerships) and hold the stock for at least five years would be permitted to exclude 50 percent of gains realized on the sale of the stock. The amount of gains that might be excluded would be limited to the greater of ten times the investor's basis in the stock or $1 million for each qualified small business.

Treasury's "Summary of the Administration's Revenue Proposals" defines "qualified small business" as a Subchapter C corporation with less than $25 million of aggregate capitalization from January 1, 1993, through the date the taxpayer acquires the stock, and that uses the assets in the conduct of a trade or business. (Personal service, banking, leasing, real estate, farming, mineral extraction, and hospitality businesses would not be qualified small businesses.) To avoid abuse, the proposal would prohibit large firms from obtaining the exclusion by spinning off subsidiaries, and forbid redeeming outstanding shares to reissue new qualified small business stock.

The venture capital industry and the small business community have been urging the President to expand his program at least to cover firms with $50 million of capitalization. Even this doubling of coverage would scarcely begin to redress the problem of overtaxation of capital income. The holding period is another problem. The tax code should not try to force people to hold shares longer than they would like. It makes the shares less attractive and raises the cost of capital to the firms.

The Treasury tries to justify aiming the proposal at small businesses because "small businesses are important to economic growth and job creation in this country... future competitiveness... [and] investments in innovation and growth". But so are large businesses. It is vital to reduce the tax element of the cost of capital for medium and large corporations as well as small firms and non-corporate businesses. Small businesses have created a large percentage of new jobs in recent years, but this is due in part to overtaxation of the corporate sector. Job growth will not be rapid if the country's major firms stagnate.

The real reasons for targeting the exclusion to small businesses are money and politics. Clinton thinks that a broad-based capital gains exclusion would be expensive, and his fairness rhetoric has blasted capital gains exclusions as unfair give-aways to the rich. Both charges are nonsense.

A significant cut in the capital gains tax rate with a short holding period would induce millions of shareholders to realize existing capital gains. Treasury revenue estimators have concluded that this "unlocking effect" would recover all of the static revenue loss over the short term federal budget period. The Congressional Budget Office and Joint Tax Committee project a revenue loss. History supports Treasury. After the 40% hike in the maximum capital gains rate from 20% to 28% in the Tax Reform Act of 1986,

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capital gains realizations began to slide. Nominal gains realizations were $173 billion in 1985, before the reform. By 1991, they had fallen to $108 billion. This decline reduced the amount of gains appearing in taxable income by 50% in real terms, meaning that Treasury is collecting less real revenue from the tax today than it did when the rate was higher.

Furthermore, neither Treasury nor CBO estimates include the effect of higher stock prices on the amount of gains to be realized, nor payroll and income tax increases from additional GDP growth due to the lower tax burden on capital.

More importantly, however, the revenue concern fails to address the important principal of having a non-biased tax system. The net cost to the Treasury of even a complete elimination of the capital gains tax would be minor -- less than 0.5% of GDP before growth considerations. Meanwhile, the ongoing cost to the economy of the current law tax bias against capital income is far larger.

The fairness issue is likewise nonsense. The real fairness issue is that the capital gains tax is multiple taxation to begin with. The entire tax is unfair, both to savers and investors who bear the tax directly, and to workers who suffer the loss of productivity and real wage rate gains from the reduced capital formation caused by the tax. The right tax rate for capital gains is zero.

Taxation of capital gains is an added layer of taxation of over-taxed capital income. Generally, income is taxed when first earned. If it is used for consumption, it is largely free of further federal taxes. If it is saved, however, the returns on the saving are taxed again. Personal taxes on interest and earnings of unincorporated businesses constitute a second round of taxation — double taxation — of saved income. Personal saving invested in corporate ownership is also subject to a second round of taxation — the corporate income tax on the corporate earnings on the saving. A third round of income tax — triple taxation — is imposed if the corporation pays out its after-tax income as dividends to individuals. If the corporation retains its after-tax earnings for reinvestment, raising the value of the business, the resulting increase in the share price is a capital gain, resulting in a third layer of tax on the retained earnings if the shares are sold.

Capital gains also occur when a business's earnings outlook improves for reasons other than reinvestment of retained earnings. The firm may develop an attractive new product, or business conditions may improve beyond previous expectations. Any 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 tax as well the increase in the current value of the business, upon sale, gift, or bequest, is to triple-tax the income.

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. The entire population is injured.

Clearly, the tax rates imposed by the multiple taxation of capital gains and dividends have reached punitive levels. The combined personal and corporate tax rates exceed 50% for many savers, and could exceed 60% on dividends under the Clinton tax proposals. (See table.) Something must be done to remove capital gains and dividends in whole or in part from the tax base, especially if Clinton's higher proposed tax rates are enacted. Reducing or eliminating the capital gains tax and curbing the multiple taxation of dividends would reduce the tax penalties on capital formation and thereby improve the competitive position of U.S. businesses in the world market place.

Reducing the multiple tax. Treasury has acknowledged the multiple tax nature of the capital gains levy. In its recommendation for integrating individual and corporate income taxes ("Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once", Jan. 6, 1992, p.24, revised Dec. 11, 1992), Treasury recommends treating retained earnings as a non-taxable "dividend" to the shareholder that was "reinvested" by the firm. The shareholder's

tax basis "would be increased by the amount of the deemed dividend, ensuring that the shareholder would not be taxed on appreciation due to retained fully-taxed earnings when the stock is sold."

Alternative: consumption-based income tax treatment. In a consumption-based income tax, such as proposed by The Strengthening of America Commission or described in Treasury's *Blueprints for Basic Tax Reform*, capital gains and losses would not be separately computed nor receive special tax treatment. The entire proceeds from sale of a financial asset or piece of property would be part of taxable income **because the amount of the purchase of the financial asset or property would have been allowed as a tax deduction at the time of the purchase**, resulting in a zero tax basis. Furthermore, if the proceeds were saved (rolled over or "reinvested"), they would be immediately re-deducted, postponing the tax until the proceeds were ultimately realized for consumption. Unless all saving is given this treatment, akin to that given saving in an IRA, the correct rate of tax for capital gains is zero.

Conclusion. The targeted capital gains exclusion is yet another instance in which Clinton indulges in a symbolic fairness gesture with the substantive result of injury to his stated growth objective. Miserly targeted proposals are inadequate to the task of spurring substantial growth of investment and employment. Correcting the tax bias against saving in the current tax code to improve the climate for capital formation would involve, among other changes, the complete elimination of the capital gains tax.

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The multiple taxation of corporate earnings, under current law and Clinton tax rates

	a) dividend payout		b) retained earnings:	
	current	Clinton	current	Clinton
Corporate income	$1.00	$1.00	$1.00	$1.00
Corporate tax rate	$0.34	$0.36	$0.34	$0.36
After-tax income a) paid as dividend or b) retained, raising stock price	$0.66	$0.64	$0.66	$0.64
Tax at top rate on dividends, 31% (current law) or 39.6% (Clinton)	$0.205	$0.253	---	---
Tax at top rate on retained earnings taken as capital gain, 28%	---	---	$0.185	$0.179
Total tax	$0.545	$0.613	$0.525	$0.539
Total tax rate	54.5%	61.3%	52.5%	53.9%

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.