

Capital Income by Tax Treatment

By Benjamin H. Harris

Capital income is subject to a wide variation in treatment under the tax code. Certain financial income, such as long-term capital gains and qualified dividends, is taxed at preferential rates. Other financial income, including certain interest income, short-term capital gains, and nonqualified dividends, is taxed as ordinary income. Income accrued within qualified defined-contribution retirement saving accounts is tax-free. Capital income derived from business passthrough income, such as that reported on Schedules C, E, and F, is taxed as ordinary income, although a substantial portion of that income is excluded by various tax preferences. Lastly, tax-exempt interest income is untaxed under the federal tax code, although recipients pay an implicit tax in the form of a reduced pretax return.

The first section of the table below displays the mean capital income received by asset type and income percentile. Not surprisingly, taxpayers in the bottom three quintiles receive little capital income relative to those with high incomes. Taxpayers in the top quintile receive the vast majority of the capital income from all the asset types.

The second section of the table displays the distribution of capital income by asset type within each income class. The bottom quintile is skewed by the receipt of negative income from Schedules C, E, and F, but it's clear that taxpayers at the bottom receive a relatively large share of their positive capital income from fully-taxable assets and relatively little capital income from defined-contribution accounts. In contrast, taxpayers in the top quintile receive a relatively high share of their capital income from tax favored sources, although those in the top 1 percent receive a lower than average share of income from retirement accounts.

Selected Capital Income by Tax Treatment, 2012 ^a						
Cash Income Percentile ^a	Tax-Preferred Capital Income	Fully-Taxable Capital Income	Returns to Defined-Contribution Accounts	Portion of Schedules C, E, and F Income ^b	Tax-Exempt Interest Income	All Capital Income
Mean Income						
Lowest Quintile	\$283	\$416	\$25	-\$207	\$19	\$537
Second Quintile	\$270	\$683	\$148	\$151	\$18	\$1,271
Middle Quintile	\$479	\$1,127	\$537	\$173	\$45	\$2,362
Fourth Quintile	\$1,277	\$2,304	\$2,432	\$263	\$197	\$6,473
Top Quintile	\$24,200	\$16,114	\$28,060	\$4,101	\$3,565	\$76,040
All	\$5,302	\$4,129	\$6,241	\$896	\$769	\$17,337
Top 1 Percent	\$332,049	\$169,345	\$226,252	\$47,139	\$42,386	\$817,172
Top 0.1 Percent	\$2,179,584	\$954,934	\$1,019,349	\$219,553	\$210,420	\$4,583,840
Composition Within Each Income Class						
Lowest Quintile	52.8%	77.5%	4.7%	-38.6%	3.6%	100.0%
Second Quintile	21.3%	53.7%	11.6%	11.9%	1.4%	100.0%
Middle Quintile	20.3%	47.7%	22.8%	7.3%	1.9%	100.0%
Fourth Quintile	19.7%	35.6%	37.6%	4.1%	3.0%	100.0%
Top Quintile	31.8%	21.2%	36.9%	5.4%	4.7%	100.0%
All	30.6%	23.8%	36.0%	5.2%	4.4%	100.0%
Top 1 Percent	40.6%	20.7%	27.7%	5.8%	5.2%	100.0%
Top 0.1 Percent	47.5%	20.8%	22.2%	4.8%	4.6%	100.0%

^aSource: Urban-Brookings Tax Policy Center Microsimulation Model.
^bBased on the proportions of corporate sector output reported as corporate profits and labor compensation in the National Income and Product Accounts, I assign 20.8 percent of passthrough income to capital.