

National Small Business Network

WRITTEN STATEMENT FOR THE RECORD

US SENATE

COMMITTEE ON FINANCE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

JOINT HEARING ON

TAX REFORM AND THE TAX TREATMENT OF CAPITAL GAINS

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As Congress considers the issues and alternatives for changing the tax treatment on capital gains we would encourage the Committees to consider three major structural changes that would both increase domestic private economic investment and job growth, and increase tax revenue.

As indicated in the excellent Joint Committee on Taxation "Present Law and Background Information" report for the committees, the Congress has varied the minimum holding period and level of tax rate reduction for long-term capital gains over time, and for different types of assets. The maximum "long term" capital gains tax rate on most assets is currently only 15%. This is less than half of the 35% current maximum tax rate on regular income even without the additional 15% payroll or Self Employment taxes on wage earnings. The tax code also provides other special rules which reduce effective taxation on capital gains including the ability to shift or delay income by not recognizing gain until the date of sale, or delay recognition of gain through Sec. 1231 like kind exchanges. Capital gains on many assets also escape income taxation entirely when they become part of estates, or as a result of special exemptions on certain assets such as personal residences.

As a result of the many tax advantages there is a strong tax incentive to create income through speculative investment which could result in a capital gain, rather than working for wages and business income or making interest bearing investments. Many compensation agreements for higher income workers are even structured to reduce regular income in favor of capital gains from stock options or "carried interest" treatment for investment partnership principals.

The capital gains tax provisions are highly regressive, with most of the tax benefit going to the top 1% of tax payers who receive 71% of all capital gains based on Urban-Brookings Tax Policy Center research. The top 1 tenth of 1% alone receives 47% of all long term capital gains. This has been a major factor in shifting after-tax income and wealth from the middle class to the top 1% of the population who now earn over 22% of all income and control 45% of all financial assets. This concentration of after-tax income in the top 1% of tax payers has reduced general economic growth because the wealthy spend a much smaller percentage of their after-tax income on consumption, reducing the average economic multiplier.

Unless the Congress extends the temporary 2001 and 2003 tax reductions the maximum rate on most long term capital gains will revert to 20% and the maximum rate on regular income will revert to 39.6%. In addition, new legislation will increase the tax rate on net investment income, including capital gains for taxpayers with joint AGI over \$250,000, by 3.8%. The 2013 re-imposition of the "Pease limitation" on itemized deductions will also add an additional effective tax rate of about 1.2% on capital gains and other income for higher income taxpayers. Special tax rates will continue to apply to specific assets such as collectables, Sec 1250 gain, qualified small business stock, and specific targeted investment zones. Even with these changes which would result in about a 25% effective Federal tax rate on most capital gains it would still only be about half of the maximum tax rate on regular income. IRS statistics for 2007 show about \$873 Billion in reported long term capital gains, so these lower rates are a very large annual tax expenditure. The tax expenditure resulting from lower rates has been justified primarily as an incentive for capital investment, and a way to compensate for inflation over the investment period, but research indicates neither justification is valid. Like any other tax reduction, lower capital gains rates do provide some short term stimulus to the private economy, but 9 years of experience indicates the high tax

expenditure cost is not efficient in building sustainable economic growth, or causing an increase of offsetting tax revenue from general economic growth.

Most economic research has also found no positive correlation between lower capital gains tax rates and general economic growth. There are several reasons for this. Most of the tax expenditure benefit goes to gains on speculative secondary market transactions such as traded stocks or existing real property which can produce gains or losses between individual traders, but provides no new actual capital for a business to use for growth or construction. On average, over the last 5 years, there has only been about \$250B in annual IPO and secondary offerings of large business stock, while \$33 Trillion was traded annually. That means that 99% of those capital transactions were speculative and only 1% was new investment to help grow a business. Although secondary stock trading re-distributes wealth, it is no more effective in promoting general economic growth than gambling in Las Vegas. Too much incentive to seek quick capital gains versus regular business income encourages excessive speculation and risk taking which leads to “boom and bust” economic cycles, such as we recently experienced. Most investments in small businesses are direct investments that create new jobs and economic growth, though with a much higher risk of failure and investment loss.

A significant percentage of the tax expenditure cost under current law also goes to investments in foreign stocks, foreign bonds, and foreign asset mutual funds which may benefit foreign business, foreign workers, and foreign economies with US tax expenditures. And, almost by definition, most of the tax benefit of lower capital gains rates goes to wealthier individuals, since you can't have significant capital gains without the capital to purchase investment assets. The economic multiplier of income received by wealthy individuals is lower than for other taxpayers because a larger proportion of it is reinvested, often in tax advantaged investments, and less is spent on consumption which benefits the broader economy.

With our continuing projected budget deficits, and a sovereign debt that now exceeds 100% of our Gross National Product, and 6.5 times total annual tax revenues, any tax expenditures to encourage investment need to be much more carefully targeted to produce sustainable economic growth. Why should tax policy reward a wealthy stock trader who spent a few minutes buying a block of stock, perhaps in a foreign company, with a 15% tax rate on income, when we tax small business owners, who create most net new jobs, and the employees who help make the business successful, with a tax rate that is twice as high, plus additional payroll taxes?

To reduce total tax expenditure costs, and at the same time improve the tax incentives for true long term direct domestic investment in starting and growing businesses and building the economic infrastructure the economy needs, we suggest three changes in the taxation of long term capital gains.

1. Encourage stable long term capital investment by adjusting the calculated long term gain or loss on assets held more than 2 years to remove the negative effect of cumulative inflation and reflect the true constant dollar value of the gain.

The investments America needs to build a sustainable economy by starting or growing a business, building buildings, or building business infrastructure, are not 366 day investments. These true long term

investments may not provide a capital return for 10, 20, 30, or 40 years or longer. But, the current tax code progressively penalizes investments held more than 366 days because of failure to compensate for monetary inflation over the investment life. Where the asset is a business, this short tax incentive peak encourages the owners to focus on short term “paper” profitability and the potential for resale, rather than long term growth and sustainability. The rate structure also encourages financial speculators to purchase and disassemble asset rich businesses to get capital gains on the components, rather than operating and growing the business.

Almost all other value comparisons that extend over long periods such as economic statistics and government budgets, and other tax provisions, are usually adjusted to remove the effect of inflation. But, the current calculation of a long term capital gain is not inflation adjusted, and that is a problem. Compensating for inflation distortion was a major part of the justification for having a lower tax rates on capital gains, but this is a classic case where a “one size fits all” approach does not work. To illustrate the progressive disincentive of the “one size fits all” approach for long term investment under current law, look at the real, after inflation, return and effective tax rate on a sample investment. Assume a business was started, or an asset was purchased, for \$1M in 1962 and held for periods of 2 to 50 years before being sold for \$2M. The taxable gain in each case is \$1M and the true constant dollar value of the gain from the year of investment is calculated using US Bureau of Labor Statistics CPI Inflation data.

Holding Period.	Capital Gains tax at 15% current rate.	Actual Constant Dollar value of gain after inflation.	Effective Tax Rate on real gain at a 15% code rate.	Capital Gains Tax at a 28% rate.	Actual Constant Dollar value of gain after inflation.	Effective Tax Rate on real gain at a 28% code rate.
2 years	\$150,000	\$948,800	15.8%	\$280,000	\$948,000	29.5%
5 years	\$150,000	\$902,200	16.6%	\$280,000	\$902,200	31%
10 years	\$150,000	\$782,800	19.2%	\$280,000	\$782,800	35.8%
20 years	\$150,000	\$610,050	24.6%	\$280,000	\$610,050	45.9%
30 years	\$150,000	\$419,900	35.7%	\$280,000	\$419,900	66.7%
40 years	\$150,000	\$181,900	82.5%	\$280,000	\$181,900	154%
50 years	\$150,000	\$131,400	114.2%	\$280,000	\$131,400	213%

Having a single, and very large, tax rate differential that provides a maximum tax benefit at 366 days is most likely to encourage investment in highly liquid marketable securities such as traded stocks, rather than in slow recovery investments like starting a business. The reduced “long term” capital gains rate on assets

held for only one year greatly exceeds the loss of value from inflation, but for real long term investments in a business or building held for 20 to 50 years, it is grossly inadequate to offset the loss of value from inflation. Although inflation is only 2% to 4% currently, the fact that the Federal Reserve is increasing the money supply 8 to 10 times faster than real economic growth may result in far higher inflation again in the near future. As shown by the two tax rates above, any increase in the capital gains tax rate multiplies the effect of inflation distortion and results in totally unreasonable effective tax rates on stable long term investments, such as small and midsize businesses.

Rather than the current illogical “one size fits all” approach, which favors certain investments and certain types of investors over others, a simple adjustment of the gain for inflation since the year of purchase would result in an accurate and equitable reflection of real economic gain regardless of the asset type. Calculation of the adjustment would be simple, requiring only a single multiplication using existing federal data on the cumulative inflation change from the year of purchase to the year of sale, and should apply to all capital gains transactions, including secondary market trading held for more than two years. The inflation adjustment should also apply to capital gains for all taxpayer entities.

2. Allow the 2003 Tax Relief Reconciliation Act reduced rates on capital gains to expire as scheduled on 12-31-2012. Then, assuming that the code is changed to adjust gains for inflation, gradually reduce the rate difference between most “long term capital gains” and regular income by increasing the long term capital gains rate by 3% per year for 3 years up to the lesser of 29%, or the taxpayers highest marginal tax rate. With the additional PPACA tax, this would increase the maximum tax rate on capital gains to about 34% for high income individuals, but the limitation to the highest normal tax rate would reduce the rate on small capital gains for lower income taxpayers. We also suggest that the holding period for long term capital gains be changed to 2 years, and that when the higher capital gains rates are in effect, that the same provisions be adopted in the Alternative Minimum Tax code to reduce tax complexity. The “carried interest” treatment of equity fund manager income should also be repealed.

3. Provide additional targeted tax incentives for capital investment in the form of lower rates on gains, or other tax incentives, only for qualified direct investments in a business. Direct investments would include direct purchases of newly issued corporate stock or other new equity investment in a corporation, partnership, or sole proprietorship business, or purchase of at least a 10% ownership interest in a business. Additional incentives could be targeted to economically disadvantaged areas, or specific economic sectors that Congress determines to need strategic investment incentives. These incentives should not apply to secondary transactions such as sales of traded stocks or sales of existing physical assets between individuals or organizations which do not result in a net direct increase of capital equity in a business or property. The limitation of tax incentives to direct business investment has the greatest potential economic benefit in relation the cost of any tax expenditure. The limitation to direct equity investments will also result in most of the tax expenditure cost benefiting US business activity, because of the much lower probability of American investors making direct capital investments in foreign based businesses.

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