

**Taxing Capital Income Once<sup>\*</sup>**  
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## ***Summary***

The President recently proposed to eliminate the double taxation of corporate income. The proposal contains the germ of a good idea, but it is incomplete. Indeed, implementing it as is would be undesirable for several reasons: it would add to our burgeoning national debt and thus reduce economic growth, it would be highly regressive, and it would have little or no effect on the epidemic of corporate tax shelters—a growing phenomenon that is both inefficient and unfair. This paper proposes to address all of these deficiencies by coupling the Administration's proposal with full taxation of capital gains upon realization. The proposal would be revenue neutral, progressive, and would do more to improve the allocation of capital than the Administration's proposal.

## ***Introduction***

The Bush Administration has proposed, as the centerpiece of its economic stimulus plan, to eliminate the double taxation of corporate income. Corporate tax integration, as tax experts call it, is a good idea. The double-taxation of corporate income penalizes investments made in corporate form, encourages companies to take on too much debt, and discourages profitable companies from disbursing their cash to investors who might have better uses for the money.<sup>1</sup> Economists disagree about how serious these problems are, but most agree that double taxation is unproductive.

Nonetheless, many economists and commentators have been unenthusiastic about the President's proposal. They argue that this is just another tax cut for the rich and that it could actually damage the economy in the long run by adding \$370 billion over the next decade to burgeoning budget deficits.

These views are not as irreconcilable as they may seem. Taxing business income once—the subtitle of an excellent 1992 Treasury report produced under the direction of current CEA chair Glenn Hubbard—would make the economy work better and should not add to our budget woes. (US Treasury 1992) Indeed, Hubbard's Treasury proposed a different version of integration that would have paid for itself.<sup>2</sup> But the 2003 Hubbard proposal would not result in business income being taxed once. In many cases, business income would be partially taxed or untaxed altogether. The consequence is that many suspect that the goal is not corporate tax integration, but corporate tax disintegration.

There are many reasons that income from capital can escape tax. At the corporate level, much income is lightly taxed or untaxed because of special tax breaks for particular industries or particular kinds of activities, or because corporations engineer transactions to reduce or eliminate tax—so-called corporate tax shelters. At the individual level, roughly half of dividends received

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<sup>1</sup> Esenwein and Gravelle (2003) and Gale and Orszag (2003) for a discussion.

<sup>2</sup> The Comprehensive Business Income Tax (CBIT) would have effectively paid for integration by eliminating corporate tax preferences.

by shareholders is untaxed in the US because the shareholders are pension funds, tax-exempt entities, or foreign investors. (Gale 2002)

But the biggest tax break on capital is the preferential taxation of capital gains. Capital gains on assets held for more than one year are taxed at much lower rates than other income. They are not taxed at all on assets held until death or donated to charity, and most home sales are also tax-exempt. Sales of small business stock get special treatment, as do gifts. All told, capital gains tax preferences cost the Treasury as much as \$120 billion in 2003 according to the Joint Committee on Taxation.<sup>3</sup> This is 6 times the revenue estimate for dividend relief in 2003 (\$20 billion), suggesting that capital gains tax breaks are worth many times as much to investors as double taxation costs.

Moreover, the most compelling argument for lower capital gains tax rates on corporate stocks is as an offset to double taxation.<sup>4</sup> If double taxation were eliminated, as under the administration's proposal, there would be no good reason to retain a tax preference for capital gains. Thus, a natural alternative would be to combine relief from double taxation with full taxation of capital gains that have not been taxed at the corporate level. This note considers the effect of modifying the Administration's proposal to also eliminate the preferential tax rates on capital gains.<sup>5</sup> In contrast to the Administration's proposal, this option would be fiscally responsible, broadly progressive, and would improve the odds that capital income is taxed once.

## **The Proposal**

The proposal would start with the dividend relief proposal put forward by the Administration. Dividends and capital gains realized on corporate stock would be tax-free to the extent that the underlying income had already been fully taxed at the company level. Under the modified proposal, any capital gains over and above the tax-free amount would be fully taxable as ordinary income, rather than taxed at the special low rates in place for capital gains.<sup>6</sup> In addition, capital gains on other assets such as real estate, bonds, precious metals, and unincorporated businesses would be fully taxed. This is appropriate because only corporate income is subject to double taxation.

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<sup>3</sup> Joint Committee on Taxation (2002). This estimate is the sum of the four largest capital gains related tax expenditures: preferential capital gains tax rates (\$65 billion), step-up in basis at death (\$37 billion), exclusion of gain on home sales (\$14 billion), and carryover basis on gifts (\$4 billion). There may be interactions among these estimates that would make the combined tax expenditure greater or less than the sum of the individual estimates.

<sup>4</sup> There are, however, numerous bad arguments for a capital gains tax preference, which are disposed of in Burman (1999).

<sup>5</sup> It would not address the other capital gains loopholes, although they could be added to a more comprehensive solution. Gale and Orszag (2003) discuss the requirements for a comprehensive solution to the uneven taxation of income from capital.

<sup>6</sup> Capital gains on assets held for longer than one year are subject to a tax rate of 20 percent for investors in the 27 percent and higher tax brackets, and a rate of 10 percent for investors in the two lowest tax brackets. Even lower tax rates (18 percent and 8 percent) apply to certain assets held for at least 5 years, although the 18 percent rate only applies to assets purchased after 2000 and so has not yet been applied to any sales.

Some may object that this option would amount to a tax increase on old capital gains, including gains that accrued on corporate stock before the new regime takes effect. But this retroactive tax increase is no more or less appropriate than the retroactive windfall conveyed by the double-taxation relief proposal. The Administration's proposal would create a substantial windfall for current owners of corporate stock, both because share prices are likely to rise somewhat and future dividends and capital gains become tax-exempt. In fact, taxation of "old capital"—the result of past investment decisions that can't be changed—is economically efficient in the sense that the tax cannot distort decisions already made. For the same reason, the subsidy to old capital conveyed by the Administration's proposal sacrifices tax revenue while producing no direct gain or loss for the economy. If the retroactive tax due to the capital gains provision and/or the retroactive windfall arising from the double taxation regime are considered inequitable, the rules could be modified to be prospective, applying only to assets purchased after the date of enactment. This would tend to reduce the short-term revenue gains and losses, but the long run effects would be identical.

**Table 1. Revenue Cost and Distribution of Tax Cuts  
From Dividend Relief Options in 2003**

Proposal	President's Proposal		President's Proposal plus Tax Capital Gains	
Revenue cost (2003-2013) <sup>1</sup>	383		-94	
	Average Tax Cut in 2003			
AGI Class (\$1,000)	Dollars	% of Income	Dollars	% of Income
Less than 10	1	*	1	*
10-20	7	*	5	*
20-30	17	0.1	12	*
30-40	29	0.1	17	*
40-50	51	0.1	26	0.1
50-75	82	0.1	35	0.1
75-100	151	0.2	46	0.1
100-200	458	0.4	80	0.1
200-500	1,766	0.8	-655	-0.3
500-1,000	4,535	0.9	-8,547	-1.7
More than 1,000	27,701	1.2	-119,174	-5.3
All Returns	160	0.4	-219	-0.5

Source: Tax Policy Center Microsimulation Tax Model

\* Less than 0.05 percent.

<sup>1</sup>Cost is shown for fiscal years 2003-2013 to be comparable with Administration estimates.

Taxing capital gains, other than exempt corporate capital gains, at the same time that double taxation is eliminated totally changes the nature of the proposal. The Tax Policy Center estimates that the dividend exemption by itself costs \$383 billion from 2003-2013 (\$370 billion by Treasury estimates). (See Table 1.) By comparison, taxing capital gains at the same time

turns the package into a revenue raiser: the combined proposal would raise \$94 billion over the same period. In calendar year 2003, the President's dividend relief proposal would cost \$21 billion by our estimates, but adding taxation of capital gains would raise \$29 billion.

Taxpayers with incomes under \$200,000 would receive a small tax cut on average under the proposal, because they tend to have more dividends than capital gains. This includes many of the elderly people who would benefit from the President's double taxation relief proposal. But taxpayers with higher incomes tend to have much more capital gains than dividends. They pay substantially higher tax than under current law. Taxpayers with incomes over \$1 million would pay an average of \$119,174 more in tax if dividend relief plus capital gains taxation is enacted than under current law. In contrast, they would receive an average tax cut of \$27,701 if dividend exemption alone were enacted. In other words, the capital gains tax break that they would lose is worth more than five times as much as the relief from double taxation that they would gain.

If capital gains taxation were added to the entire stimulus package, it would reduce its overall cost by more than half, from \$700 billion to \$283 billion over the budget period.<sup>7</sup> (See Table 2.) Taxpayers in every income bracket except the very top would still receive a tax cut under the more fiscally responsible alternative. In 2003, taxpayers with incomes under \$100,000 would receive almost as large a tax cut as under the President's proposal. However, taxpayers with incomes over \$200,000 would see their tax cut significantly curtailed, and those with incomes over \$1 million would face an average tax increase of \$26,774 under the modified stimulus package, compared with a tax cut of \$90,222 under the President's plan.

In 2010, dividend relief and the stimulus plan are nearly the same thing, because most of the other provisions are simply accelerations of provisions already enacted in 2001. In calendar year 2010, the dividend relief proposal costs \$46 billion. Adding capital gains taxation reduces the cost to \$5 billion. If EGTRRA expires after 2010 as scheduled, the augmented proposal will start to raise revenue again starting in 2011, because taxing capital gains at full rates would raise much more revenue at a top tax rate of 39.6 percent, in effect starting in 2011, than at a rate of 35 percent, in effect in 2010. Thus, adding capital gains to the Administration's proposal would not exacerbate budget deficits outside of the budget window, whereas the original proposal would add increasing amounts to the debt as the retirement of baby boomers is putting growing pressure on the budget.

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<sup>7</sup> Other elements of the stimulus package include acceleration of major elements of the 2001 tax legislation, including reduction in marginal tax rates, the increase in the size of the 10-percent and 15-percent tax brackets, increase in the standard deduction for joint returns, and the increase in the child tax credit. In addition, the package would triple the limit for expensing for small businesses, raise the income levels at which expensing applies, and index the income thresholds. The expensing provision, which would cost \$16 billion over the budget period, and a small nontax provision aimed at spurring employment, are not included in our estimates or distribution tables.

**Table 2. 11-Year Cost and  
Distribution of Stimulus Package Options in 2003**

Proposal	Stimulus Package			Stimulus Package Plus Tax Capital Gains		
11-year revenue cost <sup>1</sup>	700			283		
AGI Class (\$1,000)	Average Tax Cut		Percent of Total Income Tax Change	Average Tax Cut		Percent of Total Income Tax Change
	Dollars	% of Income		Dollars	% of Income	
Less than 10	3	*	0.1	3	0.0	0.1
10-20	58	0.4	1.2	57	0.4	1.8
20-30	196	0.8	3.2	192	0.8	4.9
30-40	339	1.0	4.1	328	1.0	6.1
40-50	469	1.1	4.3	448	1.1	6.4
50-75	780	1.4	12.4	742	1.3	18.3
75-100	1,738	2.2	15.8	1,656	2.1	23.4
100-200	2,661	2.3	23.4	2,362	2.0	32.3
200-500	5,300	2.3	11.2	3,370	1.5	11.1
500-1,000	16,831	3.3	6.2	6,692	1.3	3.9
More than 1,000	90,222	4.0	18.1	-26,774	-1.2	-8.4
All Returns	843	1.9	100.0	542	1.2	100.0

Source: Tax Policy Center Microsimulation Tax Model

\* Less than 0.05 percent.

<sup>1</sup>Cost is for fiscal years 2003-2013, as presented by the Administration in its revenue table. Revenue estimates are based on TPC model, except for the small business expensing provision, where we use Administration estimate.

Table 3 shows the effect of taxing capital gains on the distribution of tax benefits in 2010. The augmented proposal would be much less regressive than the original. Taxpayers in every income class except the very top would receive a tax cut. Unlike in 2003, people with incomes between \$200,000 and \$1 million would receive a net tax cut on average. That is because the benefits of double taxation relief grow over time, both because more tax-free dividends are paid out and more gains on corporate stock are untaxed. The only net losers, compared with current law, are those with incomes over \$1 million who would pay \$97,000 more tax than under the Administration's plan.

**Table 3. Average Tax Cut Under  
Dividend Relief Options in 2010**

<b>Proposal</b> <b>AGI Class (\$1,000)</b>	<b>President's Proposal</b>		<b>President's Proposal Plus Tax Capital Gains</b>	
	<b>Dollars</b>	<b>% of Income</b>	<b>Dollars</b>	<b>% of Income</b>
<b>Less than 10</b>	3	*	3	*
<b>10-20</b>	12	0.1	11	0.1
<b>20-30</b>	26	0.1	22	0.1
<b>30-40</b>	49	0.1	38	0.1
<b>40-50</b>	87	0.2	64	0.1
<b>50-75</b>	145	0.2	97	0.1
<b>75-100</b>	252	0.3	144	0.2
<b>100-200</b>	753	0.6	507	0.4
<b>200-500</b>	2,940	1.1	1,431	0.5
<b>500-1,000</b>	7,681	1.2	237	*
<b>More than 1,000</b>	53,200	1.9	-43,732	-1.6
<b>All Returns</b>	313	0.5	37	0.1

Source: Tax Policy Center Microsimulation Tax Model

\* Less than 0.05 percent.

The revenue estimates shown do not account for any change in capital gains realization behavior, which could reduce the revenue raised from taxing capital gains. In theory, taxpayers should be less inclined to sell assets because the higher tax rate will exacerbate the “lock-in effect.” This behavioral response is likely to be small for two reasons. First, empirical evidence suggests that the lock-in effect is likely to be modest. Estimates by Burman and Randolph (2000) suggest that an increase of the top tax rate from 20 percent to 35 percent would reduce capital gains realizations by about 15 percent.<sup>8</sup> Second, corporate stock is more sensitive to taxation than most assets because the transaction costs of selling stock are extremely low. (Burman 1999) Capital gains that arise from retained earnings that have been fully taxed are tax-exempt under this proposal. Thus, it is unlikely that it would result in substantially more capital gains tax upon sale of stock than would occur under current law. The overall response might be only half as large for illiquid assets such as real estate, which will constitute a much larger share of capital gains under this proposal. Thus, the revenue offset is likely to be small—much less than 15 percent of the static revenue gained. That would make the dividend relief plus capital gains option at least revenue neutral over ten years. The complete stimulus package would cost only about half as much with the capital gains tax offset as what the President proposed.

There is a risk that the revenue cost of both the President’s proposal and the proposal as augmented by taxation of capital gains could be much larger than projected because it would unleash an epidemic of new tax shelters. For example, whenever income is tax-exempt but losses are deductible, the losses can be used to shelter other income from tax. Clever tax

<sup>8</sup> That paper, like many others, also found that the estimated response was not statistically significant: no behavioral response was consistent with the data, as well as a response twice as large.

planners will try to figure out ways to produce offsetting income and losses, distribute the income as dividends and convert the offsetting losses into noncorporate losses that can be used to shelter other income. Those designing the tax proposal will try to anticipate those schemes and prevent them. The growth of the corporate tax shelter industry over the past decade is not encouraging in handicapping this contest.

It should be noted, however, that fully taxing capital gains would provide a powerful brake against tax shelters. A simple, common, and highly profitable tax shelter strategy is to convert ordinary income, which is fully taxed, into capital gains, which are taxed at lower rates. Eliminating the preferential rates on capital gains will not totally eliminate the benefits from that strategy, since capital gains may still be deferred indefinitely and avoided altogether if an asset is held until death.<sup>9</sup> But it will make such schemes less profitable in many cases.

## Discussion

The alternative presented here is both fiscally more responsible and also more progressive than the proposal made by the Administration. Nonetheless, the proposal retains the advantages of the Administration's proposal, and would do more to boost economic growth. The proposal would reduce the bias against distributing dividends, at a fraction of the cost of the original proposal.

Like the Administration's proposal, it would exempt previously taxed dividends and capital gains on corporate stock from taxation at the individual level. Unlike the Administration's proposal, capital gains that exceeded fully taxed retained earnings would be subject to full taxation at the individual level upon realization. Those capital gains arise from two sources. In some cases, gains exceed earnings because a company is judged by the market to have exceptional growth prospects. Gains on such lucky investments will be fully taxed. Similarly, to the extent that a company's earnings prospects fall short, it will generate capital losses, which will be fully deductible against other capital gains and against other income up to \$3,000. The taxation of supernormal returns at full rates reduces the variance of after-tax returns without affecting the mean after-tax return.<sup>10</sup> This actually raises the well being of investors compared with taxation of gains at lower rates, because the government is sharing in more of the risk of the investment without reducing the expected return.

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<sup>9</sup> Gale and Orszag (2003) point out that one way to tax all corporate income once and only once is to tax capital gains on an accrual basis, rather than allowing deferral until an asset is sold. Accrual taxation is most feasible for marketed securities, and most difficult for illiquid and hard to value assets such as a business. However, capital gains on corporate stock would be exempt under this proposal, so applying accrual taxation in the case where it is most feasible would not have much effect. Note also that the ability to avoid tax by deferring holding capital gains until death will be curtailed by the "carryover basis" provision set to take effect in 2010. That provision is extremely complex and porous, but it would probably reduce the incentive to convert ordinary income into capital gains for people with very high wealth.

<sup>10</sup> This assumes that losses are fully deductible. Although there is a \$3,000 limit on the current deductibility of net capital losses against other income, Auerbach, Burman, and Siegel (2000) find that the vast majority of capital losses that are not currently deductible are deducted within a few years of their realization. Thus, especially at low interest rates, the assumption of full loss deductibility is a very good approximation for most investors.



Of course, some investors will owe additional capital gains tax on corporate stock if the company has effectively avoided tax through the use of corporate tax shelters or other means. Taxing these gains in full at the shareholder level will improve economic neutrality—reducing the advantage firms can achieve from taking advantage of tax shelters. Unfortunately, the proposal will not eliminate the advantage because firms that engage in tax sheltering will tend to be held disproportionately by tax-exempt investors, such as pension funds and foreign investors. Nonetheless, taxing the gains would be a significant step in the right direction.

Like the Administration's proposal, the variant would significantly reduce the incentive for companies to finance investment with debt rather than equity. That will reduce the bankruptcy risk for corporations.

Taxing individual capital gains on assets other than corporate stock will improve economic efficiency by leveling the playing field between different kinds of investments. For example, there is no reason for interest income to be fully taxed while capital gains are taxed at half or less of the rate that applies to interest income. In addition, by reducing the difference between the taxation of wages and capital gains, the proposal will significantly reduce the incentive to invest in tax shelters aimed at converting wages and other ordinary income into capital gains. Those tax shelters waste real resources—both those invested in developing and marketing the tax shelters, and those lost through the investment in inefficient investments solely because they produce tax benefits. (Burman 1999)

Finally, the proposal is much better designed as an economic stimulus. It will pump almost two thirds as much cash into the economy in 2003 as the Administration's plan, while costing less than half as much over ten years. Best of all, after 2010, the proposal would not add to the public debt (assuming that the 2001 tax cut expires as scheduled at the end of 2010). That is when our budget woes will be particularly severe because of the demands of an aging population. In contrast, the President's proposal would add at least \$50 billion per year to the deficits in 2011, and that amount will grow over time.

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