

**TAX REFORM AND THE TAX TREATMENT
OF CAPITAL GAINS**

JOINT HEARING
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
AND THE
FINANCE COMMITTEE
U.S. SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

SEPTEMBER 20, 2012

Serial No. 112-29

Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

80-843

WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
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**TAX REFORM AND THE TAX TREATMENT
OF CAPITAL GAINS**

THURSDAY, SEPTEMBER 20, 2012

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC

The committee met, pursuant to call, at 10:10 a.m., in Room HVC-210, Capitol Visitor Center, the Honorable Dave Camp [chairman of the Committee on Ways and Means] presiding.
[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairmen Camp and Baucus Announce Joint Hearing on Tax Reform and the Tax Treatment of Capital Gains

September 13, 2012

Congressman Dave Camp (R-MI), Chairman of the House Committee on Ways and Means, and Senator Max Baucus (D-MT), Chairman of the Senate Committee on Finance, today announced that the Committees will hold a joint hearing to review the tax treatment of capital gains in the context of comprehensive tax reform. **The joint hearing will take place on Thursday, September 20, 2012, in Room HVC-210 of the Capitol Visitor Center, beginning at 10:00 A.M.**

This hearing was originally scheduled for 10:00 A.M. on Thursday, June 28, 2012, in Room HVC-210 of the Capitol Visitor Center, but was postponed.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committees and for inclusion in the printed record of the hearing. Invited witnesses will include the witnesses who were invited to appear at the originally scheduled hearing.

BACKGROUND:

The maximum capital gains tax rate currently is 15 percent, as compared to the maximum individual ordinary income tax rate of 35 percent. Absent Congressional action, the maximum statutory capital gains rate will increase to 20 percent on January 1, 2013, while the maximum individual ordinary income tax rate will increase to 39.6 percent. Beginning in 2013, however, an additional 3.8 percent tax will be imposed on net investment income earned by certain individuals. "Net investment income" includes, among other items, capital gains. Furthermore, the 2013 scheduled restoration of the "Pease limitation" on itemized deductions will impose a roughly 1.2 percent marginal rate on capital gains, bringing the top federal rate on capital gains to 25 percent in 2013.

With regard to the joint hearing, Chairman Camp made the following statement:

"The taxation of capital gains is one of the most widely discussed areas of our individual tax system, and it needs to be reviewed as part of comprehensive tax reform. With both the Ways and Means Committee and the Senate Finance Committee actively pursuing tax reform, it will be critical for Congress's two tax-writing panels to continue working closely together. This is the third time this Congress that our two committees have convened a joint hearing, and I look forward to continuing the dialogue on these critical issues."

Speaking about the upcoming hearing, Chairman Baucus said, **"It has been more than 25 years since the last major tax reform occurred. The world has changed drastically in that time and America's tax code hasn't kept up. It's time we had a tax code for the 21st century, one that can create jobs, spark innovation and expand opportunity. I look forward to working with Chairman Camp as we work on a balanced, common-sense plan to reform the tax code and create the jobs we need to improve our economy."**

FOCUS OF THE HEARING:

The hearing will focus on the taxation of capital gains in the context of comprehensive tax reform. It will explore several tax reform policy issues relating to the treatment of capital gains, including background on capital gains taxation and its history, the impact of the capital gains tax rate on investor behavior, the treatment of capital gains as compared to ordinary income, the revenue-maximizing rate on capital gains, the distribution of capital gains income across taxpayer income levels, and the types of assets eligible for capital gains treatment.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, October 4, 2012**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days' notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://www.waysandmeans.house.gov/>.

Present: Representatives Camp, Herger, Johnson, Brady, Nunes, Tiberi, Reichert, Boustany, Roskam, Gerlach, Price, Buchanan, Smith, Jenkins, Paulsen, Marchant, Berg, Black, Reed, Levin, Rangel, Neal, Becerra, Larson, Blumenauer, and Pascrell.

Senators Baucus, Wyden, Carper, and Hatch.

Chairman CAMP. Good morning. Thank you for joining us today for the third joint hearing of this Congress House Ways and Means Committee and the Senate Finance Committee. Prior to this Congress, our two committees had not met together for tax related hearings in more than 70 years.

Through this series of hearings, as well as the ones we have held on our own and with the Joint Committee on Taxation, we have had very productive discussions about steps that we need to take to transform today's broken Tax Code from one that hinders to one that fosters greater investment and job creation. And after more than 43 consecutive months of unemployment over 8 percent, it is no secret that we are in a jobs crisis and comprehensive tax reform is a part of achieving much needed economic growth.

Today's hearing focuses on capital gains in the context of comprehensive tax reform. For nearly its entire history, our income tax system has taxed capital gains differently than other income. Even in the years following the 1986 Tax Reform Act, when the capital gains and ordinary income tax rates were aligned, we still recognized that capital investments raised specific tax policy questions and therefore required various rules to distinguish between capital gains and ordinary income.

Today the maximum capital gains tax rate is 15 percent as compared to the maximum individual ordinary income tax rate of 35 percent. And while the focus of this hearing is a longer-term view on capital gains as a part of comprehensive tax reform, we can't forget that, absent congressional action to stop the impending tax hikes we face at the year's end, the maximum capital gains rate will increase to 25 percent and the maximum individual ordinary income tax rate will increase to 40.8 percent when certain hidden marginal tax rate increases are factored in.

The potential tax increases that we face next year would have a devastating effect on the economy. According to the Joint Committee on Taxation, a failure to enact a 1-year extension of the low tax policies first enacted in 2001 and 2003, including an AMT patch, would result in a \$384 billion tax increase. On the other hand, extending these policies on a permanent basis or, as Republicans have called for, enacting comprehensive tax reform consistent with historic revenue levels would prevent a tax increase of more than \$4 trillion over the next decade.

Clearly those increases serve as a stark reminder that without action, more and more revenue that could be used to invest and hire will be taken out of the economy. And as we consider the economic impact of the tax burden associated with capital gains, it is critical that we focus on the total integrated rate, which is nearly 45 percent, not just the statutory rate of 15 percent.

The capital gains tax is often though not always a double layer of taxation. For example, in the case of shares of stock, a company's income is first taxed at the corporate rate. Then when shareholders of the company later decide to sell their stock, they are subject to capital gains tax on the sale. But the value of the stock they sell already has been reduced by the fact that the corporation previously paid out a portion of its earnings as taxes.

So, even if we make current low tax policies permanent, the top integrated rate on capital gains is actually 44.75 percent, a 35 per-

cent first layer of tax and a 15 percent capital gains tax. If we allow current low tax policies to expire, the top integrated rate on capital gains would exceed 50 percent. Along these same lines, I believe it is important to mention that regardless of what rate we apply to capital gains, we should strive to retain parity between the rates for capital gains and dividends. Just as we need to eliminate the lock-out effect that our worldwide tax system imposes on foreign earnings, we should also not restore the lock-in effect on domestic corporate earnings that makes it more tax efficient to retain earnings inside a corporation when it might be more productive to push the cash out to shareholders so they can reinvest it elsewhere in the economy.

There are compelling reasons for providing a preferential tax treatment for capital gains, but we all know there are important tradeoffs to be considered with each piece in the complex process of comprehensive tax reform. One of the main objectives for this hearing is to examine the tradeoffs inherent in different proposals for capital gains taxation. I look forward to hearing from our panel of witnesses who are assembled here today, and I want to thank all of you for your time for coming today.

And with that, I will yield to my colleague, the chairman of the Senate Finance Committee, for his opening statement.

Senator BAUCUS. I thank you very much, Mr. Chairman.

I appreciate this joint hearing. I believe we should have more, frankly. I believe that in this partisan time, we are so polarized that the facts count. The more we have hearings, the more we can ask factual questions and the more witnesses give us factual responses, not political responses, then the closer we are going to be to reaching some kind of an agreement, hopefully, after the election, lame duck, and in the following years. But more hearings like this, just asking questions slowly, perhaps painfully, will help us get to a good result after the election.

Winston Churchill once said, the pessimist sees the difficulty in every opportunity, and the optimist sees the opportunity in every difficulty. As you work on comprehensive tax reform, the treatment of capital gains is one of the most difficult issues we face. Some are pessimistic and don't believe we can agree. I am optimistic; we need to come together and find a workable solution.

Through that process, there are four considerations. First, we need to consider the capital gains rate to compare to the rates on wage income, dividends and corporate income. The tax rate and the capital gains is currently lower than the rate on wage income. Some say this is to avoid double taxation. But most of the time, that claim doesn't prove true. Only a third of capital gains come from sales of corporate stock; the rest have never previously been taxed before reaching individuals.

Second, we need to consider how capital gains rates affect different income brackets. Capital gains grow disproportionately to high-income taxpayers. Last year, capital gains represented half the income of the top one-tenth of a percent of earners with 3 percent for the lowest 80 percent of taxpayers. Low capital gains rates are the main reason why many wealthy individuals pay lower tax rates than middle class families.

Third, we need to consider our low savings rate. Americans need to save over their lifetimes. This is an opportunity for our witnesses to talk about the relationship between tax rates and capital gains and national savings.

Fourth, we must consider complexity. Experts tell us that about half of the U.S. Tax Code, more than 20,000 pages, exists solely to deal with capital gains. That complexity, as well as the wide gap between the tax rates on income and capital gains invites people to use all kinds of shenanigans to game the system. Our entire Tax Code, including this treatment of capital gains, needs to be rebuilt for the 21st century. We need a system focused on broad-based economic growth and jobs.

I am glad today to be joined by Chairman Camp and my colleagues from the House, but in order to get tax reform done, we need members of both parties and both chambers willing to tackle these issues with an open mind. So let's set aside our differences, political differences, and listen. Let's see this as an opportunity, let's be optimistic that we can reform the code to spark growth, create jobs and strengthen our economy.

Chairman CAMP. Thank you very much, Chairman Baucus.

Let me now yield to the ranking member of the Ways and Means Committee, Mr. Levin, for his opening statement.

Mr. LEVIN. Thank you very much.

And we welcome the witnesses and welcome the opportunity to have this joint hearing. I remember back when I was in the state legislature, we held joint hearings, and they were semi-revolutionary, and I think it is a useful approach. I think we all realize that when it comes to tax reform that it is integrated that in a sense, almost every issue relates to every other issue. But I will resist the temptation to use the integrated nature of taxes to talk about other issues, including the difficult issues that we are facing and that divide us as to, for example, the taxation on high incomes. There is a new CRS report that very much questions the argument that the high income tax break promotes economic growth. But let me concentrate instead on this issue of capital gains. I think the issue as to how to tax capital gains will be one of the major and likely most controversial issues as we undertake tax reform. The reduced rate on long-term capital gains is one of the largest individual tax expenditures, as we know, adding up to hundreds of billions of dollars over a decade. It is also, as Mr. Baucus has said, a source of considerable complexity.

I noted that, in reviewing the testimony for this hearing, that by some estimates, fully half of the Tax Code is devoted to defining the difference between capital gains and ordinary income, and I am not sure it is half, but I remember our tax course back in law school trying to wrestle with these issues, and it took up maybe half of the time. When there is a significant capital gains preference, there is a lot of pressure on these rules, because the greater the tax preference for capital gains the greater the incentive to try to recharacterize ordinary income as capital gains.

That, for example, is the source of the battle over carried interest. So it is useful for all of us to really understand the issues surrounding capital gains. That includes its history. We have mostly had a preferential rate, but as we know, the 1986 tax reform elimi-

nated it. And it includes the various arguments for why you might want a lower rate, whether that is double taxation of corporate income, inflation, the so-called lock-in effect and incentive to invest, among others.

It is also important that we understand the evidence about the different rationales and how they hold up to reality. As mentioned by the chairman of the Finance Committee, most capital gains are realized by the highest earners. Some 71 percent of the benefit of the preferential rate on capital gains goes to those making more than \$1 million a year, according to the Joint Committee on Taxation. So there is a real consequence from the preferential rate as to the progressivity of our tax system.

Both our committees will have to wrestle with these issues as tax reform moves forward. So I look forward eagerly to this testimony and hope that it will help us inform that process. Thank you.

Chairman CAMP. Thank you, Mr. Levin.

I now yield to the ranking member of the Senate Finance Committee, Senator Hatch, for his opening statement.

Senator HATCH. Thank you so much, Chairman Baucus and Chairman Camp, for holding this joint hearing.

From 1921 through 1987 and then again after 1990, capital gains have been taxed at a lower rate than ordinary income. A number of justifications have been given as to why we have preferential treatment for capital gains. For example, the lock-in effect is usually given as a reason for having preferential treatment for capital gains. Since capital gains are only taken into account when realized by a sale or exchange, investors can avoid paying the capital gains tax by simply holding on to their capital assets. As a result, the capital gains tax has a lock-in effect, which reduces the liquidity of assets and discourages taxpayers from switching from one investment to another. Other important reasons given for preferential treatment for capital gains are that a low capital gains tax increases savings and investment, counteracts the two levels of taxation of corporate income and corrects the income tax law's bias against savings.

Next year, an additional tax on capital gains is scheduled to go into effect. As part of the President's health care law, a new 3.8 percent tax on the net investment income of single taxpayers earning more than \$200,000 and married couples earning more than \$250,000 goes into effect. These amounts are not indexed for inflation, and with the scheduled expiration of the 2001, 2003 and 2010 tax relief at the end of this year, capital gains will be subject to a 23.8 percent tax beginning in 2013, a whopping 59 percent increase from current law. According to the OECD, the United States has the most progressive tax system in the industrialized world. Should we make it even more progressive by raising the tax rate on capital gains? The top 10 percent of households already pay 70 percent of all Federal income taxes. So when is enough progressivity achieved?

Over 50 years ago, a leading tax scholar wrote that everything there now is to say on the problem of capital gains has already been said. I disagree. I think the issue of preferential treatment of capital gains is critically important today with new evidence being generated, as witnessed by the joint report of the staff of the Joint

Committee on Taxation and the Congressional Budget Office issued in June.

We have a very distinguished panel here with us today.

I welcome each one of you, as do all of us, to this hearing. And we all have a great desire to hear what these witnesses have to say.

Thank you, Mr. Chairman.

Chairman CAMP. Well, thank you, Senator Hatch.

And without objection, any other member who wishes to have an opening statement included in the formal hearing record may submit one in writing.

We are fortunate to have a panel of witnesses here this morning with a wealth of experience in private practice, academia and government. Let me briefly introduce them.

First, I would like to welcome David Brockway, the former chief of staff of the Joint Committee on Taxation during the process leading up to the enactment of the Tax Reform Act of 1986 and currently a partner at Bingham McCutchen here in Washington.

Second, we will hear from Larry Lindsey, who is currently president and CEO of the Lindsey Group. Dr. Lindsey formerly served as director of the President's National Economic Council and is a governor on the board of the Federal Reserve.

And third, we will hear from Leonard Burman, who is a professor of public affairs at the Maxwell School at Syracuse University. Dr. Burman is the co-founder and former director of the Urban-Brookings Tax Policy Center.

And fourth, we will hear from David Verrill, who is the founder and managing director of Hub Angels Investment Group in Cambridge, Massachusetts. He has recently assumed the role of chairman of the Angel Capital Association.

And finally, we will hear from William Stanfill, a general partner at the Montegra Capital Income Fund and a founding partner of TrailHead Ventures, L.P. Mr. Stanfill has been in the investment management business for over 40 years.

And thank you all for being with us today. The committee has received each of your written statements, and they will be made part of the formal hearing record. Each of you will be recognized for 5 minutes for your oral remarks.

And Mr. Brockway, we will begin with you. You are recognized for 5 minutes.

**STATEMENT OF DAVID H. BROCKWAY, PARTNER, BINGHAM
McCUTCHEN, LLP, WASHINGTON, D.C.**

Mr. BROCKWAY. Thank you very much, Mr. Chairman.

I am a strong advocate of comprehensive tax reform and want to commend Congress for thinking about this issue very seriously. I think that the Code desperately needs reformation. But I am not here today to advocate comprehensive tax reform or advocate any particular treatment of capital gains.

I am here more to discuss my experiences in the 1986 legislation and the likely treatment of capital gains in comprehensive tax reform. You have some great witnesses here today, and I think their is very informative, and useful in thinking about whether you wish to have comprehensive tax reform or not. The experience that I had

in 1986 strongly suggests to me that it is highly unlikely that you will find it possible to have comprehensive tax reform with a top rate below 30 percent without raising the capital gains rate close to 30 percent or probably, once you are in the neighborhood, to 30 percent or less—whatever the top ordinary incomes rate is, 25 percent, 28 percent.

Therefore, I tend to view the capital gains issue in the context of tax reform as a gating issue. If, after you understand the policy issues in regard to taxation of capital gains, you believe that it is fundamental to keep a differential in the rate structure between capital gains and ordinary income, then I think you have to think seriously about whether you wish to go forward with comprehensive tax reform. On the other hand, if you come to the same conclusion the Congress did in 1986 that overall the benefits of comprehensive tax reform outweigh the detriments of raising the tax rate on capital gains, then I think it is sensible to move forward.

In any event, given the design constraints that governed the 1986 Act, it was not possible at that time to reach a reduction in the top rate on ordinary income to 28 percent without also increasing the capital gains rate to that level. Raising of the capital gains rate to that level was absolutely not an objective in that process. In both Houses, there was great resistance to doing that. It was simply the only way that the legislation would move forward under the constraints that Congress was operating under.

Those constraints were revenue neutrality and distributional neutrality together with a significant shift in tax burden off of the individual sector onto the corporate sector. That is, the legislation we raised about \$20 billion a year in base broadeners from the corporate sector and used that to help subsidize a reduction in the individual tax rates, which might be on the order of magnitude of something like \$40 billion a year right now. It was a very large shift. And finally, the design constraints were governed by the estimating process of the Joint Committee staff, both distributional analysis and revenue analysis, using traditional revenue estimating methods. That is, they did not take into account any potential change in the overall performance of the economy that the legislation might produce. They assumed that the economy would operate at the same levels as in the CBO baseline.

Those constraints were consciously designed and executed as a “time out” from the partisan ideological struggles in regard to the size and role of the Federal Government and, for want of a better term, the class warfare issues that were facing Congress. Obviously, these are still issues today, but, at that point, without that time out, I think that it would not have been possible to secure the bipartisan support that was necessary for that legislation to pass either House.

I recognize what you are hearing this morning is designed to focus on capital gains, not the design constraints of overall comprehensive tax reform, but to my view, that is the key to the entire process, and it is the key, in the end of the day, to the tax treatment of capital gains in any such legislation.

The situation you are dealing with today is different from 1986 in a number of respects, and you are obviously free to adopt whatever design constraints you think are appropriate for this context.

But my suspicion is that you are going to find that the forces that caused those designs constraints to be adopted in 1986 will be the same today. You are going to have a much tougher time of it this time around, however. Right now, you do have to decide whether you are going to look at current policy or current law for setting both the revenue target and the distributional target. And I think the distributional target in that regard may even be more important. You also have to answer the question whether you are going to adopt dynamic revenue scoring. That wasn't really an issue in 1986, but it will be front and center at this point. And you will also have to decide whether you are going to look at changes in the relevant tax burden on income classes or whether you are going to look at the changes in the relevant after-tax income. Particularly if you are thinking about taxation of capital gains and you are thinking about dynamic scoring, you have to ask the question, are people relatively in the same position after tax as they were before or not, not what the charts show about how much tax each particular income group pays. I think have I have reached my time limit.

Chairman CAMP. The time has expired, yes. Thank you very much Mr. Brockway.

[The prepared statement of Mr. Brockway follows:]

Written testimony of David H. Brockway

Prepared for a September 20, 2012 joint hearing conducted by the U.S. House Ways and Means Committee and the U.S. Senate Finance Committee on the subject of Tax Reform and the Tax Treatment of Capital Gains.

I am not here today as an expert on the economic considerations relating to the taxation of capital gains, nor am I here to advocate any particular tax treatment for capital gains income or even to advocate fundamental tax reform itself. I was asked to appear because I was Chief of Staff of the Joint Committee on Taxation during the consideration of the Tax Reform Act of 1986 and thus have some experience in dealing with the issues involved in structuring fundamental tax reform legislation in general and in regard to the taxation of capital gains in particular. I recognize that the circumstances faced by the Congress and the Reagan Administration in 1986 were markedly different in a variety of respects from those that you and the next Congress will face if you go forward with this undertaking, and thus our experiences in 1986 are no more than reference points you should be aware of in plotting your own course and did not create a path you need to follow. I should also emphasize that the following represents a summary of my recollections of what occurred almost 30 years ago, and I am sure that others involved will have differing, and perhaps more valuable, recollections of how that legislation came to pass and viewpoints as to the lessons that might sensibly be drawn from that experience.

I am currently a partner at the law firm of Bingham McCutchen LLP, and my practice is focused primarily on corporate tax issues arising in the international context. While others at the firm may engage in lobbying on tax issues from time to time, I have no involvement in those matters. My own practice is, and has always been, strictly transactional and never has directly or indirectly involved lobbying either the legislative or the executive branch. While clients of the firm, and my own personal clients, obviously have significant interests in issues you will deal with in the course of your tax reform effort, I have not consulted with others at the firm or with my clients on the subject matter of my testimony here today, and I would like to make it clear that I am appearing strictly on my own personal behalf, not on behalf of my firm or any of its clients.

A key element of the 1986 Tax Reform Act was the elimination of the preferential tax rate for capital gains. That, however, was not as such a design objective of the reform effort itself but rather was a derivative of the consensus design constraints for that tax reform effort. While there had been several earlier comprehensive tax reform proposals made by different members, Senator Bradley developed a comprehensive and specific legislative proposal with a 30% top rate on ordinary income that he, together with Mr. Gephardt, introduced in 1984. The bill was structured to be revenue neutral over the 5-year estimating window then in use under the Gramm-Rudman budget procedures and was also structured to be distributionally neutral in the individual sector, with the benefits from the rate cuts for each income class roughly offset by revenue increases from base broadeners. Those constraints permitted tax reform to be considered on its own merits rather than as a veiled struggle between competing partisan or ideological agendas. Because at that time (and most likely at this time as well) comprehensive tax reform would not have been feasible without meaningful bi-partisan support, these design constraints were indispensable – they moved tax reform from a zero-chance talking point exercise up to a long-shot undertaking. In any event, those same constraints were subsequently adopted by Mr. Kemp in his design of the principal competing proposal that he introduced with Senator Kasten, and they likewise were adopted as a given by the Reagan Administration and both houses of Congress at all times during the consideration of the 1986 Act. Thus, throughout

that process, there was a clear consensus of all involved that (i) the legislation should be revenue neutral over the 5-year budget window, and (ii) of particular significance to the decisions ultimately made in that process to increase the capital gains tax rate, the distributional impact of the individual tax changes should be at least as progressive as existing law. (In fact, the overall estimated impact of the Administration's proposal and the bills considered by both houses was to make the distributional burden of the individual income tax slightly more progressive than prior law.¹) Another key component, probably indispensable to achieving a politically viable package, was a shift of tax burden off of the individual sector onto corporate sector of \$100 billion over the 5-year budget estimating window, or the equivalent of a shift of perhaps \$30 or \$40 billion a year today. That shift was first introduced in the Reagan Administration's proposal, and it was adopted by both committees and reflected in the House bill, the Senate bill and the final legislation. Finally, there was a consensus by the both by the Administration and the leaders of both parties in both houses that the Joint Committee on Taxation revenue estimates, based upon its historic revenue estimating conventions, would be dispositive in determining the revenue and distributional impacts of the various changes under consideration.

As things played out, the distributional constraint for the highest individual income class proved to be the binding constraint at each stage of the 1986 tax reform process. It turned out that the overall revenue constraint and the distributional burdens for the lower income classes could be satisfied with far less difficulty by adjustments to where the break points between individual income tax brackets were set. At the upper-income levels, however, that technique had no possibility of working because the prior law average tax rate for these taxpayers was near or above the top rate in the new rate structure. Therefore, the distributional neutrality constraint could only be satisfied by adopting base broadeners that had a disproportionate impact on high income groups under current system, and politically viable base broadeners having that profile were very difficult to come by. If you decide to adopt a distributional neutrality constraint, and I believe you will need to in order to succeed in enacting comprehensive tax reform legislation, you are likely to have the same difficulty. Apart from increasing current rates on capital gain income, there are only a limited number of changes you are likely to consider that would be concentrated in highest income levels (items such as, for example, limitations on certain charitable deduction planning techniques, employee stock options, tax preferred retirement plan rules for highly-compensated employees, and changes to the taxation of closely-held business), and any such changes are likely to be as politically challenging as increasing the capital gains rate. I suspect that items such as further limits on the mortgage interest deduction likely are likely to be of proportionately greater significance for upper-middle income taxpayers than they will be those in the highest income brackets. The staffs will have to go on a scavenger hunt to find possible base broadeners for you to consider in order to satisfy the distributional neutrality constraint, and they will need to exercise a fair amount of creativity because it is likely that the base broadeners you will need do not all appear in the JCT tax expenditure pamphlets.² Once

¹ At the time, in contrast to what I understand may be the case today, there was no attempt to allocate changes in the corporate tax burden among different individual income classes. I personally believe that it is a serious mistake to attempt to allocate the corporate tax burden among classes of individuals.

² The search for base broadeners should not be confined to those previously identified and listed in the tax expenditure budgets. Particularly in regard to taxation of business operations and income from capital assets, the reasons why the actual revenue generated by the current system is so much less than the rate structure might imply is not solely limited to various explicit tax incentive provisions consciously adopted to encourage certain economic

that search has been exhausted, you may well find that increasing the capital gains rate, however unpalatable, is a less unappealing alternative than other technically feasible approaches that might satisfy the distributional neutrality constraint in a reform package that has a top rate on ordinary income in the mid-twenties.

In any event, as I am sure you are aware, if you do adopt distributional neutrality as a design constraint, a crucial issue you will have to agree upon is the base line you that start with – current law with, for example, the 10% temporary individual rate cuts and the AMT fix expiring as scheduled – or current policy assuming that those and other expiring provisions would be extended. The distribution of relative tax burden of those two possible base cases differs meaningfully, which will have as large an impact on the design of a tax reform package, including in particular the tax rate on capital gains, as does the obvious question of which aggregate revenue base line the reform package would need to meet in order to be viewed as budget neutral, assuming that is also a design constraint.

At the risk of over-constraining the process, you might also consider refining the distributional analysis a little at the upper end, because my guess the biggest distribution battle this time around will be between the top 1 or 2 percent income group and the rest of the top 20 percent. That, I believe, is where the most significant potential for redistribution of tax burdens among income classes is likely to show up as you reduce rates and replace the lost revenue with base broadeners. My guess is that there will be a natural tendency, unless you have constraints designed to prevent it, to shift tax burden off of the very high income groups onto the high income groups – off of individuals earning, say, \$2 million a year or more onto those making from \$500,000 to \$2 million. While such a shift could probably be hidden in the distributional tables if the income classes used in those tables are large enough, I suspect it probably would implicitly be recognized by your constituents as they become aware of the impact of tax reform on their tax burdens. While a reasonable argument might be made that distributional shifts among those that have a lot and those that have an enormous amount should not be of vital concern as a policy matter, I believe it will have a meaningful effect on the political viability of tax reform and thus should seriously be considered.

As I mentioned earlier, the taxation of capital gains at ordinary income rates was not an initial design element of the tax reform proposal of the Reagan Administration nor was it an objective, in and of itself, of either the House or Senate bill. It was, instead, a last resort response in both committees to the need to satisfy the distributional neutrality design constraint that the participants had accepted without necessarily realizing the implications in regard to the taxation of capital gains. In the House Ways and Means Committee mark up, the rate was increased from 20% to 22% only at the very last moment to deal with a revenue shortfall. After a long and difficult process, a bi-partisan consensus had been reached on the terms of a bill that, among other elements, had a 20% top rate on capital gains. Just before the Committee was to reconvene and vote the bill out, the revenue estimators came up to me at the witness table and told me that they had discovered an error in the modeling and we were \$17 billion short over the 5-year budget window. It was already early evening when that catastrophe hit. We were sent back to the drawing board to come up with proposals that would fill the revenue hole and comply

activity but instead stems to a considerable degree from less than obvious and probably unintended interactions between the complex rules needed to measure and tax such income.

with the distributional constraints, and by very late in the evening the only way we could figure out how to solve the problem in conformity with the distributional constraints was a package of changes that included an increase in the capital gains rate from 20% to 22%. That increase was resisted strongly by Chairman Rostenkowski because he understood its political ramifications and the threat it presented to passage of the bill, but we were unable to develop alternative proposals at that time that would satisfy the distributional constraint. In fact, that last minute and unanticipated increase, when combined with the very long wait for the Committee Members that evening without clear information as to the nature of the problems we were struggling to address, caused significant defections among the minority, some of whom understandably thought we were engaged in a bait and switch. That, I think, was the principal reason the bill lost the vote on the rule when first put to the House floor. The bill was only revived by the very energetic intervention of the Administration over the next few days to secure enough votes from the minority so that wavering members of the majority were also willing to vote to let the bill go to the next stage (where the smart money believed it was fated to wither and die).

The main point here is not just to tell a war story, but rather to underscore that the capital gains rate increase in the House bill was the absolute last resort and driven by the distributional constraints more than anything else. There is, however, another point I would like to make in connection with this incident. It will be very difficult for you to move a bill to completion if you don't trust the staffs, including in particular the revenue estimating staffs, to be honest and to do their absolute bests to represent you and the interests of the general public. They are individuals of the highest integrity and dedication. I don't mean to say that they won't make some mistakes along the way – that one was a big one and we had a similar \$17 billion event with Senator Packwood that was discovered after the bill passed the Senate – but just that the mistakes, although inevitable, will be honest ones, and the staffs will do their absolute bests to shoot straight.³

In the Senate, the original mark prepared by Chairman Packwood and considered by the Finance Committee did not attempt to tax capital gains and ordinary income using the same rate structure. An increase in the capital gains rate was first seriously considered by the Committee only after his initial version crashed and burned and Chairman Packwood responded by presenting a much more radical program with a 25% top rate on all income, ordinary and capital. Even in that context, the increase in the capital gains rate was not considered as a goal in and of itself, but rather as a necessity to meet the design constraint of distributional neutrality. At what ultimately became a 27% top rate on ordinary income in the Finance Committee bill, the only plausible changes that we were able to indentify that would offset the reduction in tax burden on upper-income taxpayers due to the ordinary income tax rate cut were a combination of the passive loss limitation and an increase in the capital gains rate to the same rate as ordinary income. Having been deeply involved in this aspect of the Senate Finance Committee's deliberations, I am confident that the increase in the capital gains rate was considered and

³ I also don't mean to say that the staff members don't have policy and political views. Of course they do. For example, most, regardless of their partisan affiliations, are likely to be "reformers" at heart, with a very healthy skepticism about preferential tax treatment for any special activity. That said, they are professionals of the highest order who have worked for you for a long time and accept that there are reasons why Congress may want to make distinctions in the tax burdens borne by different activities and different groups of taxpayers, and they will work hard to implement your decisions in that regard whether or not they happen to share your belief that such distinctions are wise.

adopted only as a last resort because we could not identify any other viable base broadeners that would satisfy the distributional constraint.

It may be that in this attempt at tax reform you decide not to bind yourselves to a distributional neutrality constraint, but I believe it would be unwise to do so both because I personally believe it would be wrong as a matter of policy in a number of respects and because I do not believe it would be possible to convince the general public to accept the loss of their existing tax preferences unless they believe in the fairness of the overall legislation. Needless to say, the politics of this enterprise are fundamentally different than a rate cut in which all income classes participate, even if their relative benefits from the tax cut are not necessarily proportionate to their existing tax burdens. My own assessment of the political realities, for what it's worth, is that tax reform is not worth pursuing if you cannot meet a distributional neutrality constraint because I do not believe you would be able to pull it off and, even if somehow you could, I don't think it would last because I think it would ultimately be rejected by the general public as unfair.⁴

The necessity of turning to a capital gains rate increase in 1986 to satisfy the distributional neutrality constraints obviously does not necessarily mean that you will be forced to do so as well. It is possible that, even if you do bind yourself to a distributional neutrality constraint, you will be able to identify other base broadeners that disproportionately impact upper-income taxpayers and that are adequate to balance the reduction in the top rate on ordinary income without the need to resort to an increase in the capital gains rate. I am not close enough to the numbers and do not have any sense of the work that has been done by the staffs on this front to date. From my experience, however, I would be very surprised if you would be able to design and enact a tax reform package with a top individual tax rate on ordinary income in the mid-twenties without increasing the capital gains rate to the ordinary income rate.⁵ Accordingly, in my view, your willingness to adopt an increase in the capital gains rate, assuming some adequate rate objective for ordinary income can be achieved, is a threshold issue to be considered at the outset of the process.

If you do decide to retain a preferential rate for capital gains, there are other important issues regarding the taxation of capital gains that you should consider in this process. The definition of what qualifies for the preferential rate should be reexamined in light of the policy reasons that persuade you to retain it. There is no particular reason to believe that the current definitions are in all respects consistent with the particular investment activities that you conclude should be afforded a preferential rate.

Moreover, as long as there is any difference between the tax rates imposed on ordinary income and capital gains, there will be arbitrage activity designed to convert ordinary income (and short-term capital gains not qualifying for the preferential rate) into long-term capital gains

⁴ At its core, tax policy is not some scientific exercise that has a correct answer that can be determined by economic models implementing some academic theory; it, instead, is a considered response to, and implementation of, what the body politic accepts as the least objectional way of raising the revenue needed to operate the government.

⁵ I suspect that you might be able to do it with a slight rate differential, but once you get within 2 or 3 percentage points there does not seem to be much to be gained by not going all in.

and to convert capital losses into ordinary losses. The larger the spread in rates and the fewer and less effective the speed bumps you put in the Code to discourage this activity, the more arbitrage activity there will be. The reality is that arbitrage is an inevitable aspect of any tax system because the law generally, and the tax law in particular, is based on relatively crude attempts to compartmentalize a very complex society and dynamic economic behavior. It is not possible to create a system that does not have lines providing different treatment for activities defined by the law to be different but which, as cases get close to the line, do not in substance differ all that much. People like me will be hired to figure out how to exploit these differentials, and in due time we will succeed to a certain extent in doing so. Nonetheless, while elimination of all tax driven arbitrage is not a realistic objective, the reduction of such arbitrage in my view should be a core objective of any reform plan. Therefore, from this perspective at least, a reduction of the gap between the capital gains and ordinary income rates is a worthwhile goal in and of itself that should not be viewed as failure even if the gap is not eliminated entirely.

I do not, however, want to oversell the simplification that would come from merging the capital gains and ordinary income tax rates. While the reduction or elimination of the rate differential would, without a doubt, substantially reduce tax arbitrage activity, it is important to understand that even taxing both at the same rates would not eliminate the need for distinguishing between capital gains, or at least certain categories of capital gains, and ordinary income. The current distinction between capital gains and losses on the one hand, and ordinary income and losses on the other, serves two purposes: (i) it provides tax relief for long-term capital gain income for various policy reasons, and (ii) it limits the cherry-picking that is available to taxpayers having both appreciated and depreciated assets. A necessary component of our tax system is that, to some significant degree, income and loss from the appreciation and depreciation in value of assets will be taxed on a realization basis rather than an economic accrual basis. Because, as a general proposition, the taxpayer has control over whether and when to recognize income and loss from the appreciation and depreciation of investment assets, there is a very significant economic incentive on taxpayers to recognize for tax purposes the losses on any assets that have declined in value and defer recognition on assets with gains. Since assets receive a step up in basis at death and since charitable deductions are allowed for the fair market value of contributed assets rather than their tax basis, increases in the rate of tax imposed on capital assets will also tend to increase these distortive elements of our realization-based system. These incentives exist entirely without regard to whether capital gains receive a preferential rate – indeed, they exist with respect to assets taxed at ordinary income rates (as they do now in respect to capital assets in the corporate sector) as long as gains are not taxable until realized. In addition, since these incentives are more or less proportional to the capital gains rate, the higher the rate is raised, even if to make it match the ordinary income rate, the greater the pressure there will be on taxpayers to engage in distortive behavior. I do not believe you could operate the system without retaining some limitation on this activity, but it need not necessarily take the form of the current limitation. It probably would be worthwhile to consider in addition other techniques for dealing with the cherry-picking problem such as expanding the rules requiring mark-to-market treatment or the rules requiring the capitalization of losses where a taxpayer holds appreciated property. In any event, while I think it is an important consideration that should be kept in mind in the design of a comprehensive tax reform proposal, I personally do not believe that the inevitable distortions created by the increased incentive to defer the recognition of capital gains or engage in arbitrage activity to convert capital losses into ordinary losses that

would flow from increasing the rate imposed on realized capital gains income is a sufficient reason not to reduce or eliminate that gap.

As a tax technician by profession, I am generally quite skeptical about preferential tax treatment for particular forms of income or income from particular categories of economic activity, and from that perspective I personally start with a reasonably strong bias against a preferential rate for capital gains. Nonetheless, one can observe that for the past almost 100 years that we have had an income tax system, a preferential rate for capital gains has been the norm, with only the briefest period during which the rate structure for capital gains and ordinary income was the same. Preferential treatment of capital gains is, moreover, a common feature of most foreign income tax systems. After all the fanfare about tax reform in 1986, in 5 years' time the capital gains rate differential was reintroduced. Thus, without having to debate their merits, we must accept that there are powerful factors that operate as a political reality to impose an upper limit on capital gains rates and that, realistically, it is unlikely that it will be possible to overcome those factors for any long-term period. My guess is that the necessity of taxing capital gains on a realization basis probably puts an upper limit on the effectiveness of increases in the capital gains tax rate at some point in the mid to high twenties. I suspect that there are other powerful contributing factors at work that also operate to put a practical upper limit on the capital gains rate. We can, however, look back over our history and see that for long periods of time we have successfully operated with a 25% rate on capital gain income in the individual sector (and 35% in the corporate sector), so I think we can also be confident that a capital gains rate in that range would be viable.

If one accepts that, for whatever reasons, it is unlikely an individual capital gains rate much in excess of 25% could be realistically sustained on a long-term basis, that would also effectively impose an upper limit on the ordinary income rate as well if a fundamental design feature of the tax reform proposal is to tax capital gains and ordinary income at the same rates. If the same treatment is provided for ordinary income and capital gains, that not only would impose a governor on possible future increases in the top marginal income rate on ordinary income, but it would also operate to impose a practical limitation on the amount of income that could be raised from the individual income tax system. Consequently, if at some point a decision were made to raise revenues significantly above current levels, this dynamic should operate to push for the revenue increases to be sourced elsewhere. This in turn should, in theory at least, provide some stability for the new rate structure – the top individual tax rate could not as a practical matter be reduced to any significant degree thereafter because of the revenue loss with respect to ordinary income, and the ordinary income rate could not be raised significantly without breaking the link between capital gains and ordinary income. Whether that stabilizing tendency would be sufficient in practice to counter the pressures to reduce the capital gains rate or increase the ordinary income rate is, however, far from clear. It only worked for 5 years after 1986. If you do succeed in adopting a comprehensive tax reform and it contains, as the distributional constraint may dictate, the same rate structure for capital gains as for ordinary income, I would hope future Congresses will learn from that experience and resist both the urge to reduce capital gains rates and the urge to increase the top rate on ordinary income.

Thank you very much for this opportunity to appear at this hearing. As I have mentioned to your staffs, I would be happy to continue discussions with you or your staffs on this and other aspects of tax reform at any future time that you or they might request.

Chairman CAMP. Dr. Lindsey you are recognized for five minutes.

**STATEMENT OF LAWRENCE B. LINDSEY, PRESIDENT AND CEO,
THE LINDSEY GROUP, FAIRFAX, VA**

Mr. LINDSEY. Thank you, Mr. Chairman.

I would like to thank both committees for staging this hearing. I think it is very important. I think we need to put this a little bit in the economic context. Given the hole that we are in in the country, I think our whole focus should be on making America the best place in the world in which to invest, start a business and create jobs. It is as simple as that.

There is in that context a very strong relationship between the rate of taxation and the level of economic activity that is being taxed. I would like to discuss that. It is not as strong as some believe. It is stronger than many believe.

Finally, I would like to point out that the revenue collected from capital gains taxation depends not only on the capital gains tax rate but on the tax rate on ordinary income as well.

And those are the three thoughts I would like to leave you with today.

Let me begin with the effect of taxation on entrepreneurship and job creation. As Chairman Camp pointed out, the effect of taxation of capital gains is much higher. It is really not a taxation of capital gains; it is a taxation of capital income. It is one tax levied on top of another tax.

Moreover, if you look at the way we tax other types of receipt of capital income, such as dividends, we will be having an effective tax rate on capital income of over 60 percent next year. Frankly, that is a preposterously high rate of tax for a country that wants to compete on a global economic basis. It is simply too high. We have to consider a way around it.

That said, I understand the dilemma of the tradeoffs between capital gains taxation and ordinary income taxation. And I do come down on the side on net of bringing them closer together; on balance, raising the capital gains rate and cutting the tax rate on others, other forms of income.

In doing that, I think we need to keep in mind the experiment we are going to be running but now running backward. We did some extensive work in 2001 and in preparation for the 2003 tax cut on the effects of dividend and capital gains taxation on the level of equity prices, not just because people hold equities, but many, many millions of Americans hold it through pension funds. And frankly, we were very concerned with the plight of the Nation's pension funds back then.

The estimate we came up with was that the capital gains change would have ended up raising the level of the S&P by about 8 percent. And I would point out that Allen Sinai, who has long been one of the Nation's premier economic modelers, estimates that if we go over the cliff and all those taxes you were talking about take effect, that the decline in the S&P from current levels as a result of that tax would be 19.6 percent. So we are talking about a rather substantial possible effect.

I also think it is important that you keep in mind what happens on the small business level, and that is with regard to ordinary income tax rates. We are going to have an effective tax rate on the cash flow of small businesses next year of roughly 44 percent. If

you look at any partnership and you look at the traditional partnership draw argument, most of that draw was to pay income taxes. I can tell you, as a small business man, that is where most of my owner's draw goes; it simply goes to pay income taxes. And that money at the margin isn't coming from me; it is coming from my ability to reinvest in my business and my ability to invest in other businesses. And so the idea that this is somehow sterile money that doesn't affect the performance of the economy I really don't think comports with the facts.

If I could ask you quickly to turn to table one, I would like to show you the experiment we ran in the 1990s and what its effect was. I was a little bit startled, and you might remember that what we did then was to raise the ordinary income tax rate—by the way, this is on page 6 in the testimony—and leave the capital gains rate unchanged. What I found interesting was that, between 1992 and 1994, when this tax took effect the AGI, adjusted gross income, reported by high-income taxpayers actually declined. This was in the prosperous 1990s. When I did the numbers back, I found that the response was the same as it had been in the 1980s to the reduction of the tax rate, an income elasticity of about .7 percent—elasticity of .7. Capital gains, on the other hand, surged; proprietary income declined. So the fact that there is an effect of tax rates on the behavior of small businesses I think is incontrovertible, and it is shown even in the 1990s data.

Similarly, if you would—I know we are running out of time here—turn to figure 2, you can see what the effect of that was on revenue. We did an analysis of what happened. It turned out that about 62 percent of the expected revenue did not actually materialize from the 1993 tax rate increase on high-income taxpayers; it reduced—it came from—resulted in less economic activity.

Let me conclude then—I realize my time is up—with three points I would like to leave you with. First, tax rates need to be moderate. Once tax rates in general start to hit 40 percent, they begin to, although they still raise more revenue, the effect on the private sector is profound.

Second, capital gains taxation should be as neutral as possible with regard to other capital taxation. Currently, we are encouraging too much borrowing and not enough equity investment.

And finally, I think that the conclusion should be that the ordinary and capital gains tax rate should probably be reduced. I think it would lead to significant efficiency gains.

Thank you, and I apologize for going over, Mr. Camp.
[The prepared statement of Mr. Lindsey follows:]

Tax Reform and the Tax
Treatment of Capital Gains

Testimony Before a Joint Meeting of the
U.S. House of Representatives Committee
on Ways and Means and the Senate
Committee on Finance

Lawrence B. Lindsey

September 20, 2012

I would like to thank Chairmen Camp and Baucus for holding this very important hearing in a bipartisan and bicameral way. There are probably few issues more central to getting America out of its current fiscal and economic difficulties than fundamental tax reform and the focus of this hearing on capital gains is an important component of that effort.

This is a very complicated issue, but in the interest of time, there are three themes that are critical. First, the key to escaping the economic and fiscal morass in which we now find ourselves is to make America the best place in the world to invest, start a business, and create jobs. This involves a focus on the overall rate of taxation of both capital and entrepreneurship, and not on the capital gains tax rate in isolation. Second, there is a strong relationship between the rate of taxation and the level of the economic activity being taxed, and therefore on the revenue collected from such a tax. This relationship is not as strong as some believe, but it is far stronger than that implied by static revenue models. Moreover, the focus should not be on the revenue maximizing tax rate, but on the additional economic burden created for each dollar of revenue collected. This means that the optimal rate of taxation is well below the revenue maximizing level. Third, the revenue collected from capital gains taxation depends not only on the capital gains tax rate, but on the tax rate on ordinary income as well. A large differential between these rates skews the design of investment and financing just as the current huge differential between the taxation of debt and equity. These are important issues in designing the taxation of capital.

The Taxation of Capital and Entrepreneurship

The capital gains tax rate impacts two key economic drivers: the return on capital and the return on entrepreneurship, but is only part of the calculation on both. Consider first the taxation of the return on corporate capital in its most straightforward form. When a corporation earns a

dollar in profits domestically, it pays a 35 percent corporate rate. The remaining 65 cents is then either retained by the corporation or paid in a dividend. Typically a dollar retained by the corporation raises the value of the company by a dollar which would then be realized and taxed at the capital gains tax rate when the shareholder liquidated his position in the company. At a 15 percent tax rate, this would imply a *total* tax rate on the dollar earned by company of 44.75 percent.

Now, the shareholder might not sell the stock immediately, thus deferring the capital gains tax. But, if he or she makes that choice, the dollar remains in the corporation where it produces a rate of return that is taxed at the corporate rate of 35 percent. Internal compounding of returns by deferring capital gains tax is not particularly tax efficient, so tax calculations that emphasize deferral as a tax preference miss the point.

On the other hand, if the dollar is paid out in dividends, it is taxed at the dividend tax rate which currently is the same as the capital gains tax rate, producing a total rate of tax, again, at 44.75 percent. Some are now advocating raising the dividend tax rate. At the 44 percent rate now being contemplated by some, the effective tax rate on corporate profits paid to shareholders would rise to 63.6 percent.

From an economic point of view such a tax rate is preposterously high. It would not only not make America the best place in the world in which to invest, start a business, and create jobs, it would make it one of the worst. Even a 44.75 percent effective tax rate is far higher than is economically optimal if the objective is to promote growth in America in a very competitive world economy.

Raising the capital gains (and dividend) tax rates will be reflected in share prices. In the preparation for the 2003 tax bill, we estimated that the reduction in the capital gains and dividend

taxes would produce a minimum 8 percent rise in the level of share prices. A recent study by Allen Sinai, one of the leading macroeconomic modelers of the last 40 years, estimated that the elimination of the capital gains and dividend tax changes of 2003 would lead to an 19.6 percent reduction in the S&P 500. Such a change would not only adversely affect the wealth of American consumers, it would also severely damage the already impaired position of America's pension funds.

The capital gains tax rate also has an important effect on the formation of new businesses and entrepreneurship. Increasingly entrepreneurs are not forming traditional corporations, but instead use Subchapter S and similar corporate forms to skip the corporate level of taxation. But the dynamics of capital formation in the small business and entrepreneurial environment are the same. When a dollar is earned by the entrepreneur it is taxed at the current personal rate and is also subjected to both employer and employee Medicare taxes. This makes the effective tax rate on internal buildup within the small business 37.4 percent. Again, some are now contemplating raising this rate to an effective rate of 44 percent. Others are advocating subjecting this income to the full panoply of FICA taxes, thereby driving the rate on small business cash buildup into the mid-50s. It goes without saying that this would not be a good development for small business formation or job creation.

One advantage the entrepreneur has in this model is that the dollar retained in the small business increases his or her basis in the company, and so, if and when the company is sold, that dollar is not subjected to a second round of taxation at the capital gains level. In this sense this makes the capital gains tax rate much less important to the internal buildup of cash within the small business than the ordinary tax rate.

On the other hand, favorable capital gains tax treatment does benefit the company that creates what I think of as “sudden value” without the normal generation of cash. This might come from an invention or an innovation in marketing or being the creative force behind a new industry or business model. This is very powerful stuff in terms of economic growth, and is something that America specializes in. As others on this panel will attest, the capital gains tax rate is an important element of attracting capital to these types of enterprises. But, because this type of “sudden value” is not taxed in the cash-generation process, the capital gains tax is often the only tax on this type of activity. This leads me to conclude that the capital gains tax should not be considered independently of the ordinary tax rate when assessing the tax design that best promotes capital formation and small business creation.

Tax Rates and Tax Revenue

A substantial literature exists on the relationship between capital gains tax rates and capital gains tax revenue. And there is a good degree of disagreement within that literature on the so-called “revenue maximizing” capital gains tax rate. The bulk of the evidence suggests that this rate is probably around 20 percent and, to my knowledge, there simply is no evidence to support a conclusion that the rate is any more than 28 percent. I think this latter figure is used, at least implicitly, by the Joint Committee.

In my view, too much attention is paid to the concept of a “revenue-maximizing” rate. All that means is that the government is wringing as much as it can out of the private sector. It does not take into account the harm being done to the private sector in the process, the impact of this on economic growth, or the effect on job creation. The only point at which the concept of a revenue maximizing rate becomes useful is that higher rates of taxation become a lose-lose

proposition, with no winners. Both the government and the private sector are made worse off from higher rates.

But this does not mean that raising rates to a point below the revenue maximizing rate is necessarily good for the economy or for society. The government may be a winner, but the private economy is still a loser. The key question is one of a tradeoff: how much is the private sector made worse off to transfer each dollar of revenue to the public sector. To care only about getting the most revenue means that the government cares only about itself, and not about the public or the overall economy. This may be an appropriate calculation for a totalitarian state, but it certainly is not appropriate for a country such as America. The simple fact is that the *optimal or efficient rate of taxation is below, and possibly well below, the revenue maximizing rate*. Therefore, the capital gains tax rate needs to be set well below the 28 percent level.

But, as mentioned before, capital gains realizations depend not only on the capital gains tax rate but also on other rates as well. To see this, consider what happened after the increase in the top tax rate from 31 percent to 39.6 percent in 1993. Table 1 shows the percent changes between 1992 and 1994 of capital gains and non-capital gains income for with incomes above \$200,000 and those below \$200,000, in inflation-adjusted 1990 dollars. There were roughly the same numbers of taxpayers in each group in both years, so this is a like-for-like comparison. Adjusted Gross income rose for all taxpayers between the two years in question. This is consistent with the overall improvement in the economy. The IRS data behind the table is for real, inflation adjusted, income. So the overall 1.9 percent growth in AGI over two years reflects real income growth of approximately 1 percent per year. Note however that income grew much faster for taxpayers reporting income under \$200,000 than for taxpayers reporting income over

\$200,000. But, the distribution of that income growth, as reported on tax returns, was skewed toward people making under \$200,000.

<u>Real Income Group</u>	AGI	Cap Gains	Other	Schedule C Income	
				Proprietors	S-Corp & Part.
All Taxpayers	1.9%	14.1%	1.4%	2.1%	23.5%
Under \$200,000	2.4%	9.4%	2.2%	5.0%	56.7%
Over \$200,000	-1.3%	18.3%	-4.6%	-11.0%	16.0%

One possible explanation for this is that overall economic trends were leading to a more equal distribution of income. But careful analysis of income distribution trends throughout this period by the U.S. Census Bureau suggests the opposite was true. Overall income was becoming more skewed toward the top of the income distribution throughout the 1990s, and was particularly sharp in the early part of the decade. So, that thesis has to be rejected.

While the data is not consistent with census bureau information on overall income distribution trends, it is quite consistent with the thesis that there was a behavioral response by taxpayers to changes in tax rates. This is true both overall and given the decomposition of income into capital gains and non-capital gains sources. While all income groups experienced increases in their capital gains realizations during this period as the stock market revived, the percentage gains among higher income taxpayers was nearly twice that for taxpayers earning less than \$200,000. So, when capital gains is excluded from income, the percent change in reported income shows an even greater disparity than for overall AGI. Taxpayers earning less than

\$200,000 reported a 2.2 percent increase in their non-capital gains income while taxpayers earning over \$200,000 reported a 4.6 percent decline in that income. Again, the former group did not see their marginal tax rates increase between the two years taxpayers while the latter group saw an increase of either 5 percentage points or 8.6 percentage points, depending on whether they were going into the 36 percent bracket or the 39.6 percent bracket.

It is also important to bear in mind why capital gains realizations rose so much for the higher income group even though the capital gains tax rate was unchanged. The data confirms the hypothesis that the realization of capital gains depends not only on the level of the capital gains tax rate, but also on the differential between the tax rate on capital gains and the rate on ordinary income. In 1992 the capital gains of 28% was similar to the ordinary income tax rate of 31% for taxpayers earning about \$200,000. In 1994 the ordinary income tax rate was raised by 5 to 8.6 percentage points for these taxpayers. The effect of this was to encourage taxpayers to rearrange their portfolio of investments in ways that increased the realization of capital gains and reduced the realization of other forms of income. The reverse effect happened after the 1986 tax reform, when the differential between capital gains and ordinary income was eliminated after having been 30 percentage points.

Further evidence of a strong behavioral response by taxpayers is provided by what happened to Business and Professional Income between 1992 and 1994. This income classification is known as "Schedule C" income because it is reported on that schedule on Form 1040. This is income received by individual sole proprietors. The economy expanded between 1992 and 1994 as did the profitability of businesses rose across the board. The National Income and Product Accounts compiled by the Commerce Department reported that corporate profits surged 25 percent, from \$496 billion to \$628 billion. The same non-tax measure of profit growth

for the unincorporated business sector rose from \$415 billion to \$485 billion or 17 percent. The overall tax data also showed growth in the reporting of profits for the unincorporated business sector. The overall income of proprietorships grew 2.1 percent between 1992 while the profits reported by partnerships, LLCs and Subchapter S corporations expanded 23.5 percent. The combined profits of both forms of unincorporated business organization rose 9.9 percent, very much in line with the data compiled by the Commerce Department's Bureau of Economic Analysis that puts together the National Income and Product Accounts.

But when this data is decomposed into the same income classifications described above, the tax sensitivity becomes clear. The income of sole proprietorships rose \$6 billion or 5 percent on tax returns with AGI under \$200,000 but *fell* nearly \$3 billion or 11 percent on tax returns with AGI over \$200,000. Either one would have to conclude that well-to-do proprietors suddenly became incompetent and less profitable at a time when all other businesses suddenly got more profitable, or that the same kind of tax responsiveness that was exhibited to other, earlier, tax changes was still in play. As expected, the tax responsiveness at the partnership and Subchapter-S level was less than at the proprietorship level, but was still present. Upper income taxpayers reported a 16 percent rise in their income from these companies while tax returns with AGI under \$200,000 saw a stunning 57 percent growth in such income. Again, it seems implausible that firms owned by higher income individuals were only one-third as successful as those of lower income individuals at raising profits during this time period.

To see the effect of this on tax revenue, we used the published data compiled by the Statistics of Income division of the Internal Revenue Service in its annual report on Individual Income Tax Returns. This data is unadjusted for inflation, and so differs somewhat from the previous analysis. We created a standard "counterfactual" to see what would have happened had

the tax rate not been increased, using the growth in income for taxpayers earning less than \$200,000, and who did not see a tax rate increase, as a baseline.

Table 2 presents this data for the three major income groups most affected by the tax rate increases: taxpayers with AGI between \$200,000 and \$500,000, between \$500,000 and \$1,000,000 and over \$1,000,000. The first column shows the amount of non-capital gains taxable income that would be predicted for each group using the counterfactual analysis. The level of non-capital gains income for each group in 1992 was increased by 6.3 percent, the per-return increase in taxable income for taxpayers not affected by the tax rate changes to get the counterfactual level for 1994. The second column shows the actual non-capital gains taxable reported for each group in 1994. The difference between these two columns represents the estimated behavioral response of taxpayers (in terms of taxable income) to the higher tax rates they faced. This calculation suggests that non-capital gains taxable income was about 8.1 percent, or \$31.3 billion lower than it would have been without the tax rate hike. The table then extends this analysis of the shortfall in taxable income to tax revenue. The third column presents the Internal Revenue Service's computation of the taxable income that was taxed at the new 36 and 39.6 percent rates. The fourth column simply extends this analysis to compute the *extra* revenue that was collected by taxing this income at 36 percent and 39.6 percent instead of at the old 31 percent rate. As the figure shows, the 36 percent bracket collected an additional \$4.2 billion compared to what would have been collected on that income had the top rate remained at 31 percent. The 39.6 percent tax bracket produced an extra \$14.17 billion compared to having had that income taxed at 31 percent.

Figure 2 Expected vs Actual Non-Capital Gains Taxable Income in 1994									
Income Group	Expected Non-CG Income	Actual Non-CG Income	Taxable Income at			Extra Tax at		Foregone 31% Tax at Lower Tax Rate	Revenue Raised
			36%	39.6%		36%	39.6%		
\$200k-\$500k	179.2	168.9	61.9	21.9		3.1	1.9	3.2	1.8
\$500k-\$1,000k	77.9	75.1	15.2	45.2		0.8	3.6	0.9	3.5
Over 1 million	129.1	110.8	7.1	100.7		0.4	8.7	5.7	3.4
Total	386.1	354.8	84.1	164.8		4.2	14.2	9.7	8.7

But those numbers only reflect the higher rate on income that was realized despite the rate being higher. The behavioral response of taxpayers lowered the amount of income that was reported and the IRS would have collected taxes on that revenue at a 31 percent rate. This calculation is provided in the final column. The difference between the counterfactual level of non-capital gains taxable income and the actual level of non-capital gains income is multiplied by the 31 percent tax rate to produce this measure of foregone revenue. By this calculation, the true *net* increase in revenue collected by the IRS was only \$8.66 billion, the difference between the extra revenue collected at the higher rate and the foregone revenue that would have been collected at the lower rate on the income that was not produced. On net therefore, the total effect of the higher rates was to add only \$8.66 billion to federal coffers, only about 38 percent of what was originally estimated, leaving the behavioral response of taxpayers to offset roughly 60 percent of the static revenue gain from higher rates. Some supply-siders might be disappointed by these figures. It does confirm that the tax rate hikes of 1993 did produce more revenue for the federal government. The more important point is that the dislocating effects of the higher rates were large relative to the extra revenue collected.

Moreover, from the point of view of making America the best country in the world in which to invest, start a business, and create jobs, the adverse effects of higher tax rates is greatest in the entrepreneurial and small business sectors. The revenue maximizing tax rate is not a good target for tax policy to shoot at. Instead, it is the rate at which further tax hikes are totally counterproductive, making both the government and the taxpayer worse off. The key question to decide for public policy is *how much* worse off is it prudent to make the private sector in order to improve public finances. As this analysis makes clear, as taxes approach the 40 percent rate, the

extra burden high rates put on the private sector becomes serious enough to be taken into proper policy analysis. That is true regardless what the capital gains tax rate might happen to be.

Capital Gains, Ordinary Rates, and Economic Distortions

The current tax structure is based on measuring “income”, as opposed to broader notions such as revenue or cash flow. It has emerged in an ad hoc fashion, beginning with the taxation of corporate income and then being augmented with personal income taxation. As a result, there are multiple definitions of “income” in the law. Accounting Standards require one measure. The corporate income tax another, the personal income tax yet another and the payroll tax still another. Interestingly, capital gains is not even considered income on the National Income and Product Accounts.

As long as we have an income-based tax system, we will continue to have distortions and unintended adverse incentives created as we try and work around these issues. The fact that the distortions are inevitable does not mean that we shouldn’t try to minimize them. Let me suggest three basic rules related to capital gains and the general taxation of capital income and entrepreneurship that should be foremost in minimizing these distortions. In all cases I will presume that we share the common objective of getting America out of its current economic and fiscal mess and that we seek a tax policy that helps to make our country the best place in the world in which to invest, start a business, and create jobs.

First, rates need to be moderate. The current effective tax rate on capital income and entrepreneurship is in the 38 to 44 percent range. That is internationally uncompetitive and raising rates from that level can only be viewed as counterproductive.

Second, capital taxation should be as neutral as possible with regard to financial decisions. The current heavy taxation of equity capital and generous taxation of debt helped

create an overleveraged economy for which we are now paying a heavy price. It also has tended to distort and overly complicate the tax treatment of capital gains since the gains implicit in debt financed capital get doubly preferred treatment. Limiting the favorable tax treatment of debt relative to equity will produce a better tax system while also providing revenue gains that can be used to pay for lower and better designed taxation of equity.

Third, the differences between the ordinary and capital gains tax rates should probably be reduced. As noted above, the incentives provided for both capital formation and entrepreneurship depend crucially on the ordinary rate as well as the capital gains rate. Although there are many competing cross-currents in these issues, on balance, it seems that low-to-moderate rates of taxation of both types of income would be the best approach.

Thank you.

Chairman CAMP. Thank you, Dr. Lindsey.
Dr. Burman, you are recognized for 5 minutes.

STATEMENT OF LEONARD E. BURMAN, DANIEL PATRICK MOYNIHAN PROFESSOR OF PUBLIC AFFAIRS AT THE MAXWELL SCHOOL, SYRACUSE UNIVERSITY, SYRACUSE, NY

Mr. BURMAN. Thank you very much for inviting me to speak before my two favorite tax committees on a very important subject.

I think when you get around to comprehensive tax reform, capital gains will be very important. It is a special pleasure to be on a panel with David Brockway, who is one of the heroes in the 1986 tax reform. And I remember I was a staffer at the Treasury Department working on capital gains, and I heard that the draft proposal would tax capital gains the same as other income. And my first reaction was, that is a terrible idea. I was a few years out of grad school and the first thing I thought, and Larry mentioned this, is that it would raise the effective tax rate on corporate capital.

I have obviously come around in the intervening years that taxing capital gains like other income was actually genius. It was the thing that made the income tax rate cuts in 1986 possible. And I also think that the story in graduate school is vastly over-simplified. And in fact, taxing capital gains at a lower rate than other income can do more harm than good.

First, I will mention the equity issue, which obviously is a concern. That was a big part of the reason why capital gains were taxed like other income, because capital gains are so skewed by income. The top 400 taxpayers in 2009 had 16 percent of the capital gains. It is very hard to maintain the progressivity of the income tax, and certainly without very, very high tax rates at the top, without taxing capital gains as something close to ordinary income tax rates.

The other issue is, do we need to lower capital gains tax rates to boost the economy? I certainly agree with Larry that we need the economy to grow robustly in the years to come, and we wouldn't want to do anything that would cause the economy to stall. But the issue for capital gains is complicated. For one thing, it is the single biggest factor behind individual income tax shelters. The differential in tax rates between ordinary income and capital gains, 35 percent, 15 percent, is a huge incentive to convert ordinary income into capital gains. And there is a whole industry devoted to making compensation of high-income people into capital gains.

The kinds of investments that produce these tax shelters are extremely inefficient. They often involve things that would make no sense to invest in absent the tax consequences, but you have money that could be going into productive investments that goes into investments that only make sense because of the tax break on capital gains.

There is also just an enormous amount of wasted human capital. Some of the smartest people, certainly in the tax profession, maybe in the country, are devoted to figuring out clever ways to get around the rules the IRS has put in place to try to keep people from converting ordinary income into capital gains. Those people, under other circumstances, might be able to invent products that people would want to buy in the rest of the world. I think that would be a better way for them to spend their time.

It also affects allocation of labor. There is a big incentive for very talented high-income people to engage in activities where they can earn their income in the form of capital gains; private equity, hedge funds. The people who do that, I think two of them are sitting to my left, I think they do enormously valuable work. But we shouldn't have a tax subsidy that tilts the balance in favor of that line of business relative to others. It should be neutral.

Now, there is the issue of cost of capital for corporations. It is certainly true that taxing capital gains and dividends, as well as taxing corporate income, can result in a double tax. But a lower tax rate on capital gains is a very blunt, poorly targeted instrument for dealing with that. Some corporations pay a lot of tax; some corporations pay very little tax. A lot of capital gains are on assets other than corporate stock. We provide a capital gains tax break on all assets not just stock. President Bush had a proposal that would have targeted capital gains and dividend relief to actually companies that were paying tax.

Other countries have what is called corporate tax integration, a system where you get a tax credit for the tax paid at the corporate level. That would save revenue, and it would eliminate a lot of the incentives for tax sheltering that exist under the current system.

There is the issue of lock in. I have actually done a lot of research on this. There certainly is an incentive to hold onto assets to avoid paying tax on capital gains, but the economic impact of that is vastly overstated. There is a chart in my testimony comparing individual capital gains with corporate capital gains. The tax rates changed at different times, and the two lines are almost indistinguishable.

I also have a proposal in my testimony for providing a tax credit effectively for capital gains taxes paid against the estate tax that would reduce the strongest incentive to, the so-called angel of death loophole, that if you hold your assets until you die, you avoid tax altogether.

There are a number of issues I can talk about in Q and A. There is an argument to not tax capital gains because of inflation; that you don't want to tax savings at a higher rate to encourage entrepreneurship. I believe all of those arguments are arguments for lowering tax rates on capital overall. They are not an argument for a lower tax rate on capital gains. I think using the capital gains tax as a way to cut ordinary income tax rates would be a win-win. It would reduce the incentive for tax sheltering, and potentially it could be the basis for another bipartisan plan like the Tax Reform Act of 1986. I would hope that that would be the direction you would go.

Chairman CAMP. Thank you very much, Dr. Burman.

[The prepared statement of Mr. Burman follows:]

Embargoed Until 10am
September 20, 2012

Statement of

Leonard E. Burman
Daniel Patrick Moynihan Professor of Public Affairs
Maxwell School
Syracuse University

Before the
House Committee on Ways and Means and the Senate Committee on Finance

Tax Reform and the Tax Treatment of Capital Gains

September 20, 2012

Chairman Camp, Chairman Baucus, Ranking Member Levin, Ranking Member Hatch, and Members of the Committees: Thank you for inviting me to share my views on tax reform and the tax treatment of capital gains. I am speaking for myself alone. My views should not be attributed to any of the organizations with which I am affiliated.

No issue ignites such fierce passions as the taxation of capital gains. Columbia law professor Michael Graetz (1997) referred to the epic battle between President George H. W. Bush and Senate Majority Leader George Mitchell as “the madness of two Georges.” President Bush was convinced that cutting tax rates on capital gains would turbocharge the economy and actually increase tax revenues. He could not understand why Democrats in the Senate would stand in the way. Senator Mitchell, however, was convinced that cutting capital gains tax rates would simply provide an unfair windfall to the wealthiest people in society.

How *should* capital gains be taxed? Under an income tax the answer is that capital gains should be taxed in full as they are earned, not when realized. Capital gains are income, not really different in substance from interest, rents, and royalties: other kinds of capital income that are taxed as ordinary income. Under the pure comprehensive income tax, corporate income would be allocated to shareholders and taxed as ordinary income, in the same way that S-corporations and partnerships are taxed.

Obviously we don't tax capital gains or corporations that way. Capital gains are taxed only when realized, and gains on assets held for at least a year are generally taxed at a lower rate than other income. Capital gains on assets held until death or donated to charity, however, are never subject

to income tax. And corporations are subject to a separate tax that is not integrated with the individual income tax. The consequence is that some corporate income may be subject to two layers of tax: the corporate income tax plus the individual income tax on capital gains and dividends.

Although most taxpayers are subject to a maximum statutory capital gains tax rate of 15 percent, various provisions of the tax code can raise the effective rate on capital gains. For example, the provisions that phase out tax benefits with income all have the effect of imposing a surtax on capital gains (and other forms of income). The phaseout of the alternative minimum tax (AMT) exemption can add up to seven percentage points to the effective capital gains tax rate. In addition, the Medicare surtax scheduled to apply to high income taxpayers under the Affordable Care Act will add 3.8 percentage points to the effective tax rate on capital gains and other forms of nonlabor income starting in 2013.

Thus, the effective federal tax rate on capital gains, while usually significantly lower than the tax rate on labor income, can vary significantly.

Issues in taxation of capital gains

If capital gains cannot be taxed on an accrual basis and corporate income is subject to a separate tax, it is not obvious how best to tax capital gains. There are a number of factors that weigh on the decision:

- Taxing capital gains at a lower rate than other income creates incentives to invest in inefficient tax shelters and other economic distortions.
- Capital gains are disproportionately realized by extremely wealthy taxpayers. A tax preference for capital gains inevitably provides large benefits to very high-income people.
- Taxing capital gains differently from other income is a major source of complexity in the tax code.
- Taxing capital gains on realization discourages sales of assets: the so-called “lock-in effect.”
- The corporate income tax and the capital gains tax may create an economically inefficient double-tax on corporate investment, although there are large disparities in the overall effective tax rate on corporate income.
- A portion of capital gains is really inflation and thus not income; however, that is true of *all* forms of capital income. Indeed, the implicit inflation surtax on capital gains is somewhat lower than on other forms of capital income because of the ability to defer tax payment until assets are sold.

- Some argue that the right tax base is not income but consumption, in which case capital gains should not be taxed; however, even if one accepts the premise, it's not clear that exempting only one form of capital income from tax is an improvement.
- Some argue that a lower tax rate on capital gains is necessary to encourage risk-taking and entrepreneurship.

In my testimony, I shall address each of these issues in turn.

To summarize, while targeted relief from capital gains tax may be warranted for some corporate stock, the current blanket income tax preference for capital gains is very poorly targeted and, on balance, may do more harm than good to the economy. The capital gains tax preference also creates gross inequities, significantly undermining the progressivity of the income tax.

Capital gains reform was the lynchpin of the 1986 reform and several recent bipartisan reform proposals. It could be an important element of the next tax reform. The best option, in my view, would be to tax capital gains as ordinary income and use the revenue gained to lower individual and corporate income tax rates. Reform might also tackle the largest capital gains tax loophole—the non-taxation of capital gains held until death. Mitigating this loophole could substantially reduce the lock-in effect and help protect the capital gains tax base. I discuss a potentially politically feasible option to tackle the “angel of death loophole” in the context of estate tax reform.

A capital gains tax differential creates significant economic distortions

Whatever its benefits, the difference in tax rates between capital gains and other income is a prime factor behind individual income tax shelters. Since ordinary income is taxed at rates up to 35 percent while long-term capital gains are taxed at a maximum rate of 15 percent, there is a 20 percent reward for every dollar that can be transformed from high-tax compensation, say, to low-tax capital gains.

The basic idea is to make an investment that generates deductions, such as for interest, lease payments, or depreciation, to reduce (or eliminate) current income tax liability and ultimately get the money back in the form of a capital gain. Because of the rate differential between capital gains and ordinary income, a tax shelter can return significantly less than a dollar for every dollar invested and still be profitable. Before enactment of the Tax Reform Act of 1986, taxpayers could use accelerated depreciation and interest deductions to shelter current income. Investment in “see-through office buildings” in the early 1980s and other dubious tax shelter investments were the result. This produced a boom in investment in commercial real estate, far beyond anything that could be justified by economic fundamentals. Effectively, capital was being steered away from productive investments into relatively unproductive uses simply because the latter generated huge tax benefits.

The Tax Reform Act of 1986 clamped down on many of those tax shelters through the passive loss limitation, limits on interest deductibility, elimination of investment tax credits, and the curtailment of accelerated depreciation. But the single biggest factor in stamping out those tax

shelters was the taxation of capital gains at the same rate as other income. My research with Tom Neubig concluded that the very complex passive loss limit and investment interest limits were probably superfluous as long as capital gains and ordinary income were taxed at the same rate. (Burman and Neubig, 1987) But those limitations became increasingly important as ordinary income and capital gains tax rates diverged in the decades after tax reform.

In 2012, the biggest tax shelter may arise from the fact that certain forms of compensation are taxed as capital gain. For example, managers of private equity funds hold a “carried interest”—a right to receive a share (typically 20 percent) of the profits produced by an investment fund over and above any share corresponding to their actual cash investment. As a result, a significant portion of their compensation is ultimately taxed as capital gain, rather than ordinary income. Private equity managers also receive fees that are taxed as ordinary income, but if the investments are successful, that is a small portion of their compensation.

Besides for the obvious inequity of people with multi-million dollar earnings being taxed at lower rates than middle-income workers—a disparity that at least in part motivated the Buffett Rule—this is also economically inefficient. While there probably would be a role for private equity funds even in the absence of the capital gains tax break, it is surely true that more people and capital are drawn to such firms by the tax breaks.

Data compiled by the Internal Revenue Service suggest a marked shift in the kinds of assets that generate capital gains over time. In 1997, more than half of capital gains came from corporate stock, either held directly or indirectly through mutual funds. Only 30 percent was generated by so-called pass-through entities: S-corporations, partnerships, trusts and estates. (See Table 1.) Ten years later, corporate stock was less than 40 percent of all long-term gains while pass-through entities comprised more than 44 percent. Over that same period, there was also a very large increase in the dollar amount of pass-through gains—296 percent—compared with a 91 percent increase for stocks and mutual funds. The growth of private equity firms, which are typically organized as partnerships, and other investment partnerships might be a significant factor in this shift.

**Table 1. Percent Distribution of Net Long-Term Gains,
by Asset Type, 1997 v. 2007**

	<u>1997</u>	<u>2007</u>
Corporate stock and mutual funds (except muni bond funds)	53.7	38.7
Pass-through (S corporations, partnerships, estates, and trusts)	30.1	44.4
Business	7.4	7.4
Land	3.8	3.4
Other	5.1	6.1

Source, Wilson and Liddell (2010).

Thus, the lower tax rate on long-term capital gains produces several distortions: (1) It encourages investments purely for tax purposes that would not make any sense without the tax savings, draining capital away from other more productive investments. (2) Since tax shelters that can pass legal muster or escape detection tend to be extremely complex, brilliant financial planners,

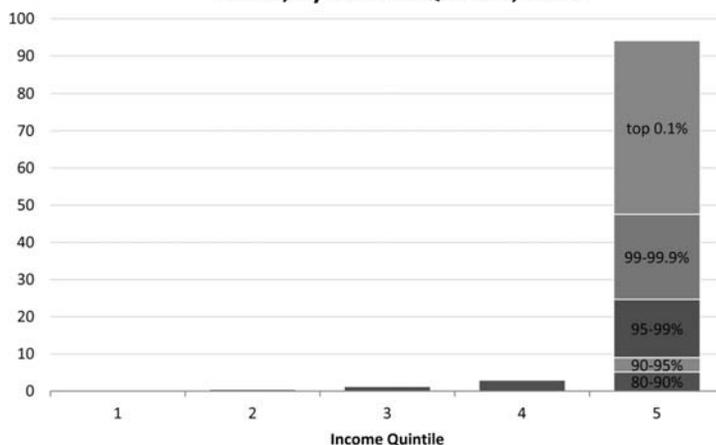
lawyers, and accountants turn their talents to this lucrative, but socially unproductive line of work. (3) Similarly, the enormous tax savings available likely lure too many highly productive people into the private equity business, drawing them away from other potentially more socially valuable enterprises.

The larger the rate differential between capital gains and other income, the larger these distortions will be. This doesn't prove that a low rate on capital gains is on balance counterproductive, but it does suggest that any benefits from a capital gains preference must be very significant to offset the substantial incentive it creates to engage in tax sheltering.

The benefits of lower capital gains tax rates are extremely concentrated at the top

The benefits of a capital gains tax preference are extremely concentrated among those with very high incomes. In 2010, the highest-income 20 percent realized more than 90 percent of long-term capital gains according to the Tax Policy Center. (See Figure 1.) The top 1 percent realized almost 70 percent of gains and the richest 1 in 1,000 households accrued about 47 percent. It is hard to think of another form of income that is more concentrated by income.

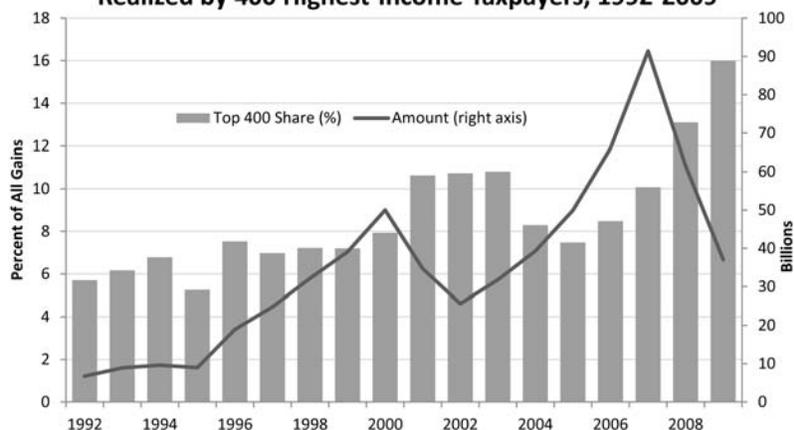
Figure 1. Percent Distribution of Long-Term Capital Gains, by Income Quintile, 2010



The concentration of capital gains has also been growing over time. The IRS has published aggregate data from the income tax returns of the highest-income 400 taxpayers from 1992 to 2009. In 2009, the "fortunate 400" had adjusted gross incomes of at least \$77 million. That

small group, which corresponded to 0.00028 percent of taxpayers, realized 16 percent of all gains (\$37 billion). (See Figure 2.) That share is an all-time high because, even though ultra-high income households' capital gains fell in 2009, the capital gains of other less well off taxpayers fell even more. But Figure 2 shows that the trend toward increased concentration has tended to increase over time.

Figure 2. Share of Capital Gains and Total Amount Realized by 400 Highest-Income Taxpayers, 1992-2009



Source: Internal Revenue Service (2012).

Based on surveys (e.g., Pew 2011), a majority of Americans favors a more progressive tax system. A higher level of progressivity could be achieved without raising top ordinary income tax rates by reducing or eliminating the capital gains tax preference. (This approach was taken in 1986 and proposed by the Bowles-Simpson debt reduction commission.) Alternatively, if capital gains tax rates are to be kept low, it will be very difficult if not impossible to cut top income tax rates as part of tax reform while satisfying the public's preferences with respect to the distribution of tax burdens.

The preferential taxation of capital gains complicates the tax code

If capital gains were taxed the same as other income, defining them would be fairly straightforward. The prime source of complexity would be the relatively simple matter of defining what events trigger the realization of gain. Classifying income as capital gain or wages or rents would have no tax consequence. However, when capital gains are taxed at much lower rates than other income, the tax code needs complex rules to delimit the boundary between

capital gains and other income. In addition, complex anti-tax shelter provisions, such as the passive loss rule, limitations on the deductibility of interest, and a host of other provisions are necessary to deter abuse. Tax lawyers have told me that half of the Internal Revenue Code is devoted to defining the difference between capital gains and ordinary income. If capital gains were taxed as ordinary income, much of that complexity could be eliminated.

Additional complexity arises from the peculiar way we have chosen to favor capital gains. For most of the history of the income tax, a portion of long-term capital gains was simply disregarded in calculating gross income. For example, in 1986, 60 percent of long-term capital gains were excluded from income. Effectively, this lowered the top tax rate on capital gains from 50 percent, the rate that applied to ordinary income for high-income taxpayers, to 20 percent. A \$1,000 capital gain contributed just \$400 to taxable income. This was fairly straightforward.

As noted, the Tax Reform Act of 1986 taxed capital gains as ordinary income, at rates up to 28 percent — the top rate set under the new law. However, some lawmakers were concerned that ordinary income tax rates would creep up over time and they did not want the capital gains tax rate to rise as well. The compromise was a provision limiting the maximum capital gains tax rate to 28 percent. When ordinary income tax rates increased in 1990 and again in 1993, the maximum 28 percent tax rate became a tax preference compared with the ordinary income tax rates that rose as high as 39.6 percent.

In 1997, President Clinton and Congress agreed to reinstate an explicit preferential tax rate for capital gains. However, instead of restoring a partial exclusion for capital gains, they created an alternate rate schedule. At that time, there were two rates on assets held over a year: 10 percent for low-bracket taxpayers and 20 percent for those in higher tax brackets. (Lower tax rates were also scheduled for assets held longer than five years, but they never took effect.) When the top rate was cut to 15 percent in 2003, the alternate rate schedule still prevailed.

Implementing the alternate rates is extremely complicated as a cursory glance at the 37-line tax computation worksheet for the schedule D makes apparent. The same complex calculations also must be done under the alternative minimum tax, because the alternative capital gains tax rate schedule applies there too. It would be much simpler, if the capital gains preference is to be retained, to return to a partial exclusion.

Taxing capital gains upon realization creates a "lock-in effect"

Under our income tax, taxpayers do not pay tax on capital gain until the asset is sold and the gain is "realized." Even without an explicit capital gains tax preference, the ability to defer tax until realization is valuable. For example, if you hold a bond that pays a 5-percent interest rate, you have to pay tax on the interest income every year. At a 35 percent tax rate, this reduces the after-tax return to 3.25 percent. However, if you invest in an asset that produces capital gains at a rate of 5 percent per year and hold the asset for 10 years, you need not pay capital gains tax until sale. If the gain were taxed at the full 35 percent rate, the after-tax annual return would be 3.49 percent. The annual effective tax rate is 30.3 percent. If the capital gains asset is held 20 years, the effective tax rate falls to 25.7 percent. (The tax rate on the bond stays the same—35 percent.)

This is an example of the well-known fact that income deferral is valuable, and that valuable benefit is an intrinsic feature of a realization-based capital gains tax.

However, taxation upon realization has a significant downside: the “lock-in effect.” Taxpayers have an incentive to hold onto assets to postpone realizing the gain. This can be economically inefficient if taxpayers hold onto assets that are underperforming. It's not much of a problem for publicly traded corporate stock since the biggest actors in the market — institutional investors and foreign investors — are unaffected by the individual capital gains tax so prices should reflect market participants' best guess of intrinsic values. But lock-in may be significant for assets like a business, where the owner might be induced to hold even when a buyer might be able to run the business better. The lock-in effect is exacerbated by the fact that capital gains on assets held until death are generally exempt from income tax.

Beside for the efficiency costs of lock-in, there's also the possibility that raising capital gains tax rates would not increase revenues. At higher tax rates, there's more of an incentive to hold. At some sufficiently high tax rate selling would decline to the point where revenues could actually decrease when rates go up.

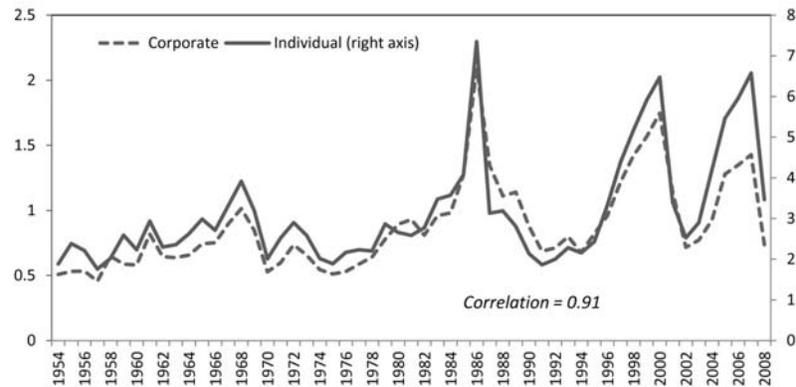
Both the Joint Committee on Taxation (JCT) and Treasury's Office of Tax Analysis built substantial behavioral responses into their estimates of the revenue effect of raising capital gains tax rates. In consequence, raising rates much above 28 percent or so would likely not be scored as increasing capital gains revenue (although there might be a small additional revenue gain from deterring income tax sheltering). Recent research by economists at the CBO and JCT (Dowd, McClelland, and Muthitacharoen, 2012) suggests that the revenue-maximizing tax rate might be even lower (although the paper does not explicitly estimate that rate).

Jane Gravelle (2010) of the Congressional Research Service surveyed the literature on the responsiveness of capital gains to tax rates and concludes that the revenue-maximizing tax rate is probably significantly higher than 28 percent. She argues that the level of responsiveness suggested by Dowd, et al. (2012) and others would imply that realizations would far exceed the amount of accrued gains if capital gains taxes were eliminated, which clearly cannot be true over the long run.

University of Connecticut economist George Plesko found indirect evidence that other factors are likely much more important to realization decisions than tax rates. He compared corporate and individual capital gains over time and found that the two series are highly correlated. (Figure 3 is based on data provided by Plesko and my own calculations.) This is surprising since the tax rates on individual and corporate capital gains often changed at different times. If tax rates were the primary determinant of realizations, one would expect the two time series to diverge in 1981, 1997, and 2003, when individual capital gains taxes were cut while corporate rates stayed the same. That did not appear to happen.

Lock-in might constrain the tax rates that could be imposed on capital gains under current law, but another option to reduce lock-in is to tax capital gains at death or impose “carryover basis”— a provision that would require heirs to pay tax on the entire accumulated capital gains when they

**Figure 3. Individual and Corporate Capital Gains
as % of GDP, 1954-2008**



sell an inherited asset (rather than just the gain accrued since inheriting it). Carryover basis was briefly enacted for very wealthy taxpayers along with repeal of the estate tax in 2010, but carryover disappeared when the estate tax returned in 2011.

A final issue created by taxation upon realization is that deductions for capital losses must be limited. Currently, taxpayers may only deduct up to \$3,000 of net capital losses against other income. Losses in excess of this amount may be carried over to later tax years, but not currently deducted. The loss limit is necessary because otherwise well diversified investors would be able to shelter virtually all of their income from tax by selectively realizing losses and deferring capital gains. However, the loss limit can be a hardship for investors with only a single asset that is sold at a large loss.

Evidence from the 1980s (the most recent available) suggests that taxpayers with net losses in excess of the \$3,000 annual deduction limit were usually able to deduct them within a year or two. (Auerbach, Burman, and Siegel, 2000) Thus, although the asymmetric treatment of gains and losses might create a burden, especially for the risky investments most likely to generate losses, the evidence suggests that the loss limit is not especially onerous for most taxpayers.

Taxing capital gains double taxes corporate stock

One argument for a lower tax rate on capital gains is that corporations already pay income tax, so any tax on individual capital gains and dividends amounts to double taxation. The ideal solution to this problem is to integrate the corporate and individual tax systems. There are various ways to do this, but integration basically amounts to taxing corporations the same way we tax S-

corporations and partnerships. Income would be allocated to shareholders and taxed at the shareholder level annually.

Economists have long been enamored of this solution, but it has never gained much traction with policymakers. If integration is not possible, is a lower tax rate on capital gains an appropriate offset to the double taxation of corporate stock? Table 1 suggests that a blanket capital gains tax preference is a very poorly targeted offset to double taxation of corporate income. In 2007, only 39 percent of long-term capital gains were on corporate stock or mutual funds. While it is possible that some of the capital gains in pass-through entities is attributable to corporate stock, it's likely that most capital gains are from other sources.

Moreover, there is wide disparity in the taxation of corporate income. McIntyre, et al. (2011) reported that "a quarter of the companies in our study paid effective federal tax rates on their U.S. profits of less than 10 percent. ... [A]n almost equal number of our companies paid close to the full 35 percent official corporate tax rate." (p. 1) Corporations in some industries benefit from special tax breaks and some are more aggressive or effective at avoiding taxation than others. It is clear that a blanket reduction in capital gains (and dividend) tax rates provides too little relief for some companies and too much for others.

Burman (2003) proposed that capital gains and dividend tax relief be tied to the amount of tax paid at the company level and that capital gains on assets other than corporate stock should be fully taxed. However, allocating corporate taxes to shareholders is complex and policymakers rejected a similar proposal when made by President George W. Bush (although he would not have eliminated the capital gains preference for non-corporate stock).

Altshuler, Harris, and Toder (2010) suggest an alternative approach to providing relief from double taxation: tax capital gains at rates up to 28 percent and dividends in full and use the revenue gained to pay for corporate tax rate reductions. They estimate that the top corporate tax rate could be reduced from 35 percent to 26 percent or less on a revenue-neutral basis. They also point out that this reform would be more progressive than the current system.

A significant portion of capital gains simply reflects inflation

It is certainly true that when an asset is held for a long time, much of the apparent gain simply reflects inflation. That is an argument for indexing the whole tax system for inflation (Shuldiner 1993), not a preference targeted at capital gains. In fact, the benefit of deferral may offset part or all of the inflation tax. (Burman 1999) This isn't true for assets that pay annual income such as bonds and rental properties. So if there is an argument for selective inflation relief, it would apply with most force to income other than capital gains.

The other concern is that the correct inflation adjustment would be very different from a flat reduction in tax rate. Indexing involves increasing the cost basis of a capital asset to reflect inflation since it was purchased before computing capital gain. At a constant inflation rate and real rate of return, this would correspond to an exclusion that declined with the holding period. And, of course, the appropriate amount of relief would depend on the inflation rate, which varies

over time. The alternative rate schedule applied to capital gains under current law is clearly a very poor proxy for inflation indexing.

Moreover, if capital gains are taxed at lower rates when capital expenses are not adjusted for inflation, there remains the incentive to use the unindexed deductions to shelter current income while ultimately realizing income that is taxed at only a fraction of the nominal value. In other words, the distortion created by differential tax rates remains.

Capital gains would not be taxed under a consumption tax

Some argue that the proper tax base is not an income tax but a consumption tax. Under a consumption tax, capital gains and other returns to savings would not be taxed. Therefore, eliminating the tax on capital gains is a step in the direction of a better tax system.

Whether consumption tax or income tax is the appropriate base is obviously a contentious issue, but even accepting the premise that we should have a consumption tax, taking one step in the direction of a consumption tax — by exempting capital gains alone from tax — does not necessarily represent an improvement. The problem, just as in the case with indexing for inflation, is that a low or zero tax rate on capital gains when the rest of the income tax is left alone creates huge incentives for tax sheltering, as discussed above.

If the concern is that capital income is overtaxed, then the appropriate solution is to reduce the taxation of all capital income, not just capital gains. One option for doing this is to adopt a value-added tax and use the revenue raised to lower income tax rates. This was the approach taken by the Bipartisan Policy Center (2011) Debt Reduction Task Force. A more radical alternative would be to adopt a dual income tax, as is used in Scandinavian countries. Such a system explicitly taxes capital income at a lower rate than other income.

Do we need lower tax rates on capital gains to encourage entrepreneurship and risk-taking?

Capital gains taxes have mixed effects on risk-taking. Given that most losses are ultimately deductible, the capital gains tax includes a kind of risk-sharing. Investors have to share gains with the government, but losses are also shared. Moreover, economist James Poterba (1989) has found that much of the capital that finances new investment comes from foreigners and pension funds and is thus not subject to capital gains taxes and unaffected by capital gains tax breaks.

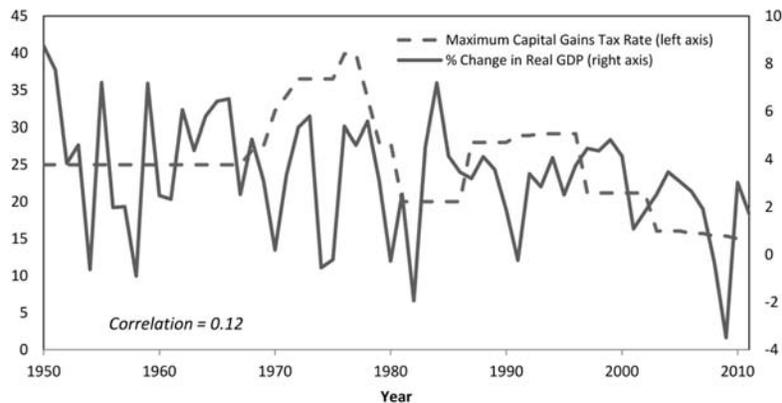
One other area of concern is the effect of the capital gains tax on entrepreneurial activity. In fact, the income tax treats investments of “sweat equity” very favorably. Entrepreneurs do not have to pay tax on the value of their labor until it produces income. Effectively, investments in one’s own business are expensed in the sense that tax is avoided altogether on the value of the uncompensated labor invested. Like an IRA or 401(k), this makes entrepreneurial capital tax-free. To the extent that entrepreneurial capital ultimately produces returns in the form of capital gains, entrepreneurs effectively pay a negative tax rate on their own labor input because the

contributed labor is expensed while the ultimate return is only partially taxed. And capital gains that are considered “small business” may qualify for a zero rate, creating an even bigger subsidy.

There is no obvious relationship between capital gains taxes and economic growth

The heated rhetoric notwithstanding, there is no obvious relationship between tax rates on capital gains and economic growth. Figure 4 shows top tax rates on long-term capital gains and real economic growth (measured as the percentage change in real GDP) from 1950 to 2011. If low capital gains tax rates catalyzed economic growth, we’d expect to see a negative relationship—high gains rates, low growth, and vice versa—but there is no apparent relationship between the two time series. The correlation is 0.12, the opposite sign from what capital gains tax cut advocates would expect, and not statistically different from zero. Although not shown, I’ve tried lags up to five years and using moving averages, but there is never a larger or statistically significant relationship.

Figure 4. Top Capital Gains Tax Rates and Economic Growth, 1950-2011



I also posted this chart on my blog on Forbes.com and offered the data to all comers. A half dozen or so people, including at least one outspoken critic of taxing capital gains, took me up on the offer, but nobody to my knowledge has been able to tease a meaningful relationship between capital gains tax rates and the GDP out of the data.

Does this prove that capital gains taxes are unrelated to economic growth? Of course not. Many other things have changed at the same time as tax rates on capital gains and many other factors affect economic growth. But the graph should dispel the notion that capital gains taxes are a very

important factor in the health of the economy. Cutting capital gains taxes will not turbocharge the economy and raising them would not usher in a depression.

Options for Reform

As members of these two committees know better than most people, tax reform will be a challenging undertaking. It is also tremendously important. The tax code is unfair, inefficient, and much too complex. Changing the way we tax capital gains can help improve the tax code in all three dimensions. It could also improve the odds of a successful tax reform.

First, taxing capital gains at full rates can make it possible to significantly cut individual and corporate income tax rates. This was what made the Tax Reform Act of 1986 work. Since capital gains are so highly concentrated among high-income taxpayers, taxing capital gains allows disproportionate cuts in income tax rates without reducing the overall progressivity of the income tax or sacrificing overall revenues.

Second, if the lock-in effect is a serious concern, then Congress might consider either taxing capital gains at death or reinstating carryover basis. Either measure would substantially reduce the tax incentive to hold assets until death, reduce the distortions created by lock-in, and raise revenues that could be used for income tax rate reduction and/or deficit reduction.

Alternatively, lock-in might be addressed as part of permanent reform of the estate tax. (Temporary estate tax relief is scheduled to expire at the end of 2012, at which time the exemption level will fall from \$5.12 million exemption to \$1 million and the top estate tax rate increase from 35 percent to 55 percent.) As part of that reform, taxable estates might be allowed a tax credit for basis, effectively rebating capital gains taxes paid on estate tax returns. (Jerry Auten, the Treasury Department's staff expert on capital gains, suggested this approach many years ago. Burman (1997) derives the tax credit rate, which depends on the capital gains tax rate and the estate tax rate.) The credit provides the same economic incentive as taxing capital gains at death, but in the form of an estate tax break rather than a penalty. It obviously only applies to those who expect to owe estate tax, but since most capital gains are realized by people with very high incomes, such an approach could substantially reduce lock-in on most capital gains, even if only affecting a minority of capital gains taxpayers.

Third, a real reform might consider corporate tax integration. The U.S. Treasury (1992) laid out several options to eliminate the double taxation of corporate income, without favoring tax-avoiding corporations over others that pay full rates or providing tax relief for assets other than corporate shares.

And if major reform proves infeasible, Congress might consider replacing the schedule of alternative tax rates with a partial exclusion, as existed prior to 1987. That would significantly simplify compliance, especially for those brave souls who still complete their tax forms by hand.

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Chairman CAMP. Mr. Verrill, you are recognized for 5 minutes.

**STATEMENT OF DAVID L. VERRILL, FOUNDER AND MANAGING
DIRECTOR, HUB ANGELS INVESTMENT GROUP, LLC, CAM-
BRIDGE, MA**

Mr. VERRILL. Thank you, Chairman Camp, Chairman Baucus, Ranking Member Hatch, Ranking Member Levin and members of both committees.

Thank you for inviting the Angel Capital Association to speak before this joint hearing on tax reform and treatment of capital gains.

The impact of the capital gains tax rate is of significant importance to those collectively referred to as Angel investors. Those are individuals who provide most of the seed stage capital to start up businesses that drive our Nation's innovation economy.

My name is David Verrill, and I am founder of the Hub Angels in Boston, actually Cambridge, and chair of the Angel Capital Association. Please know that the ACA supports a maximum capital gains rate of 15 percent.

The story of Angel investing is a story of success in America. Here is what we do: First, Angel-backed companies are the well spring of our innovation economy. We fund early-stage high-growth companies that generate new high-paying jobs. Last year, Angels helped start more than 65,000 companies by investing more than \$22 billion out of their own wallets. These investments created more than 165,000 jobs in 2011. This included companies like Advanced Battery Concepts in Michigan and RightNow Technologies in Montana, where our chairmen represent.

Second, Angels invest on every Main Street in every State and every business sector. We invest where we live in every congressional district. We provide not just capital but time, expertise, mentorship and governance, often to first-time entrepreneurs who dearly need all the help they can get.

I should point out that the 60 members of your two committees represent 37 States and 150 of the 170 ACA member groups. You know better than I do how important these young companies are to your State and our national tax base.

Third, Angels are the only source of capital for many, many startups. Angel groups like mine focus on development of disruptive technologies in critically important sectors, including medical breakthroughs. In fact, one of our biggest hits this year was Intelligent Biosystems, a DNA sequencing company. We invest, even though more than half of the companies that we invest in will fail and will lose our invested capital in those companies. Just 7 percent of investments account for 75 percent of the positive returns. Those positive returns have to make up for the losses. This is a very, very illiquid and long-term investment space.

Fourth, Angels invest their own money of their own free will and capacity. We don't tend to invest other people's capital, just ours. There is no market for this private stock. We have no way of predicting if or when a company will exit and when we will make our investment return.

Fifth, successful Angel investments create a virtuous cycle. Angels tend to plow returns back into more startups and the teams of those successful companies pay more taxes, consume more products and services and, even better, many of them become Angel investors themselves.

An increase in capital gains would reduce Angel investment in these promising companies at the very time we need to create jobs in the United States. It would be taking our foot off the gas pedal just when we need to accelerate this economic engine of growth. And make no mistake, Angel investors are the source of much of this capital and drivers of much of this growth.

Let me provide you with some data. First, Angel investors support up to 90 percent of the outside equity raised by startups. These companies are too embryonic to qualify for bank loans and too small or too early for most venture capital firms.

Second, Angel investing is far more prevalent than venture capital in seed stage companies, startup companies. This is the stage when companies need a few hundred thousand dollars to just get started.

And third, private investment by accredited investors overall generates more new capital to our economy than the public equity markets.

So here is the dilemma: Raising the capital gains rate significantly will force many Angels to turn away from an asset class in which they are the most experienced recognized experts and dominant players. There are no replacements for Angels.

And I would note, as mentioned previously, there are other pending tax changes to the code that would increase a 5 percent increase in the effective tax rate on Angel investors next year.

The best way to ensure a strong flow of Angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk more of their own capital to support startups and early stage businesses.

With that driving force in mind, the ACA advocates for a maximum capital gains rate of 15 percent. Consistency in this rate has led to a tremendous surge in Angel investment over the past decade alone.

Second, we ask your support for reinstatement of the 100 percent exclusion of the capital gains tax on qualified small business stock, Section 1202, led by Senators Kerry and Olympia Snowe, which is included in the Senate version of the tax extender bill. We encourage the House to support it as well.

Third, we recommend Congress consider instituting tax credit policies in support of Angel investors, like the Senate bill 256, supported by Senators Pryor and Scott Brown of Massachusetts; 22 States in our Nation have tax credits for a reason. They create jobs. We should have a tax credit at the Federal level.

As my fellow panelists have commented, tax policy is complex. My point is simple. If Angel investors are taxed more, they will have less to invest.

Thank you for the opportunity to speak today. I would be happy to answer any questions about Angel investing. I do have additional materials on Angel investing in the U.S. and respectfully request that that be accepted into the record.

Chairman CAMP. Without objection.

Thank you Mr. Verrill.

[The prepared statement of Mr. Verrill follows:]

**TESTIMONY OF
DAVID VERRILL
CHAIRMAN, ANGEL CAPITAL ASSOCIATION
FOUNDER AND MANAGING DIRECTOR, HUB ANGELS INVESTMENT GROUP
U.S. HOUSE COMMITTEE ON WAY AND MEANS
AND
U.S. SENATE COMMITTEE ON FINANCE
SEPTEMBER 20, 2012**

Chairman Camp, Chairman Baucus, Ranking Member Hatch, Ranking Member Levin and members of both committees: thank you for inviting the Angel Capital Association (ACA) to speak before this joint hearing on tax reform and treatment of capital gains. The impact of the capital gains tax rate is of significant importance to those collectively referred to as angel investors – individuals who provide most of the seed capital to the nation’s innovation economy of startup businesses.

My name is David Verrill, and in addition to my role as Board Chair of ACA, I am co-founder of the Hub Angels, a Boston-based group of nearly 100 accredited angel investors who have collectively invested more than \$24 million in 28 startup companies over the past dozen years.

The story of angel investing is a story of success, and in keeping with the entrepreneurial spirit of our nation. Here are several reasons why:

- Angel-backed companies are the wellspring of our innovation economy. Angels fund early stage high growth companies – those that will go from a few jobs to thousands – and often high paying jobs at that.
- Angels are on every Main Street, in every state and every sector.
- Angels are the only source of capital for many early stage companies, and we do it even though we know that more than half of our portfolio will fail and we will lose our money.
- Successful angel investments create a virtuous cycle – angels plow back our returns in more startups, and the management teams and employees of successful companies pay more taxes, consume more products and services, and most importantly, many become angel investors themselves.

An increase in capital gains rates will reduce angel investment in promising, job creating companies at the very time our country needs to create jobs. It would be like taking our foot off the gas pedal at the very time when we are trying to get our economy moving faster.

It is also important to note that in 2013, angels already face an increase in taxes due to new taxes that are part of the Affordable Care Act. These five percentage points alone may be the tipping point that drives some angels down a safer investment path, away from risk capital.

ACA recommends that the capital gains rate remains at 15%.

Hub Angels and Angel Capital Association

Angel capital comes from our personal pocketbooks, and is directed toward the very essence of capital formation in the US – small business startups with high growth and job creation potential. Hub Angels – like most angel groups – focuses on companies developing disruptive technologies. Companies that Hub

Angels has funded – including ZipCar, Experion Systems, Copiun, Catalyst Oncology, Daktari Diagnostics, and Intelligent Bio-Systems – have collectively created hundreds of jobs nationwide, and attracted follow-on capital in the hundreds of millions of dollars.

These efforts are not unique to Hub Angels; in fact, they are repeated among hundreds of angel networks and individuals in every state – and they represent the dominant source of funding to early-stage, high-growth enterprises.

ACA is the professional alliance of angel groups across North America. We have more than 170 member angel groups that invest in every geography and market sector, plus another 20 affiliated organizations that share our focus on seed stage investing. ACA member groups are comprised of nearly 8,000 accredited investors, for whom ACA provides professional development, public policy advocacy and other services essential to successful investment in the startup economy. As chair of the Angel Capital Association, I am here to represent this vital and growing community of sophisticated, accredited investors who not only infuse money but also their wealth of experience, knowledge and skills in high potential start-up companies. Our members invest in more than 1,000 seed stage companies per year, after screening as many as 75,000 contenders to identify the most promising ones.

Angel Investors, Job Creation, and Capital Gains Taxes

ACA has a keen interest in the capital gains tax rate, and we believe our members should rank high among capital market participants considered by Congress as it debates appropriate overall tax reform. We urge Congress not to increase the current maximum capital gains tax rate of 15%. Any increase will have a negative impact the number of seed stage investments that constitute primary capital formation for small businesses – which is the essence of the angel investing domain. And, we concurrently urge this Committee to support reinstatement of the 100% capital gains tax exemption for investments in qualified startups that was included in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, and which is also included in the current Family and Business Tax Cut Certainty Act of 2012 marked up in the Senate in August and the Startup Act 2.0.

We understand the need for the government to identify new revenue sources as it seeks to balance the country's budget. We advocate a 15% cap on capital gains – and even lower rates (perhaps through tax credits) for the riskiest capital that directly goes to startups, because we believe such use of tax policy will help generate more tax revenues for the government than would an ill-advised tax increase.

The tens of thousands of startups we fund each year are formed in every state and every industry sector. You know how important these young companies are to your state, municipal and our national tax base. Without the private investment of angel capital, most of the truly high growth companies – those that will go from a few jobs to hundreds or thousands on payrolls – would simply not get off the ground.

And, make no mistake, angel investors are the source of this capital and drivers of this growth:

- New companies are critical for job growth and economic vitality, especially in an economy struggling to combat high unemployment. There is a growing body of focused research, based on the Census Bureau's *Business Dynamics Statistics* database that dramatically illustrates that it is a smaller subset of dynamic, high-growth startups – mostly funded by angels -- that make up the vast majority of that job growth. These so-called "gazelle" firms (ages three to five years) comprise less than 1% of all

companies, yet generate 10% of all new jobs in any given year.¹ After controlling for age of a small business, startups account for almost 20% of gross job creation in any given year.²

- The nation's leading expert on entrepreneurship, the Marion Ewing Kauffman Foundation, estimates that angel investors support up to 90% of the outside equity raised by startups, after they have exhausted personal resources and those of "friends and family."³ These companies are too embryonic to qualify for bank loans, and too small for most venture capital firms, which aggregate pension and other institutional dollars and must place substantial bets on later stage opportunities to efficiently deploy their funds.
- Angel investing is far more prevalent than venture capital in seed stage companies. Angel investors funded more than 66,000 companies with nearly \$23 billion in 2011 – or about \$350,000 per company on average.⁴ In contrast, the National Venture Capital Association estimates that VCs invested \$28.4 billion in institutionally-raised money 2011 in about 3,800 companies, mostly at later stages.⁵ These are similar amounts of capital, but 20 times the number of companies, and most in the earliest stages of formation.

Private investment by accredited investors overall generates far more new capital than the public equity markets. The SEC recently analyzed all the Regulation D filings from 2009 through early 2011. Filings for amounts at or below the median of \$1.2 million – which is a reasonable proxy for seed-stage investment – increased nearly 42% between 2009 and 2010 (from 10,315 to 14,635), and were on track to exceed 43% growth in 2011. This is an enormous upsurge in small business investment – most of which is in startups or very young companies seeking follow-on investments that now also increasingly come from angels. Total investments in Reg D filings in 2011 were nearly \$1.3 trillion. In contrast, total new equity capital raised in the public stock markets in the US was a mere \$250 billion in 2010.⁶ According to Renaissance Capital, a research firm in Greenwich, Connecticut, the \$1.3 trillion in private investment in 2011 is triple the total raised in all the IPOs in the US over the past ten years.

Risk is Big Part of Angel Investment

Angels who invest in startups take great risk in making these illiquid investments. A 2007 study reports data that angels already know: more than half of angel group investments lose money and just 7% of the investments account for 75% of positive returns.⁷

Angel capital is not swirling around the stock market in high speed, secondary trading. In fact, it is highly risky and extremely illiquid. Unlike almost any other tangible capital investment, the angel investor has limited practical control over the realization of a gain on these crucial startup investments. Angels give

¹ *High-Growth Firms and the Future of the American Economy*, Kauffman Foundation, 2011.

² Haltiwanger, Jarmin, Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER.org, August 2011.

³ Marianne Hudson, Kauffman Foundation, *Why Entrepreneurs Need Angels – and How Angels are Improving*, Kauffman Thoughtbook, 2005.

⁴ Jeffrey Sohl, Center For Venture Research, University of New Hampshire, 21012.

⁵ National Venture Capital Association/PwC MoneyTree, 2012.

⁶ Ivanov and Bauguess, *Capital Raising in the US: The Significance of Unregistered Offerings Using the Regulation D Exemption*, Securities and Exchange Commission Staff Report, February 2012.

⁷ Robert Wiltbank, Willamette University, and Warren Boeker, University of Washington, *Returns to Angel Investors in Groups* (published by the Kauffman Foundation, 2007).

their time and expertise freely, and often without compensation, but without liquidity for on average eight years, this is a market few others will support.

Angel investors are experienced in taking these risks, enduring uncertainty and foregoing the liquidity of a public stock. There is no doubt that we do this to generate returns on our investments, but we do it also to mentor young entrepreneurs, to give back to those who are giving up corporate jobs to start companies, and to support an asset class that is vital to our nation's economic health.

It takes a great deal of energy, ongoing learning and time to for angel groups to identify great start-up investments. Hub Angels looked at more than 250 companies last year and invested in two. And it takes even more time, energy and experience to nurture these tiny teams of entrepreneurs to become powerhouses in their markets. Many startups will fail entirely due to a host of market circumstances. Some will do well. A few will succeed brilliantly and return many times the investor's initial capital. Angel investors endure a lot of losses in order to arrive at a net gain – in a cycle estimated to take anywhere from 3-10 years per company on average.

Angel capital represents the dominant and primary engine of new business development in the country. It is very risky, and the rewards are intermittent and unpredictable. Despite this, when angels do realize a gain, they routinely put much of it back into funding more startups. But more than just the investors, the management teams of successful companies very often become active angel investors themselves. It is a virtuous cycle.

Allow me to digress ever so briefly on the difference between angels, venture capitalists and private equity. Angels invest their own money in management teams and technologies they like, typically where they live. So angels are on Main Street of every state in the US. Venture capitalists typically invest institutional capital from endowments, corporations and family offices. In 2011 VCs invested some \$28.4 billion dollars in 3,752 companies⁸ – the vast majority in the major metropolitan regions. They must invest their capital, and given the growth in the average fund size for VCs, they tend to skew their investments toward later stage companies that have revenues. Private equity, much like VCs, invest institutional money but their focus is on mature companies. Each of these members of the venture community invest tens of billions of dollars each year. We need each other. Angels fund companies that act as deal flow for VCs. VCs grow companies such that private equity has opportunities to invest. My point is, angels invest their own money – but they don't have to. They invest largely where they live – not just in the tech centers of the US. They invest in the earliest stages of a company's life – when nobody else will.

We believe that the country needs this type of investing, with its very high chance of failure and uncertainty in both the degree and timing of reward. And a higher tax rate would simply make this type of investing uneconomic.

Raising Capital Gains Rate Will Reduce Angel Investment in Small Businesses

Here is the dilemma. Raising the capital gains tax rate significantly will force many angels to broadly turn away from an asset class in which they are the most experienced, recognized experts and dominant players. At a time when crowdfunding and general solicitation by issuers are about to come into play under the JOBS Act, the wisdom of angels is going to be needed more than ever to maintain discipline and order in this market.

⁸ National Venture Capital Association/ PwC MoneyTree, 2012.

Angels rely on such a small percentage of startup investments to be successful and provide the majority of their return, that a higher capital gains tax could very likely be the tipping point that drives them down a safer path – towards tax advantaged vehicles like municipal bonds rather than the risk capital so much needed for job creation.

As one of my ACA co-board members told me: *“A significant increase in the capital gains tax rate lowers the potential for an overall positive return on a well-diversified, early-stage portfolio. The small percentage of successful companies that generate positive returns will not generate after-tax returns that make up for accumulated losses. A higher capital gains tax rate would provide undeniable evidence that there is very little opportunity for a positive return on the total startup portfolio. As much as I enjoy working with startup companies and placing investments for growth, I would have little option but to reduce my startup investment activities.”*

As another ACA member put it: *“My asset allocation will shift from early stage companies to tax favored investments such as municipal bonds. For those companies that I do invest in, I will look toward safer later-stage companies, further exacerbating the funding gap for small companies.”*

And I would note that there are other pending changes to the tax code that would already impose a significant increase in the effective tax rate on angel investors, including health care legislation which imposes a 3.8% tax on some capital gains by income earners above \$250,000; and the Pease amendment, which limits the deductions itemizers can claim, effectively a 1.2% tax. These five percentage points alone could be the tipping point that drains seed stage investing of viable returns to angel investors. Add anything more, and you start to shoot yourself in the foot.

Both of these shifts would strike a blow to entrepreneurship and job creation that is essential to our nation’s economic health. It would stifle innovation by diminishing its likelihood of it being commercialized to the benefit of society. I would note that angel groups as a class focus on the development of disruptive technologies in areas such as technology and medical breakthroughs. These sectors currently are not being funded by the large corporations until well after first funds have been raised from angel investors, and later stages from venture capital. Without angel investing available to prime this engine of innovation, many breakthroughs will simply never realize their potential.

Focusing on the combination of keeping capital gains taxes to a minimum, and developing well thought-out income tax incentives could ensure that more deserving small businesses get the capital they need, especially during our current tough economic times.

Supporting Policy Recommendations

Before I conclude my remarks, I would like to make a case for a few other tax opportunities that would be very valuable in helping maintain the vigor that exists today in the seed stage investment arena.

- As I noted, we ask your support for reinstatement of the 100% exclusion of capital gains tax on Qualified Small Business Stock (“section 1202”) that is currently included in the House Finance Committee’s mark-up of the tax extender bill. Further tweaking 1202 to have a shorter holding period and to cover additional corporate structures would generate far more uses of the bill.
- Additionally, we recommend Congress consider instituting tax credit policies support of angel investors. 22 states have tax benefits for angel investors – for good reason, as the companies they

invest in generate new jobs. For instance, ACA members have seen this in Wisconsin, Ohio, Kansas and Oregon. Senator Pryor's S.256 or the American Opportunity Act would go a long way toward helping all 50 states – including my Commonwealth of Massachusetts which currently has no state tax credit – to provide angel investors with more incentive to invest more money in more companies to create more economic benefit.

Final Thoughts

The question about how much to change the capital gains rate is not an easy one, and as a member of the angel community I understand that. However higher taxes will always cause behavioral change. My argument is that we have found a rate that works. At a time when small businesses and startups are still having trouble accessing capital, this is not the time to increase the capital gains rate for individual investors who take great risks in supporting job creating businesses.

Our overall recommendation is that the best way to ensure a strong flow of angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk their own capital to support start-ups and early-stage businesses.

Thank you for the opportunity to speak today. I would be happy to answer any questions about angel investing, Hub Angels, and ACA, and to stay involved in your process to ensure that angel investing—which is a critical driver of our innovation economy is stimulated to create new, high value jobs.

MORE INFORMATION AND RECOMMENDATIONS

National Angel Investing Landscape

Angel investors are high-net-worth individuals⁹ as defined by the Securities and Exchange Commission who provide money for start-up firms with growth potential. Many of them started, built and sold their own companies and are now in a position to invest their money and equally important, their time, in new or early stage businesses. The nation's leading expert on entrepreneurship, the Ewing Marion Kauffman Foundation, estimates that angel investors may be responsible for up to 90% of the outside equity raised by start-ups after the capital resources of their founders, friends, and family are exhausted.¹⁰ These firms rarely have the collateral to receive bank loans and they are generally too small and too young to receive venture capital.

The Center for Venture Research estimates that angels invested \$22.5 billion in 66,230 companies in 2011. One of the trends in the field over the last decade is the growth of angel groups, in which investors join together to invest in and mentor companies, pooling their capital to make larger investments and developing best practices for investing and mentoring. ACA estimates there are more than 350 angel groups, located in every state, compared to about 100 groups ten years ago. The new HALO Report¹¹ describes the investments angel groups made in 2011:

- Median round size of \$700,000;
- 58% of investments were in healthcare/life sciences and Internet/IT sectors;
- Two-thirds of the investment rounds were syndicated, often with multiple angel groups; and,

⁹ www.sec.gov/answers/accred.htm

¹⁰ Marianne Hudson, Ewing Marion Kauffman Foundation, *Why Entrepreneurs Need Angels – and How Angels are Improving*, Kauffman Thoughtbook, 2005.

¹¹ www.angelresourceinstitute.org/halo-report, Angel Resource Institute, Silicon Valley Bank, and CB Insights

- Investments were distributed throughout the country – two-thirds of the deals were outside of traditional equity centers of California and Boston.

Hub Angels' experience fits within these national statistics. About 25% of our investments are in life sciences, with the remainder in a variety of high tech industry sectors ranging from financial services software to transportation to water resources to mobile to information technology. We are active investors and tend to take a board seat and otherwise help portfolio companies in any way we can - whether it is finding the next customer, a service provider, space, hiring, strategic advice and of course help in the sale of the company. We are seed stage investors, typically taking a 5% to 10% stake in each company, and continuously investing in the portfolio as it grows. We syndicate most of deals with other angel groups - there are more than 20 in the New England region - and smaller venture capital firms. The New England angel groups meet regularly to share best practices, deals, and provide education.

Angel investors are proud to be an important resource for the startup companies that have created the large majority of net new jobs in the United States over a 25 year period¹². Angel-backed companies have been some of the most prolific job creators and innovators in recent times: Google, Facebook, and Starbucks are just a few examples. Thousands more companies supported by angel groups and individual angels are less known, but significant in the innovative products and jobs they have created.

Risk and Angel Investment

The *Returns to Angel Investors in Groups*¹³, the first ever dataset and analysis of angel group returns, confirmed what many investors thought about their success:

- 52% of all exit returns less than the capital the angel had invested in the venture (with 35% of all exits losing all of the money invested)
- 7% of the exits achieved returns of more than ten times the money invested, accounting for 75% of the total investment dollar returns
- 31% of the exits returned the investment between 1 and 5 times the investment.

The study, which looked at 1,137 exits from angel investors connected to angel groups in many areas of the United States, also provided data to support that best practices in angel investment lead to better results for investors and the entrepreneurs they invest in. This includes matching investor expertise with the company, conducting a good level of mentoring and monitoring of company progress, and conducting at least a minimum amount of due diligence in reviewing investment opportunities.

Angel Investors, Entrepreneurs and Capital Gains Taxes

A preferential capital gains tax rate for seed-stage investing is essential for the continuing economic recovery and health of the economy. It is a foundational element of what makes this type of high risk, illiquid investment a viable option for accredited investors. And, without a robust capital market for startup entrepreneurs building innovative, disruptive businesses, we believe the country would face an inescapable decline in the job market and economic growth.

There is a great deal of data indicating how a change in the capital gains tax rates impacts when gains are realized (i.e., if there is a rate change, there is a spike either up or down in the amount of gains realized either just before (if the rate change is up) or after (if the rate is reduced).

¹² John Haltiwanger, University of Maryland, Ron Jarmin, U.S. Bureau of the Census, and Javier Miranda, U.S. Bureau of the Census, *Business Dynamics Statistics: An Overview*, 2009.

¹³ Robert Wiltbank, Willamette University, and Warren Boeker, University of Washington, *Returns to Angel Investors in Groups* (published by the Kauffman Foundation, 2007).

But, the importance here is how the capital gains tax rate affects where money is invested in the first place. It is conventional wisdom that small business is responsible for the majority of net new job creation in the country in any given year. But there is a growing body of focused research, using the Census Bureau's *Business Dynamics Statistics* database that dramatically illustrates that it is a smaller subset of dynamic, high-growth startups that make up the vast majority of that job growth

- According to a Kaufman study, these so-called "gazelle" firms (ages three to five years) comprise less than 1% of all companies, yet generate 10% of all new jobs in any given year.¹⁴
- A similar study from the National Bureau of Economic Research using the same database, found that, after controlling for age of a small business, startups account for almost 20% of gross job creation in any given year.¹⁵

These are exactly the businesses that angel investors – and mostly only angel investors -- invest in.

The true shift in job creation has moved away from publicly-traded companies to the realm of startups that are funded almost entirely by private capital. And, reductions in the capital gains tax rate over the past decade directly correspond to the increase in angel capital investment over the period.

Historically, until 2009, non-corporate taxpayers were permitted to exclude 50% of the gain from the sale in startups if the investments were held for five years. American Recovery and Reinvestment Act of 2009 increased the exclusion of capital gains from the sale of certain small business stock held for more than five years from 50% to 75% through 2010. The Small Business Jobs Act raised this exclusion to 100% through the end of 2011.¹⁶

However, unless Congress reinstates the 2011 exclusion I, beginning in 2012, it appears that startup investments no longer receive any special capital gains treatment.¹⁷ **This is a dramatic and perhaps cataclysmic event for seed-stage investing.** It means that, for the first time in recent history, there would be no preferential capital gains treatment for this high risk, highly illiquid nascent type of investment that stokes innovation and entrepreneurship in our country.

While the improvement in the capital gains tax exclusion is not the only reason for this surge (which also reflects technological change that makes it easier for entrepreneurs to start a business and because higher unemployment rates may encourage more people to do so), it is a significant contributing factor.

What happens if these preferential gains tax rates are not reinstated – or worse, if they not only are abolished but the standard capital gains taxes is increased from its current 15% rate? Angel investing could become almost universally uneconomic. And, rational accredited investors will greatly reduce or even stop participating in this market sector.

A reasonable assumption in the current interest rate environment is that the baseline real pre-tax return on a carefully selected portfolio of startup investments approximates 10%.¹⁸ This implies that \$100,000 invested in a diversified portfolio of startup companies would be worth \$161,100 in five years – although there is no assurance that these gains, or even the initial invested amount, could be monetized and realized in that timeframe. In theory, under the exemption for capital gains taxes on certain classes of startups, this would be a reasonable return. However, since not all these seed investments would necessarily qualify for the exemption (those in health care, law, finance, etc., that are not QSBSs), and since it is unlikely that all the investments would find an exit in exactly five years – many will take longer -- actual returns would vary.

¹⁴ *High-Growth Firms and the Future of the American Economy*, Kauffman Foundation, 2011.

¹⁵ Haltiwanger, Jarmin, Miranda, *Who Creates Jobs? Small vs. Large vs. Young*, NBER.org, August 2011.

¹⁶ Litan and Robb, *A Market-Based Approach for Crossing the Valley of Death*, Kauffman Foundation January 2012.

¹⁷ Litan and Robb, *A Market-Based Approach for Crossing the Valley of Death*, Kauffman Foundation January 2012.

¹⁸ Litan and Robb, *A Market-Based Approach for Crossing the Valley of Death*, Kauffman Foundation January 2012.

If the gains are taxed at the current standard 15% rate, the tax reduces the gain to \$136,850 over five years, and the annual return drops to barely over 7% -- or a 30% reduction in the expected rate of return. If the capital gains tax is actually increased, and there is no preferential treatment for private, seed stage investing, these returns will shrink further, with no reduction in risk or illiquidity of the asset class. And, as I noted earlier, other changes to the tax code could add five percentage points to the effective tax rate on angel investors – health care legislation and the Pease amendment.

Overall, capital gains tax revenues have been a fairly small source of total government revenue, averaging about 5.2% of all taxes and 4.2% of total Federal revenues (including licensing, fees, etc.) from 1995 through 2009.¹⁹

The amount of tax revenues generated from gains on start-up investments is far lower – and would constitute a rounding error in filling the void to reduce the deficit. Yet, to shut off this vital flow of innovation capital would deal a devastating blow to high-growth innovative startups and the massive economic benefits that result.

Higher taxes cut into the cash angels have available to reinvest in additional startups. Many ACA members re-invest most or all of their returns into the next crop of innovative entrepreneurs. The surge in new angel investment after a great exit is tangible in many communities. For example, the success of Living Social has led to more investment in the Washington, DC area.

Increases and differences in long and short term capital gains may also distort investor behavior in the coming months. Angels and entrepreneurs could try to accelerate to an exit in 2012 to lock in a known capital gains rate. In 2013 angels could become even pickier in their investments and perhaps lengthen the investment evaluation process. Or they could turn to more tax advantaged instruments like municipal bonds or cash. The first quarter of 2013 could be a desert for financing new businesses simply due to the uncertainty around rates.

The short term versus long term rate is also likely to have an impact on investors' decision-making related to exits. With big differences between the two, some investors would seek stall an “early exit,” so that none of the investments would receive short-term tax treatment. This would change the risk profile of the entrepreneurial companies involved and possibly decrease chances of success for these businesses.

Balanced Strategies to Catalyze Early-Stage Investment

Our overall recommendation is that the best way to ensure a strong flow of angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk their own capital to support startups and early-stage businesses.

In addition to favorable capital gains treatment, we recommend that Congress consider the very successful tax credit programs now in 22 states. States offer a variety of tax benefits for angel investors – for good reason, the companies they invest in generate new jobs. I would point you to the legion of great examples of economic growth that have resulted from these state policies.²⁰

For example, Wisconsin's Qualified New Business Venture (QNBV) program – also known as the Angel Investment Program, has become a model of success. Since 2005, the QNBV program has driven investment in early-stage businesses, creating jobs and stimulating Wisconsin's economy. More than 216 companies have been certified through the QNBV program, helping leverage \$637 million in investments. Among those companies still certified as QNBV businesses, reports show that the program has helped create 1,112 Wisconsin jobs. But this number is

¹⁹ Hungerford, *The Economic Effects of Capital Gains on Taxation*, Congressional Research Service Report for Congress, June 2010: www.crs.gov R40411.

²⁰ *Act 255: Early Stage Business Investment Program 2012 Annual Report*, Wisconsin Economic Development Commission.

actually much higher because successful companies eventually “graduate” from the program and no longer report employment numbers to the commission.²¹

In addition to Wisconsin, states with angel investment tax credits include: Arizona, Arkansas, Connecticut, Georgia, Illinois, Ohio, Kansas, Louisiana, Maine, Maryland, Minnesota, Nebraska, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, Vermont, and Virginia.

The American Opportunity Act, S.256, includes many of the components of the successful Wisconsin legislation.

Another recommendation is to reinstate the 100% tax exemption on gains in Qualified Small Business Stock (QSBS). The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 included a provision that provides a 100% exemption for gains made in Qualified Small Business Stock for investments made before December 31, 2011. The exemption has expired and ACA recommends that this exemption be made permanent. When the 100% exemption was first announced in another bill in September 2010, it caught the attention of angel investors. ACA found several examples investments that happened more quickly because of the new exemption. While the QSBS or 1202 program has been around for some time, the program was not well known or used by private angel investors until the 100% exemption became law.

Several updates are needed so that QSBS stimulates even more angel investment in innovative early-stage companies. The recent acts making the 100% gain and AMT exclusion a reality have generated interest and impact in the angel investment community. The changes we recommend, in priority order are:

- Extend Section 1045 roll-over period. With regard to Section 1045, increase the roll-over period from 60 days to a year. The issue arises because QSBS exits are unpredictable and 60 days is simply not enough time to re-invest in new deals. Startup deals are not like real estate; they require locating the deal, due diligence and negotiating terms, and often deals don't close. Extending the period will encourage more investment.
- Shorten the hold period on 1202. Currently, it requires holding the stock 5 years before exit to qualify for the exclusion. Given the trend toward earlier exits these days (eg, gaming, consumer internet), a two-year holding period would be more appropriate to create incentives for investment.
- Allow Limited Liability Companies to qualify. Many startups are organized this way to minimize their initial costs.
- Make clear that stock acquired on convertible notes and warrants and options qualifies. Right now this is not 100% clear.
- Fix working capital and redemption limitations. Down in the details of the definition of QSBS there are some things that could be improved, such as removing the working capital requirement and clarifying that all startups qualify without regard to how long their R&D process is, and broaden the redemption triggers. These are traps that can inadvertently eliminate the exemption.
- Allow “tacking” of QSBS status for transfers, even if for value. Right now, if the stock is transferred for value, it loses the exemption. Allowing QSBS treatment to tack would improve early stage investor returns (albeit taxed) because the stock will have more value to a secondary buyer.

²¹ Act 255: *Early Stage Business Investment Program 2012 Annual Report*, Wisconsin Economic Development Commission.

Chairman CAMP. Mr. Stanfill, you are recognized for 5 minutes.

**STATEMENT OF WILLIAM D. STANFILL, GENERAL PARTNER,
MONTEGRA CAPITAL INCOME FUND, FOUNDING PARTNER,
TRAILHEAD VENTURES, L.P., DENVER, CO**

Mr. STANFILL. Chairman Camp, Chairman Baucus, Members of the Committees, it will come as no surprise to any of you that I am closer to the end of my career than beginning. Therefore, permit me to lead with my conclusion: The sky will not fall if capital gains go up.

I have been in the investment business for 45 years; first as a broker with Dean Witter, then as a money manager, a venture capitalist, an Angel investor and an asset-based lender. During the course of my career, capital gains rates have ranged from the current 15 percent to as high as 28 percent. The capital gains rate has had little impact on our investment planning, our ability to attract investors or the financial results of those investments.

As for the capital gains rate going forward, tell me what the rate will be, make sure it is fair, and we will work within the guidelines.

During my career, I have competed for investors with all types of investment funds, oil and gas exploration funds, real estate development funds, timber funds, private equity, hedge funds, you name it. They all had souped-up tax treatments, accelerated depreciation, up-front deductions for exploration and development, special rates for timber sales, big interest deductions for leveraged buyouts. Invariably they spent more time and energy on the tax structure of the deal than on the economic merits of the investment.

Frequently investors I lost to these sophisticated product offerings would boast about the money they saved on taxes. Seldom did they care about the rate of return from the deal. Occasionally, they screamed when they had to repay recaptured taxes.

My goals and the goals of the firms and individuals I have worked with are simple: Make money by leveraging the creativity, talent and passion of entrepreneurs. Tax rates are merely part of the landscape. We are looking to leverage talent, not tax breaks. We manage risk, not the Tax Code.

The preferential tax rates for capital gains and dividends are simply a windfall for wealthy investors. In my view, this special tax treatment is neither fair nor equitable nor available to any other professional endeavor. After all, a gifted teacher, who is inspiring and challenging our children and enriching human capital, gets no such special treatment.

I would caution members of the joint committee to be skeptical when people like me testify to you that we give lip service to the idea of the level playing field. We make campaign contributions. We hire lawyers and lobbyists to persuade you that if the field is not level, it should be tipped in our favor. In addition, we prepare elaborate spreadsheets to prove our point, while rejecting data that may lead to different conclusions resulting in what Woody Brock refers to as the dialogue of the deaf in his book "American Gridlock."

Frankly, I was reluctant to testify on this occasion, for like the vast majority of my fellow citizens, my faith in the U.S. Congress to set aside party and ideology and do the People's business has

been dashed. But I am nothing if not resilient and hope springs eternal, so here I am urging you to lead and to find a win-win solution and forge comprehensive tax reform.

What better way to begin than to tax all income—wages, dividends, capital gains, carried interest, royalties—alike. End preferences, close loopholes, eliminate most deductions, add a dash of progressivity. Let the market, not the Tax Code, determine the allocation of investment capital. Let various legal and accounting and lobbying industries refocus on more productive work.

You have choices to make, change in the Tax Code in favor of equity, transparency and predictability, or continue to stroke the flames of public cynicism, a divisive option that ensures the widening gap between the government and the governed. I wish you good luck in your efforts. I look forward to your questions. Thank you.

Chairman CAMP. Thank you, Mr. Stanfill.

[The prepared statement of Mr. Stanfill follows:]

**House Committee on Ways and Means
Senate Committee on Finance
Joint Hearing on Tax Reform and the Tax Treatment of
Capital Gains
September 20, 2012**

Testimony of:

William D. Stanfill

General Partner, Montegra Capital Income Fund

Founding Partner, TrailHead Ventures, L.P.

Denver, Colorado

Chairman Camp, Chairman Baucus, Ranking Member Levin, Ranking Member Hatch, and Members of the Committee, my name is William Deming Stanfill. I am general partner of Montegra Capital Income Fund. I was a founding partner and head of the Denver office of TrailHead Ventures, a private venture capital partnership whose investment focus is information technology.

I've been involved in the securities business since the late 1960s, first as a stockbroker with Dean Witter and Co., then as a money manager, venture capitalist, angel investor and asset-based lender. I've done well: provided for my family, educated our children and invested considerable resources in charitable and civic initiatives.

I joined the Centennial Funds of Denver in 1982 and was responsible for the firm's fund of funds activity. We invested in 30 venture partnerships around the United States. Those partnerships collectively invested in 600-700 portfolio companies including telecommunications, medical, and information technology, throughout the country: Massachusetts to California, Florida to Oregon, Colorado and Utah, Arizona, Texas, and New Mexico, Alabama and Georgia.

In 1995, I left the Centennial Funds, purchased the fund-of-fund activity and formed Trailhead Ventures to invest directly in early stage information technology enterprises. By industry standards we are a small fund. Our advantage is our ability to provide seed and early-stage capital of \$2-4 million to start-up companies.

In 2009 I joined Montegra Capital Resources, Colorado's leading asset-based lender for more than 40 years. Montegra principal, Bob Amter, and I formed the Montegra Capital Income Fund, which provides short term financing for first mortgage-secured loans. The Fund offers capital preservation and income generated by a diversified loan portfolio.

For 45 years I've competed for investors with investment funds of all kinds: oil and gas exploration funds, real estate development funds, timber funds, private equity funds – you name it. They all had souped-up tax treatment: accelerated depreciation, up-front deductions for exploration and development, special rates for timber sales, big interest deductions for leveraged buyouts. Invariably, they spent more time and energy on the tax structure of the deal than the underlying economic merits of the investment. Frequently, investors I lost to these 'sophisticated' product offerings would boast about the money they saved on taxes. Seldom did they crow about the rate of return earned from the deal. Occasionally they screamed when they had to repay recapture

taxes.

My goals and the goals of the firms and individuals I work with are simple: make money by leveraging the creativity, talent and passion of entrepreneurs. Whether venture, equity or angel investing, the vagaries of the tax code haven't driven our investment strategy or decisions. In the 45 years I have been in this business, I can't remember one client whose investment decision was made based on the tax rate – and I certainly never made such a decision myself.

Rather we look for entrepreneurs who have good ideas and an obsession to bring them to market – a fire in the belly. We make investments because we believe in the goals of the entrepreneur and think there's a potential profit for us and our investors. Those decisions don't change based on whether we pay a 15 or 20 or 28 percent tax rate on our gains. We're looking to leverage talent, not tax breaks.

What limited partners should expect from a venture capital investment is a 500 basis point (5%) premium over a portfolio of publicly-traded securities. And that premium is not a risk premium, but a premium for illiquidity. Why? Because our investment partnerships usually have a ten-year lifespan. In addition to that premium, the investor gets a lottery ticket and the results can be substantial. In the first Trailhead Fund, we have produced a 54% internal rate of return net to the investor and if we liquidated the remaining public securities today, we would return 10 to 11 times our partners' capital.

The preferential tax rates for capital gains and dividends are simply a windfall for wealthy investors. In my view this special tax treatment is neither fair nor equitable or available to any other professional endeavor. After all, a gifted teacher who is inspiring and challenging our children and enriching *human* capital gets no

such special treatment.

Some predict that firms will locate overseas, taking jobs and tax revenue out of the country. My firm is too small to play in the international field—the learning curve is too steep and the costs are too high. And because we believe in seed investing, we’ve always found sufficient deals in our own backyard. Further, my accountant advises me that if we did move our fund offshore, as a U.S. citizen, I am still subject to U.S. tax on my income.

I have loved my work over the past decades and I would not stop doing it because my tax rate was adjusted. I do not believe that higher capital gains tax rates will drive venture capitalists and other investment managers to look for other lines of work. We like the excitement and satisfaction of assisting management in transforming good ideas into successful businesses. We get ample compensation, financial and psychic, for the work we do and the risks we take. We share handsomely in the profits and earn fees along the way.

For more than 45 years I’ve contended with capital gains rates as high as 28 percent and as low as the current 15 percent. Never has a client, investor, partner or entrepreneur hesitated to invest because of the tax rate on capital gains. Tax rates were merely part of the landscape. We kept our heads in the game, making long term investments that had merit. We managed risk, not the tax code. We played by the rules and we prospered.

The sky will not fall if the rates go up.

We’ve seen this movie – Chicken Little – before. Our industry won’t end or be significantly disrupted if tax reform raises the rates on capital gains, any more than the auto industry ground to a halt when mileage standards, seatbelts, and air bags were mandated – although the auto industry’s executives certainly

predicted such doom at the time.

It's disturbing that the richest country in the world doesn't assure quality healthcare for low-income children, quality life-long education for all or first-rate medical care for our injured soldiers. I am dismayed that these and other human priorities remain ignored while we pretend we can afford to continue these tax breaks.

Frankly, I was reluctant to testify on this occasion for, like the vast majority of my fellow citizens, my faith in the U.S. Congress, to set aside party and ideology and do the people's business has been dashed. But I'm nothing if not resilient and hope springs eternal. So here I am, urging you to lead and find a win-win solution and forge comprehensive tax reform.

What better way to begin than to tax all income – wages, dividends, capital gains, royalties – alike. End preferences, close loopholes, eliminate most, if not all, deductions and add a dash of progressivity. Let the market, instead of the tax code, determine the allocation of investment capital. Let the various legal, accounting and lobbying industries re-invent themselves and do productive work for a change.

We have a choice. We can change the tax code in favor of equity and fairness. Or we can continue to cut back vital services and pile up debt while we give tax breaks to the wealthy. Let's not come to the same conclusion reached by Walt Kelly and his mouthpiece, Pogo, "we have met the enemy and he is us."

Thank you and I would be pleased to answer your questions.

Chairman CAMP. We will now proceed with member questions for the witnesses.

Due to the joint nature of today's hearing, questioning will alternate between Members of the Senate, as recognized by Chairman Baucus, and Members of the House, as recognized by myself, for a single round of questioning.

Senators will be recognized in an order consistent with the rules and practices used at Senate Finance Committee hearings, and House Members will be recognized in an order consistent with the rules and practices used at Ways and Means Committee hearings. Each Member will have 3 minutes to question witnesses.

So, with that, let me invite Chairman Baucus to begin the questioning.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Verrill, that is very clever of you to mention Michigan and Montana. I coincidentally, because we are not a big State, spent one day working at RightNow Technologies. That company, as you know, has done quite well. It sold for \$1.4 billion just about a year or two ago to Oracle. They've done very well.

The question I have, though, is listening to you and comparing with what Mr. Brockway said, I hear you basically saying to keep capital gains rates for Angel investors down to 15 percent so on and so forth because that is good for Angel investing.

And Mr. Brockway has pointed out that, basically, you got a choice here: If you want comprehensive tax reform, Congress, you are going to have to raise the capital gains rate. That is, if you want to reduce the rates, the marginal rates on ordinary income, the only way you can do it is to get rid of a lot of the tax expenditures as well as capital gains differential or significantly raise capital gains rates. So are you saying, I am just asking the question, that we should focus more on Angel investing venture capital incentives for investment and forget about tax reform?

Mr. VERRILL. Well, I think there is a clear difference between Angel investing and venture capital that I can talk more to.

But in response to your question, I think the longer-term virtuous cycle of a tax benefit in terms of capital gains for Angels actually increases the amount of revenue that comes into the Federal Government over time rather than thinking of it as a tax break.

Senator BAUCUS. My point is, are you basically saying to keep the capital gains rate very low, which means it is going to be very, very difficult to get the marginal rates down—you have lots of proposals around here. You got 25–10 and so forth. And as I think as Mr. Burman pointed out, it is virtually impossible to get to 25–10. In fact, it is impossible without either raising rates on middle-income Americans and/or raising capital gains rates.

Mr. VERRILL. AC advocates for a low 15 percent capital gain rate, but equally importantly, consistency over time. We don't have a lock-up issue in the Angel world. We can't determine when we exit a company. So I think we need to have a long-term stable tax policy so that we can understand that when we invest today, we understand how it will be taxed in 5, 6, 7, 8 years from now.

Senator BAUCUS. So do you—Mr. Brockway feels we should pursue comprehensive tax reform. Do you agree?

Mr. VERRILL. I think that you people have a very difficult decision to figure that out.

My personal opinion is that, and with respect to the ACA, that we can't have complete neutrality, we can't have complete comprehensive taxes that are across the board. We need to have some means of incenting people, particularly in my space, to continue to make investments in these companies. Nobody else will.

Senator BAUCUS. Mr. Chairman, I think somebody forgot to push the clock. My 3 minutes is up.

Chairman CAMP. You are not on the clock.

Senator BAUCUS. I am not on the clock? Okay.

Chairman CAMP. Mr. Chairman, you are not on the clock.

Senator BAUCUS. Well, I will keep myself to the clock. Thanks. Chairman CAMP. Thank you.

Dr. Lindsey, you mentioned in your testimony, and I also in my opening statement, the focus on the statutory rate might be misplaced when you consider that is often based on income that has already been taxed in another layer another place. And you said—sort of suggested we should look at this integrated tax rate. Can you elaborate on this, why that should be the focus for policymakers rather than whether there is a headline statutory rate of 15 or 20 percent?

Mr. LINDSEY. Certainly. Just to keep the math simple, let's imagine we have—our objective here is to tax capital at a reasonable rate. And right now, if I am an investor who wants to earn through the corporate sector a dollar of dividends, the first thing that happens is the corporation is taxed at the margin at 35 percent on the money it earns, it has \$0.65 left. I am then taxed at a 15 percent rate on that \$0.65 that it is going to ship to me in dividends. That is another roughly \$0.11. So the combined tax is not 15 on the thing; it is a number like 46. Now, if the capital gains tax is raised, if the ordinary income tax rate is raised, that number gets to be even higher. If you do it via dividends, we are going to see an effective tax rate in January on a dollar earned—63 percent. Nobody that I know of in the economics profession thinks that that would be an optimal situation.

And the one point of agreement on this panel was that even if you raised the ordinary rate—excuse me, even if you raise the capital gains rate, it should be used to reduce the ordinary rate, because you have an interaction between the ordinary rate on taxation of income and capital gains rate that is very pernicious and comes right out of the cash flow of businesses. And I would strongly urge you to look at the rate in a comprehensive fashion.

Chairman CAMP. I have a question for you and for Mr. Burman and for Mr. Verrill, if you could answer quickly. At one point, Congress had modified the capital gains so that investments held for less than a year had ordinary income, investments held for 1 to 5 years had a 25 percent rate and more than 5 years at an 18 percent. If you could, each of you, comment just on what the economic and tax policy considerations might be in multiple holding periods and rewarding what some people call patient capital, I would be interested in your views on that issue.

Mr. LINDSEY. I think, as with most things in this area, that solves one problem and creates another. The problem that it creates is complexity. Capital gains, it is half the Tax Code. It also takes a lot of time to do your taxes right on it.

You know, I was listening to his testimony, and I think there is another way of solving the problem of Angel investors, and that has to do with the limitation that we have on capital losses being applied to other income. I mean, the great risk to me as a prospective Angel investor is that I lose money on some investments, and if I happen to lose, the government washes its hands of me; it is no longer a partner with me. If I happen to make money, the government wants to come in and be a full partner with me. That is unfair. It is inefficient, and I think that that is a better remedy to pursue with regard to Angel investing than manipulating the rate.

Chairman CAMP. Mr. Burman, quickly, I know we are running out of time here.

Mr. BURMAN. The taxation on capital gains on realization already provides lower effective tax rates on long-held assets. Basically, you get to defer the tax, which is as valuable benefit. My former boss Bob Rubin liked the idea behind the 18 percent rate for assets held 5 years or longer. I disagreed with him. I thought that we should actually be striving more toward neutrality.

I also could say something about losses if you are interested because I think the issue is more complex.

Chairman CAMP. All right. Thank you.

Mr. Verrill.

Mr. VERRILL. I think 1202 is the right direction. I don't think adding any phasing of years to it would help us because we simply don't know the term which we will own these equities; 1202 could be made better. The holding period could be made less in general, from 5 to 2 years. The rollover period could be made longer. This isn't a mortgage transaction; this is a company. So I think 1202 really goes to solving that problem if we tweak it a bit.

Chairman CAMP. All right. Thank you.

Senator BAUCUS. Senator Hatch.

Senator HATCH. Let me ask a question for Dr. Lindsey.

A popular talking point on capital gains is the revenue maximizing rate. That is the tax rate on capital gains that will bring in the maximum amount of revenue to the Federal Government.

But in your testimony, you believe too much attention is paid to the revenue maximizing rate, and the focus should be on the optimal or efficient rate of taxation, which is well below the revenue maximizing rate. Would you please comment on why the focus should be on the optimal or efficient rate of taxation and where that rate should be today and where you would see that rate if the top corporate and individual tax rates were reduced to 25 percent?

Mr. LINDSEY. Certainly, Senator, I think it is an important point. I am going to try and convert the words "revenue maximizing rate" into English. What it really means is the government is soaking you for as much as they can possibly squeeze out of you without regard to what it does to your business.

So at the revenue maximizing rate, or beyond the revenue maximizing rate, the government is losing and the individual firm is losing. At the revenue maximizing rate they are just squeezing you for as much as possible, but that doesn't mean that it is best in society's interest. You only want to be at the revenue maximizing rate if all you care about is the government and you don't care at all about the private sector.

If you take the standard assumptions we are using now, that even the Joint Tax Committee uses, and apply the loss to the private sector, to pull a dollar of revenue into the public sector, we are talking about \$2.50 to \$3 per dollar revenue. In other words, you are harming somebody out there by \$2.50 or more just to collect another dollar by raising the tax rate.

To me, that is not a cost-effective way of looking at taxation; and I do think you have to take into account the cost to the private sector, the dead-weight loss, the other efficiency costs, and not just try and get as much revenue as you can.

Senator HATCH. Well, let me ask this next question to Mr. Verrill.

As I stated in my opening statement, with the scheduled expiration of the Bush tax cuts at the end of this year, capital gains will be subject to a 23.8 percent tax beginning in 2013—a whopping 59 percent increase from current law. Now how would such an increase in the capital gains tax affect angel investment in early-stage companies, companies that in many cases are highly dependent upon such funding?

Mr. VERRILL. I think the uncertainty of that is going to create a lot of people that sit on the sidelines and sit on their money. I think that fewer people will be contemplating investments early in the new year, and I think that will have a cascading effect on the number of companies started, the number of jobs created. I think we need to figure this out before the new tax year and give people solid ground on how they are going to be taxed. Even though it is a tax on the return, I think it will influence negatively the number of investments that people make early in 2013.

Senator HATCH. Well, thank you.

Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Levin is recognized.

Mr. LEVIN. Thank you.

Well, I think this has been so far a very sobering hearing, and I am glad we are holding it. Because I think there are a couple of lessons to be drawn. One is that we need to be optimistic but realistic; and, number two, I think we need to have much less talk about targets and more discussion about trade-offs. Because I think the testimony of several of you has very much underlined the need for us to talk about trade-offs.

You know, I, some years ago, proposed some amendments to 1202, and I guess the law now reflects the changes. But, again, if we are realistic, we wrestled with how we approached it; and it is a very limited and carefully crafted, up to a point, provision and doesn't affect most investment. And so I go back to the issue of trade-off and also the issue of equity.

Mr. Verrill, as I said, 71 percent of the benefit of the preferential rate on capital gains goes to those making more than \$1 million a year, according to Joint Tax. Do you have any idea as to how that would apply to angels? How much are we talking about in terms of the capital gains tax? Do you have any idea? I mean, you want to differentiate between angels and venture capitalists. What portion of this 71 percent is represented by angels? Would you know?

Mr. VERRILL. Well, first of all, angels are sympathetic to venture capitalists because they are the ones who fund a relatively high percentage of our companies. In my portfolio, about three-quarters of the companies are funded by VCs. So we are important components to the value chain.

The Kauffman Foundation did a study a couple of years ago that tried to get at the effect of an increase in the amount of income or investable capital on accreditation; and, surprisingly, it pointed out that something on the order of half of angel investors are not in the one percentile of income, that many of them are certainly ac-

credited investors but investing significant amounts of their available capital.

I don't have a figure for you. I apologize.

Mr. LEVIN. Okay, I guess my time is up. Thank you.

Senator BAUCUS [presiding]. All right. Next, Mr. Wyden.

Senator WYDEN. Thank you very much, Mr. Chairman.

A question for you, Dr. Burman. You and Mr. Brockway are really some of the heroes of the 1986 reform effort, and we dealing are some of the same challenges now. I wanted to ask you about a particular approach that might help to bring people together.

We have heard again this morning that conservatives want to keep rates down, and progressives want to ensure fairness. And it seems to me that one of the ideas you are suggesting, Dr. Burman, the idea of an exclusion for capital gains, could achieve both. And let me just ask you about some math that we ran.

If you, for example, had a 35 percent exclusion from capital gains and you were in a 15 percent bracket, that would result in an effective capital gains rate of about 9.75 percent. That same exclusion in a 25 percent bracket would result in an effective rate of a little over 16 percent. So you could then say that there would be lower rates for capital gains and ordinary income rates, but you would also say there would be graduated rates so that those who earn most of their income from capital gains would pay higher rates.

Wouldn't this kind of idea give us an opportunity to bridge the gap, much like what was done in 1986, so that conservatives would have a path for lower rates for capital income but progressives could see that there would be a clearly outlined fairness in tax reform?

Mr. BURMAN. Mr. Wyden, as you know, I am a big admirer of yours because you worked tirelessly to try to advance bipartisan tax reform through your career.

If there is a lower rate for capital gains, I think it would make a lot more sense to return to an exclusion, which was done for most of the history of the income tax until the 1986 act. You are right that it would produce some more progressivity in the taxation of capital gains.

The other thing is the current alternative rates are extremely complex. There is a 37-line work sheet—

Senator WYDEN. A 37-line work sheet.

Mr. BURMAN. Basically, it is like an alternative maximum tax on capital gains. I don't know that anybody still does their taxes by hand, but if they do you would probably hear screams from them in the middle of the night when they get to line 28.

So I think it would be a good idea to restore an exclusion.

Senator WYDEN. Thank you.

Mr. Brockway, you want to chime in on that?

I understand that some are going to favor as their first choice making ordinary income and capital gains essentially the same. I think that is going to be a real challenge in terms of creating a bipartisan approach again—and last couple of seconds, perhaps, for you, Mr. Brockway.

Mr. BROCKWAY. Well, I don't have access to the estimating process anymore, so I am just going to speculate on this.

If you are going to have a preference, I would probably say exclusion would be somewhat better. But I would have thought that most of the capital gain income is for taxpayers in the highest-income brackets, so I am not sure it would have a significant effect. There would be some people in lower-income brackets that would have substantial capital gains, but I don't think that the aggregate amount of capital gains for that group would be a large portion of the money.

The comments I have been making about where I think you are going to be forced to be, as opposed to where you want to be and maybe what policy would lead you to be, is simply that, in constructing a reform package with a top rate at that level, and if you stay revenue neutral with current law or current policy, either one, as your baseline for the top-income class, the top 10 percent, and certainly if you get narrower than that, there aren't enough base broadeners out there that will pay for the rate cut to get into the 20s, other than attacking capital gains. There may be ones that I am not aware of, but certainly I don't think you are going to find enough in the tax expenditure budget. You are going to have to do something else. That is why I am saying that you have to—

Senator WYDEN. My time is way up. I was just thinking about seniors on limited incomes who might have some stock and that kind of thing.

Thank you for courtesy, Mr. Chairman.

Chairman CAMP [presiding]. Thank you.

Mr. Herger is recognized.

Mr. HERGER. Thank you, Chairman Camp.

In 2003, Congress tied capital gains and dividend rates together creating parity between gross stocks and dividend-paying stocks. The Obama administration's latest budget calls for untying these two rates and allowing the rate on dividends to rise to 43.4 percent, while the top rate on capital gains would be 23.8. I would like to get each of your thoughts on this proposal. How would a nearly 20 percentage point disparity between the capital gains and dividend rates affect investment decisions? Mr. Brockway.

Mr. BROCKWAY. Well, I guess I tend to be a skeptic on all of this. The country at times has had vastly different rates for capital gains and ordinary income, and also has had times where the rates were similar. I don't know that the economy performed better in one situation than in the other. So I am reluctant to say whether you had a large differential or you had the same rate. that it would have a significant impact on the overall performance of the economy. I think the overall performance of the economy is far too complex to ascribe a substantial difference based on the taxation of capital gains versus other income.

Mr. LINDSEY. Just to show you how old I am—I was going to do the calculation—I think it was 25 years ago I wrote a paper with Professor Bolster at Northeastern University, the chairman of the Finance Department Business School there, that looked at the effect on the stock market after the reverse story was done in 1986. And while I agree that it would have a very complex effect on the economy, there is no question it would lead to a liquidation of dividend-paying stocks and a reallocation into capital-gains-paying stocks.

Mr. BURMAN. My impression actually is that President Obama's budget would tax dividends at a 20 percent rate, but the substantive question is about what it would mean to tax dividends the same as other income.

First, I think most economists think that some kind of integration would make sense, providing a credit for taxes paid to company level. The lower tax rate on dividends and capital gains is too much for some stocks, and some companies don't pay any tax at all, and too little for others.

The overall economic effects probably would be smaller than you would think. If you actually look at the response to the cut in dividend rates in 2003, there was a short-lived surge in dividend payments. Basically, companies that intended to pay dividends over time sped those up. But the long-term effect, according to evidence from research at the Federal Reserve and others, was actually pretty modest. So it is not clear that it would have a very large overall economic effect.

Mr. VERRILL. I think the point was made toward public equities. If you look in the private space where angels make their investments, a miniscule amount of investments use a dividend or royalty based model to pay back the investors, so ACA has no position on it.

Mr. STANFILL. And I think I would resort to simplicity, as I said in my testimony, taxing all income at the same rate.

Mr. HERGER. Thank you.

Chairman CAMP. Thank you.

Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Burman, you recently wrote an op-ed for the New York Times titled, "The Buffett Rule: Right Goal, Wrong Tool." In the article you argue that instead of enacting the so-called Buffett Rule, which has drawn considerable attention in Congress, you would require Americans with incomes over \$2 million to pay an income tax rate of at least 30 percent. And some of the defects that we are currently arguing over certainly have—I think legitimately would allow those to dispute tax rates. And, at the same time, Mr. Buffett has suggested that, in terms of consequence, he should not be paying at a lower rate than his secretary. Do you want to elaborate on this point and how Congress in your judgment should address the inequity of very wealthy paying at a relatively low rate?

Mr. BURMAN. Sure, thank you for the question.

My reaction to the Buffett Rule comes from the fact that I actually spent a lot of time working on the alternative minimum tax, which was originally intended to make sure millionaires, people earning over \$200,000 in 1969, equivalent to \$1 million now, paid some tax. It was originally targeted at very high-income people, it was poorly designed to begin with, it mutated and morphed over time, and now I pay it, and I take that really personally. I am not a millionaire.

I don't like alternative taxes. The problem with the AMT in the first place was that if there are some loopholes the rich people are taking advantage of that are unwarranted, you should get rid of the loopholes.

The reason that Warren Buffett pays a lower tax rate than his assistant is that he earns almost all of his income in the form of capital gains, and it is taxed at a 15 percent rate. If you want to fix that problem, the thing to do would be to tax capital gains as ordinary income, or at least at higher rates. If you think it should be a 30 percent rate, then capital gains tax rates should be up close to that. And narrowing the difference between ordinary income and capital gains makes that more viable as well.

Mr. NEAL. Just a note based on your discussion of the AMT. As you know, I spent a lot of time on this for a long, long part of my career, but with some interest. When we get done, as we surely will be patching AMT again, we will then have been north of \$600 billion in patches.

Mr. BURMAN. Yeah.

Mr. NEAL. And I think it speaks to the ineffectiveness that some of us define common ground on an issue like that that we should be able and should have been able to address a long time ago.

Mr. Lindsey, in your testimony, you suggested that limiting the favorable tax treatment of debt relative to equity will produce a better tax system. We certainly heard a lot about the bias in the Code in favor of debt-financed investment relative to equity financed investment. Can you explain how you think we, in Congress, should limit the favorable tax treatment of debt relative to equity?

Mr. LINDSEY. I am about to make myself very unpopular.

I think that the conversation—

Mr. NEAL. You are talking to a group that is not exactly held in highest regard by—

Mr. LINDSEY. I think all of the discussion that is happening here, the fact that we have 20,000 pages on capital gains, points up to the fact that we have reached the end of the road with regard to income as the base of taxation. There are a long range of distortions that we have, including an unfavorable trade consequence to this country by the fact that we use income-based taxation. It is a mistake. We should get rid of all of this by moving towards a cash-flow-based taxation. All of the questions of neutrality, all of the arguments of tax this or that would be solved by doing that, as would the difference in the tax treatment of debt and equity; and that would be the direction I would urge you to go.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Johnson is recognized.

Mr. JOHNSON. Thank you, Mr. Chairman.

I think an important, but perhaps overlooked issue that we should bear in mind, as we look at tax reform, is the role the Joint Committee on Taxation plays with respect to its revenue estimates which are based on how it analyzes tax changes.

You may be familiar with the July 21st Wall Street Journal editorial, "Washington's Tax Oracles." That editorial calls into account JCT's complete revenue myths with respect to the 2003 capital gains tax cut. Bottom line, instead of costing the Government revenue, the capital gains tax cut generated tax revenue, significantly higher revenue, I think.

As we seek to do reform, it is critically important we can rely on the revenue estimates from JCT. Given your experience with the last major reform effort, as JCT's chief, you no doubt can appreciate the importance of getting revenue estimates right, Mr. Brockway. And, with that, don't you believe there is a need—indeed a need for dynamic impact when it comes to lower capital gains taxes? In other words, don't you believe the 2003 capital gains tax cut can have a positive macroeconomic impact, that such a tax cut can also generate greater tax revenues, not revenue losses?

What are your thoughts, please?

Mr. BROCKWAY. Well, I have no doubt that—

Chairman CAMP. Is your microphone on?

Mr. BROCKWAY. Hopefully.

I have no doubt that changes in the Tax Code can have some economic effects. I think it is a political issue, not a scientific issue, as to what that economic effect will be. I don't think the staffs should be delegated the responsibility to decide. If you all think that enacting a certain provision is going to expand the size of the economy, then I think you should decide to do it.

I don't think there is consensus on the question of whether or not tax reform, whether or not a particular tax cut will expand the economy. The fact of matter is the the economy grew after the 1982 Act, which was the biggest peacetime tax increase in history. That helped turn around a very difficult situation. We were in dire economic straits. We also had a big tax increase in 1983, and another big tax increase in 1984. These are the largest tax increases outside wartime in the country's history, and the economy grew.

So I am not sure what to make of these arguments. I am not sure whether the Wall Street Journal is just saying post hoc ergo propter hoc, that, yes, the economy expanded in the 1990s following a capital gains rate cut. Whether it is because of the cut in the tax rate on capital gains, I don't know. Someone may know, and the Journal may know.

But all I do know is that you will have a very difficult time if you put on the staff the responsibility to make it what is essentially a political decision. I don't think you want to do that. This is something that you all have to decide.

If you think that what you are doing will expand the economy, then say, look, this is what we think it will expand the economy by, and staff can produce numbers that are consistent with that. I don't think that they are competent—either JCT or CBO—to make that decision.

Mr. JOHNSON. Thank you.

Chairman CAMP. Thank you.

Mr. Pascrell is recognized.

Mr. PASCARELL. You have been in the business 40 years, and your expertise is the reason why you are here. Are you familiar with the report that came out just a few days ago, "Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945?" It is put out by the Congressional Research Service, Thomas Hungerford, a specialist in public finance. Are you familiar with that, sir?

Mr. STANFILL. No, sir, I am not.

Mr. PASCARELL. Well, now I would like your opinion on it, because this is what it says: "Advocates of lower tax rates argue that reduced rates would increase economic growth, increase saving and investment, and boost productivity." In other words, increase the economic pie. "Proponents of higher tax rates argue that higher tax revenues are necessary for debt reduction." You have heard that many times. "The tax rates on the rich are too low and violate the Buffett Rule." And you have heard that today. "And the higher tax rates on the rich would moderate increasing income inequality." In other words, change how that economic pie is that is distributed. I am not afraid of that word.

But it says this: "There is not conclusive evidence to substantiate a clear relationship between the 65-year steady reduction in the top tax rates and economic growth. Analysis of such data suggests the reduction in the top tax rate reductions appear to be associated with the increasing concentration of income at the top of the income distribution. The evidence does not suggest, necessarily, a relationship between tax policy with regard to the top tax rates and the size of the economic pie, but there may be a relationship to how the economic pie is sliced."

What is your opinion on that?

Mr. STANFILL. Well, to the extent I remember the question, I think I would default to fairness in tax matters. I think that in a broader sense what is needed is a Marshall Plan for the middle class. I think what we have had is a Marshall Plan for the top 1 or 2 percent; and I think, therefore, that fairness, as you move through tax reform, has to have an important place in your proceedings.

Mr. PASCARELL. In the comparing of taxing income and taxing assets—and there has been a shift over the last 30 or 40 years—where does the burden fall when that shift took place and up until this point in taxing income and assets differently? Where is the algebra here in terms of where does the major burden fall? On the shoulders of those holding assets or those that still depend mainly on income?

Chairman CAMP. And if you could answer briefly, because we are over time.

Mr. STANFILL. Yes, indeed.

Well, I am one of those—I am not in—I am one of those whose assistant pays a higher rate than I do. So I think the burden has fallen on my assistant more heavily than it has fallen on me.

Mr. PASCARELL. Thank you very much.

Chairman CAMP. Thank you.

Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman.

Let me ask a question. I want to focus a little bit on jobs and how this whole tax discussion affects job creation. So, Dr. Burman, in your testimony, you talked about how raising the capital gains tax in order to lower the income tax rates could help to create jobs in the United States. And I know that some of my colleagues would have concerns that raising the capital gains rate could discourage investment. Could you tell me and the panel here a little more about your theory, and do you have any rebuttal for those who worry that raising the capital gains rate would discourage investment?

Mr. BURMAN. Thank you for the question.

The basic point is that that differential between capital gains tax rates and ordinary income rates produces an enormous amount of unproductive activity that actually makes the economy work more poorly than it would. One argument people make for a lower capital gains tax rate is that it encourages entrepreneurship. But if you actually look at the incentives to start your own business, even if the capital gains are fully taxed you have a very strong incentive to invest your own labor, your sweat equity into the business. It is kind of like an IRA, you save payroll taxes as well as income taxes on the contributions of your own labor, and that is a strong incentive.

The main thing, and I think what most economists believe, although there is obviously some disagreement about how best to achieve this, is that, to the extent you can, the tax system ought to be relatively neutral. We shouldn't be picking winners and losers. We shouldn't be favoring angel investors over other kinds of investors who are investing in other kinds of activities. When the capital gains tax break favors particular kinds of investments over others, it provides a very strong incentive for inefficient tax shelters.

Mr. REICHERT. Anyone on the panel wish to comment further?

Mr. VERRILL. I will, if you don't mind. I thank you for the question.

Mr. REICHERT. Your name was mentioned.

Mr. VERRILL. I think the brush is too broad that Mr. Burman paints, and I think there is real economic value in efficient use of capital and energy and expertise in the angel domain. And certainly entrepreneurs put sweat equity into a company. They ultimately will generate some tremendous wealth out of that in a perfect world and they will give back. They will purchase products and services. Those companies will grow. Their salaries will become more market-oriented. And I think, all-encapsulated, it is a much better economic analysis than simply a broad stroke of a brush.

Mr. REICHERT. Thank you, Mr. Chairman. My time is expired.

Chairman CAMP. Thank you.

Mr. Larson is recognized.

Mr. LARSON. Thank you very much, Mr. Chairman.

Chairman CAMP. Your microphone.

Mr. LARSON. Thank you, Mr. Chairman, and I want to thank all of the panelists.

Mr. Lindsey, you said something very intriguing when you said this is going to be unpopular for me to say this, but I think that our revenue should be more cash-flow based. What did you mean by that?

Mr. LINDSEY. There is a saying on Wall Street that cash is a fact and income is an opinion. And right now—and that is—actually, you know, if you think about the typical business, right now, the Securities & Exchange Commission has one definition of income. Generally Accepted Accounting Principles have another definition of income. The IRS has another definition of income for purposes of the corporate income tax. They have a different definition of income for purposes of the payroll tax and a different definition of income for the income tax. So the government is now telling businesses that they need to keep five sets of books.

Well, that can't possibly be a good outcome, and that is why I think in the end we are going to have to move away from income-based taxation towards a cash-flow-based taxation. And, again, I know this is a curse word here, but, ultimately, I think Congress is going to be abandoning income taxation and moving to value-added-based taxation.

Mr. LARSON. Would you describe cash-flow-based as transaction taxes?

Mr. LINDSEY. Well, I would call it a net transaction tax, yes. So that—

Mr. LARSON. Right. A net or, you know, a broad transaction tax, not transaction on a specific industry.

Mr. LINDSEY. Correct, and where you would pay tax only on the transaction that—in other words, you would get—if I hired my colleague here, he would pay a transaction tax.

Mr. LARSON. How would that differ in many respects to what Mr. Stanfill's point—and I would like to see how people would have reacted to that when he says, let's let the marketplace set it and let's go through—eliminate all of the tax breaks that are there, and whether it is royalties, whether it is—how would you look at those two intersections and is there an intersection or an apex in which that could happen?

Do you follow what I am saying? Mr. Stanfill's proposal I believe at the end was, whether it is wages, dividends, capital gains, royalties alike, end the preferences, close the loopholes, eliminate most, if not all, and add a dash of progressivity. How would you respond to that?

Mr. LINDSEY. That would actually accomplish what he said.

Mr. LARSON. Do you agree with that, Mr. Stanfill?

Mr. STANFILL. I think I do.

Mr. LARSON. Yeah. Thank you.

Chairman CAMP. Thank you.

Dr. Boustany, is recognized.

Mr. BOUSTANY. Thank you, Mr. Chairman.

Mr. Brockway, I want to examine the kinds of assets that should be treated as capital assets consistent with policy rationale for a preferential capital gains rate. In your testimony you suggest that the current definition of a capital asset in the Tax Code perhaps is not entirely consistent with the policy reasons behind a lower capital gains rate. So can you elaborate on that some and maybe provide a current example of a particular asset or capital asset that we should review in this regard?

Mr. BROCKWAY. Well, I mean, obviously—

Chairman CAMP. Your microphone, please.

Mr. BROCKWAY. You all have had a fair amount of discussion about carried interests, so I am not going to be able to say anything here that is going to educate you further on that subject matter. But, obviously, you are considering as what is the appropriate rate there—does income from gains on carried interests deserve taxation at capital gains rates or ordinary income rates?

But let me give you a simple example, land. There is a finite amount of land in the United States, more or less. I guess that we created some more with the fill from the excavation to build this visitors center, but, as a general proposition, there is a finite amount of land. So whatever you do with the capital gains rate

there is going to be that amount of land. The fact of the matter is, however, that you have a preferential rate for transactions in land.

So it is not about economic growth. It is not about jobs or anything else. It is just you happen to have the preferential rate because you invested in land.

I am not saying it is good or bad. I am just saying, stand back, ask yourself, why do we think it is important to have this difference in treatment and does it make sense in that context?

And I can look at a question that I think has been picked up in the testimony already, if you are concerned about the double tax on corporate investments, which I think is something serious to think about, perhaps the appropriate way to think about that is integration of the individual and corporate tax regimes. The plain fact of the matter is that I make my living by the fact that corporations do not effectively pay tax at a 35 percent rate. You have to separate between what the Code says is the top marginal rate and what actually happens before determining whether there is a double tax and how it should best be addressed.

Another thing you can think about is what Professor Burman has been discussing about the benefits of deferring realization. At some level, you may want to think about expanding the existing marking-to-market and loss capitalization regimes. You have to think about something in that regard if you are going to expand the ability to deduct current losses on capital assets. You have to think seriously about capitalizing loss regimes so you don't get a substantial amount of arbitrage.

The staff can do a lot of thinking technically about your question and make some proposals. I am not saying that, for example, that taxing gains on farmland at ordinary income rates is going to be particularly popular. It is just something to think about. You are not going to get more farmland, whatever you do with the capital gains rate.

Mr. BOUSTANY. Thank you.

I see my time is expired. Thank you, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Rangel is recognized.

Mr. RANGEL. Thank you so much.

I know we are concentrating really on capital gains, but having experienced the 1986 tax reform and thinking at that time that it was partisan and it was rough, I had no idea that the Congress could really get to the stage that we are today, where even allowing the President to be able to adjust the debt ceiling became a partisan issue.

Having said that, I was talking to Senator Wyden to say that before we concentrate on this we have to get some sense of civility that the parties really want to talk. And I assume that all of you are wishing, if you don't believe, that after the election there will be a better sense of responsibility that Republicans and Democrats have to the economy and to the country.

Having said that, I don't think we will ever get away from the fact that everyone wants reform as long as it doesn't adversely affect them; and the question of a mortgage and charitable contributions and local and State taxes would remain an issue. But can anyone tell me before my time runs out exactly why religious insti-

tutions are exempt from taxes on income that they receive? I mean, we just accept it, but does anyone just—it shouldn't be something you have to—

No? Because I had thought it was because they provided the glue in terms of moral responsibility, that gap between capitalism that should work to make money and that bridge between government that should provide for the poor and the vulnerable. And they play absolutely no role in the budget that we are dealing with today as the institution. They play no role as relates to peace and war. They play no role as to which countries we bomb. Their voices are not heard except perhaps on same-sex marriage. But I assume none of you believe that we would ever contemplate of even considering taxing religious institutions. That is correct, right?

Having said that, do you think that there is an area that we could go into local and State taxes and have that not deductible? Is that one of these third rails that we could get over if we were talking to each other?

Mr. Burman, you remember in 1986 the problem we had with that. At least I do.

Mr. BROCKWAY. I think the question about religious institutions generally is a policy issue. I don't really think it is something that is an economic issue that tax experts can speak to.

Mr. RANGEL. I don't understand. I would assume there is trillions of dollars out there if we looked at it as a tax issue. I know politically—

Mr. BROCKWAY. But, Mr. Rangel, I think they generally operate as charitable institutions. They are nonprofit, and they are performing services but not raising net profit by the time you look through their books. To the extent they are running businesses, profit-making businesses, I think they are already brought into the system.

On the State and local tax issue, that obviously was a critical part of the 1986 discussion, and the bill almost cratered precisely over that issue. It comes down in good part to being a regional issue. At the end of the day when people understand the way that you are thinking about paying for the rate cuts is eliminating the deduction for State and local income tax, they may think that is a good idea if they live in Texas, Florida, or Oregon but not if they live in one of the other States that has a higher rate.

Chairman CAMP. We really are out of time now.

Mr. RANGEL. We are? I am over?

Chairman CAMP. You have gone over.

Mr. RANGEL. Well, okay, Mr. Chairman. Thank you for your great contribution in clarifying the religious institution issue. I leave a better person. Thank you.

Chairman CAMP. Thank you.

Mr. Marchant is recognized.

Mr. MARCHANT. Thank you, Mr. Chairman.

For Mr. Lindsey and Brockway, I have been spending my time at home with two groups of investors lately, business owners, and seniors. When you talk about the tax reform of 1986 and talk about the realignment of capital gains rates and dividend rates, in 1986, after the reform, there was a significant realignment of interest and liquidation in the real estate industry; and I wonder if in fact

we could approach that subject in this tax reform in the time that we are living in now, where we have already had a significant amount of liquidation and realignment in the real estate industry. I think that would be something we have got to talk about.

Secondly, in 1986, there were options besides dividends for those that needed income, and there were less people in 1986 that depended on income. There were fewer seniors. So if you have a significant liquidation and realignment, if you raised the dividend rate now, there are no alternatives for income. They are not the same alternatives for income that existed in 1986. I think you could probably get 8 or 10 percent on a long-term CD.

So if that significant realignment and liquidation takes place, then does it, in fact, actually result in an increased tax revenue or does it have a very—does it have a flat effect or does it have a negative effect on it?

And the last thing is that the investors that I talked to say at 15 percent they do not spend any time or money on tax avoidance exchanges, et cetera. They do the deal, they pay the tax, and they go on down the road. They say that there is a rate at which they will return to the old behavior of avoiding the tax, doing tax free exchanges. And, in fact, if we raise that too high, where would the sweet spot be where you would not in fact have a decrease in tax revenues?

I know that is a long question.

Mr. BROCKWAY. Well, certainly after the 1986 Act, if I were dealing with real estate investors, I would go under an assumed name. So I am not arguing that it didn't have an adverse impact on that industry.

But I think where it most significantly had an impact was that a substantial part of the financing of real estate was in the form of tax shelter arrangements that had created a bubble in some real estate prices at that time, but it was because of the effective negative tax on real estate investment that was in place.

So, yes, when you change things, there is going to be a discontinuity, a disruption in the marketplace, and that is inevitable whatever change you make, because the market will adjust to whatever current law is. And that is unfortunate, but sometimes you just simply have to break a few eggs, if you will. How big it would be in this situation, I am not sure.

For the issue about the elderly who are dependent upon dividend income, if your concern is that elderly lower middle income taxpayers may be subject to increased tax on their retirement income, you can still have comprehensive tax reform and meet the design constraints if you provide preferences for up to a certain dollar amount. Now I am not advocating that as a theoretical matter of tax policy, but if that is what your economic and social concerns are, which are very valid, then think of those alternatives as well, I guess I would say.

Chairman CAMP. All right. Thank you. Your time is expired.

Mr. Reed is recognized.

Mr. REED. Thank you, Mr. Chairman.

Mr. Brockway, I want to continue on that conversation. Because I try to ask as many practical questions, being a new member here.

I know we spend a lot of time on numbers and rates and everything else and how it impacts investors and the theory. But when I go back to my family farm or when I go back to my senior citizen, I want to learn from your experience in 1986 when the capital gains rate went up and the impacts it had on the markets and those sectors in particular. Is there anything you could tell me, having lived that experience, that you could give me, as going through the upcoming experience, some guidance as to how to lessen the impact on those folks, especially the family farmers and the seniors that you were just referencing?

Because, to me, it would seem like there is a potential threat here. And a lot of these guys, especially my family farmers, they are planning their retirements. A lot of that is based on the sale of their inventory, their family farms, and that tax bill that is going to be potentially in there. And if people are talking about raising the rates to some of the rates that I hear being thrown around this town, I am very concerned about that.

So is there a way to transition through that in a practical way or is that just not something we can expect to achieve?

Mr. BROCKWAY. Well, again, it is a matter of what trade-offs you want to accept, and you can provide benefits up to certain income levels if you wish to. If you do move the rate of capital gains taxation to, let's say, 25, 30 percent, somewhere in that range, it is obviously going to have a negative impact on someone who has had a farm for a long time in their family and all of a sudden has this very large amount of income after 30, 40 years of holding the farm. And they thought that revenue was going to be for their retirement, and it turns out a lot of it is going to taxes.

So it is a very difficult problem. I am not sure what you do about it at the end of the day. For most investors, for real estate investors, for example, their problem was so much the capital gains rate increase in 1986; it was the limitations the Act put on passive losses. For family farmers, I think a very major tax concern has always been the estate tax treatment. It is a similar problem for them where there is potentially a very large tax being imposed.

But I do think you have to accept that if you raise the rate for capital gains, unless you make some special exception that goes against the theme of comprehensive tax reform, you will have a difficult problem for certain people.

I don't think the financial markets minded changing capital gains rates at all—nor do I think it was a major burden for the real estate markets. I don't think that affected them at all, as best as I can tell. But in situations like that of the family farm, it may have been significant. In any event, the lower rate on capital gains only lasted 5 years, so it obviously was of significant concern to some people and you will get feedback if you raise the rate. There is no doubt about it.

Mr. REED. Thank you. My time is expired. I yield back.

Chairman CAMP. Thank you.

And for our final question, Mr. Smith is recognized.

Mr. SMITH. In the interest of time, it won't take long.

I was wondering if you could reflect a little bit in terms of investor behavior within the 1031 like-kind exchange and the impact that that has had? Anyone on the panel.

Mr. BROCKWAY. Well, taxpayers certainly use those provisions to be able to reinvest in other assets. Whether it is in real estate or in autos or leases or whatever else, all sorts of businesses use the like-kind provisions because the alternative is that they would be required to take a slug of their capital away and not reinvest it in their businesses. Deferring that tax, at least in terms of immediate cash flow, is the same position as not having a tax on that income. So it certainly is beneficial to the business. But, again, you have to have this choice. If that tax isn't being paid, then where is the tax coming from?

Mr. BURMAN. That is a good example of how taxation of capital gains along with other provisions in the Code can produce inefficient behavior. I think the idea behind 1031 was you trade one kind of business for another and defer the gain. But my understanding, which is fairly limited, is that there is a whole industry devoted to chains of exchanges that are all tax free and go way beyond the original intent of the legislation.

So it does mitigate the sort of cash-flow burden that is created by taxation of gain on sale, but it would make sense for Congress to think about whether 1031 exchanges are actually encouraging a lot of really economically inefficient behavior.

Mr. SMITH. Thank you. I yield back.

Chairman CAMP. Thank you.

I see Mr. Tiberi has arrived. You are recognized.

Mr. TIBERI. Thank you, Mr. Chairman.

One question to all of you, if you would try to answer it. And it revolves around the short-term impact of raising capital gains rates. In July, the Wall Street Journal published an article that was entitled: Get Ready for the New Investment Tax, in which the author described how taxpayers were beginning to react to the 3.8 percent tax that is going to go into effect in January of next year.

One analyst predicted that investors would likely apply—or re-apply, shift assets into investments that would not be taxed at that 3.8 percent tax like the municipal bonds, for instance. Others said that they were—another analyst predicted investors would accelerate their investments into other options.

Anecdotally, I can tell you of a family in Columbus, Ohio, in my district that has been in the real estate investment field for two generations now, going on the third generation, and their tax lawyer has told them that they need to get out of that business and begin getting out of it quickly, which they are.

So my question to all of you is, what would be the impact for taxpayers if we did the same with respect to capital gains? Would we see the same sort of reaction on the street from investors who would say, I am going to do this because of that?

Mr. BURMAN. I actually did an article in 1986 where I looked at the response of capital gains to the increase in tax rates that took effect in 1987, and it would actually be very good for the Treasury in the short term. There was a huge surge in realizations at the end of 1986, total realizations doubled. Realizations on corporate stock, which are the ones that are easiest to get rid of, actually increased much faster and there was a huge short-term boost in revenues.

Whether this would actually cause investors to massively move out of capital gains assets into others is more questionable. If you actually look at the data, there didn't seem to be a huge amount of change in the ownership of assets.

The other thing is whether it has an effect on markets overall. Certainly on the stock market the effect would be pretty minimal, because even if individual investors decided that they wanted to hold less corporate stock, institutional investors, pension funds would just pick up the slack.

Mr. TIBERI. Can we hear from everybody else?

Mr. VERRILL. Yeah, I will go quickly.

We don't have the luxury of immediately exiting a public stock in order to change the means on which we might be taxed. A fellow board member of mine, when asked this precise question, said my asset allocation will shift from early-stage companies to tax-favored investments, such as municipal bonds. For those companies that I do invest in, I will look towards safer later-stage companies, further exacerbating the funding gap for small companies.

So I don't have a statistically significant response for you, but I suspect if I did take a poll of the 7,000 angel investors that represent the ACA, you would have a pretty representative sample that would find very significant change in their behavior.

Mr. TIBERI. Thank you.

Next?

Mr. STANFILL. I think in my case I would sell a public security, which we funded as a venture capital firm, and use the proceeds to do more angel investing.

Mr. TIBERI. The last two.

Mr. STANFILL. I think I would refer you to Allen Sinai's work on this. He estimates that if the cliff were about to go over it would result in a 19.8 percent decline in the S&P, and I thought it was carefully done. I don't know that it described any one number, but it was a carefully done analysis.

Mr. TIBERI. Thank you.

Last?

Mr. BROCKWAY. I don't have a view on what would happen. In 1986 I am pretty comfortable that there wasn't any drastic result from that change. I think everybody thinks the economy performed reasonably well after that Act.

If you simply allow current law to go back to where it was in the 1990s, I have no idea what would happen. Obviously, in the 1990s, the economy worked well. So my instinct is it is not the end of the world, but I am not an economist.

Mr. TIBERI. All right. Thank you.

Chairman CAMP. Thank you all very much. I appreciate your participation in this hearing and your testimony.

Senator Baucus, would you like to make any closing remarks?

Senator BAUCUS. No, just thank you very much. This is one of many steps we all are going to take.

Chairman CAMP. Thank you. Thank you very much. This hearing is now adjourned.

[Whereupon, at 12:03 p.m., the committees were adjourned]

[Questions For The Record follow:]

UNITED STATES SENATE
COMMITTEE ON FINANCE
UNITED STATES HOUSE
WAYS AND MEANS COMMITTEE

Senate Finance Committee Hearing
“Tax Reform and the Tax Treatment of Capital Gains”
September 20, 2012
Questions for Mr. David H. Brockway

Questions from Chairman Baucus

1. Capital Gains Rates and Economic Growth

There has been much discussion in the Finance Committee and the Ways & Means Committee about tax reform – both the need for it and what it should look like.

I believe a 21st century tax code must advance America’s security in the global economy. To do this, the code must promote jobs from broad-based growth, competitiveness, innovation, and opportunity.

- Would relatively lower or higher tax rates on capital gains advance those goals?

It is not clear to me whether either relatively lower rates or higher rates on capital gains would advance those goals. I personally believe that the current tax rates on capital gains are too low because I am not comfortable with the distributional consequences of the current rate structure. If Congress moves toward comprehensive tax reform lowering the top rate on ordinary income, I believe it would be advisable to increase the rate of tax on capital gains to compensate for the ordinary income rate cut for upper income taxpayers, but that is primarily because I believe it would be important to maintain a reasonably progressive income tax system and not because I have any particular insights as to the impact of a capital gain rate change on growth, competitiveness, innovation, and opportunity.

While, as noted, I claim no special expertise in regard to the economic consequences of changes in the rate of tax imposed on capital gains, I am skeptical about claims that preferential treatment for investment income has a positive economic impact. Absent clear and convincing evidence to the contrary, I am very reluctant to conclude that individuals earning income from investments contribute more to the economy than individuals earning ordinary income.

In 1996, the top, long term capital gains rate was 28%. Between 1996 and 2002, it was 20%. Since then it has been 15%.

- What information do we have that these rate changes changed how investors made investment decisions? How did those rate changes affect economic growth and job creation?

As far as I know, those capital gains tax rate changes had no material impact on the aggregate level of investments in, or performance of, the U.S. economy or job creation. I am not aware that there are empirical studies enjoying consensus academic support that demonstrate any meaningful link between the changes to the individual U.S. capital gains tax rate over that period and the performance of the U.S. or global economy. The increase in the U.S. capital gains tax rates in the 1986 Act did not appear to have an adverse impact on the performance of the economy or on investment decisions apart from curtailing certain investment activities funded through tax shelter syndications. Between 1986 and 2001, the economy performed relatively well, but factors such as the revolution in computing almost certainly had much more impact on investment activity and economic growth than the capital gains tax rate. It escapes me how one could disaggregate the effect of the reduction in the rate of tax on capital gains and in the increase in the top effective rate for ordinary income that occurred in the early 1990's to claim to know with any confidence which had the dominant effect, if any, on the performance of the economy. Over the past 10 years, the economic performance of the United States, and of the world, has been suboptimal, but I doubt seriously that the low rate of tax on capital gain and dividend income of individual U.S. taxpayers had much to do with the financial collapse beginning in 2007 and its aftermath that continues to affect economic performance today.

2. Capital Gains Taxes and Distributionally Neutral Reform?

In the Tax Reform Act of 1986, we raised taxes on capital gains in order to make sure that we maintained the progressivity of the tax code. We concluded that there was no way to maintain progressivity and cut the top marginal rate to 28 percent without raising taxes on investment income. We also raised taxes on corporations.

- How far can we lower top rates and maintain the progressivity of the tax code without raising taxes on capital gains?

Without raising taxes from the corporate sector or increasing the rate of tax on capital gains and dividend income, I am very doubtful that a significant reduction in the top rate on ordinary income could be made without reducing the progressivity of the individual income tax. It is very hard, however, to have a good sense of maximum cut that could be made to the top ordinary income tax rate with access to the revenue estimating models.

- How else can we make sure that we maintain the progressivity of the tax code as part of tax reform?

Elimination of the preferential rate for dividend income would be one possible change that might be considered as an offset to a cut in the top ordinary income tax rate. Consideration might also be given to placing per-individual dollar limits on the maximum amounts of retirement income and incentive compensation that can qualify for tax preferred treatment. While, as a self-employed taxpayer, I enjoy a deduction for one half

of my medical insurance premiums, it would be a rationalization of the tax system to eliminate that deduction in partial compensation for a rate reduction regardless of whether changes are made to the taxation of employer provided medical care. It might also make sense to consider the imputation of the value of employer-provided medical care to employees with compensation over some level. Limitation on the deduction for state and local taxes of upper-income taxpayers should also be given consideration, but I personally think that the analytical basis for limiting the deduction for state and local income taxes is not all that strong as a matter of tax policy.

- Recent CRS reports have found that changes in capital gains and dividends were the largest contributor to the increase in income inequality in recent decades. Should that conclusion affect how we move forward on tax reform?

Yes. I believe that it is extremely important that tax reform not be structured in a manner that exacerbates the current levels of income inequality.

3. The Lock-In Effect of Capital Gains Taxes

One purpose of having a lower rate for long-term capital gains is to reward investors for investing long-term. However, some economists say that taxing capital gains on realization is inefficient because it encourages investors to hold assets for too long. This is called the "lock-in" effect. The "lock-in" effect is exacerbated by the fact that the tax rate on long-term capital gains is lower than the tax rate on short-term capital gains.

a) Is "lock-in" a drag on economic growth?

Increasing the rate of tax on long-term capital gain income would increase the lock-in effect, and thus it is one consideration to take into account in deciding what treatment to provide for capital gains in comprehensive tax reform. While it seems logical that the lock-in effect would, considered in isolation, be detrimental, it is not at all clear that the lock-in effect has a material adverse macroeconomic impact. Any tax provision on any type of income will have an impact on economic behavior, as will reductions in spending or spending without raising revenues to pay for the spending, so in assessing the ultimate impact of taking steps to reduce the lock-in effect would be a very complex, if not impossible, analysis to undertake.

For example, eliminating the tax on both long and short term capital gain income would eliminate the lock-in effect. It would, however, induce an enormous amount of arbitrage activity, significantly reduce the progressivity of the tax system, and require offsetting tax increases on other types of income, reductions in spending, or increases in the deficit, each with a potentially significant adverse economic effect, etc. My judgment is that the detrimental impact of these other collateral consequences of the attempt to ameliorate the lock-in effect would likely greatly outweigh any advantage gained.

b) Is encouraging longer-term investment an important consideration in setting capital gains tax rates?

I doubt seriously that providing a preferential tax rate for long-term capital gains of individual U.S. taxpayers has a significant positive influence on the aggregate amount of investment in long-lived plant and equipment in the United States.

c) If both are important, how can we square these two goals?

Accept the fact that economists and editorial writers know far less about the ultimate macroeconomic impact of changes to the tax system than they affect to know. With respect, I do not believe that Congress should attempt to optimize aggregate economic performance by codifying permanent preferential tax treatment for particular activities or categories of income.

4. How Much Capital Gains Income is Double Taxed?

Under our current tax code, income from investments in corporate stock is taxed twice: once at the entity level, and once when that income is passed on to investors, either through dividends or through capital gains. However, most capital gains are not from gains in corporate stock.

a) How concerned should we be about this double taxation?

It is very difficult to know how much double taxation of income from investments in corporate stock there is under the current system. Certainly, in many cases, corporate income is taxed at a combined individual and corporate effective tax rate in excess of the top ordinary income tax rate. In other cases, however, the combined effective rate of tax is lower. One can see that the aggregate amount of U.S. corporate income tax actually paid by corporations is relatively low as compared to the aggregate amount of income reported to shareholders. The effective rate of tax on gains on corporate stock is also reduced by the fact that the gains generally are not taxed until the stock is disposed of. I do not know whether there have been any careful academic studies undertaken to determine the net effect of the various favorable and unfavorable tax consequences of operating in corporate form or whether such income is taxed at a higher aggregate effective rate of U.S. tax than compensation income.

b) Should we attempt to remedy double taxation of capital gains? If so, how?

It is worth giving serious consideration to the issue. Some corporate/shareholder integration regime that provides relief for actual double taxation would be the preferable means of doing so. If it is determined that the steps taken to integrate corporate/shareholder taxation would cost significant revenue, that must be weighed against the benefits from providing such relief.

c) Should Congress consider a different capital gains rate for the gain on the sale of C corporation stock than for other capital assets?

I do not believe that a preferential rate for gains on corporate stock is an effective or sensible means of addressing the adverse consequences of the double tax on corporate income.

5. Does the Deferral Benefit Remedy the Double Tax?

Unlike businesses organized as partnerships or other “pass-throughs”, income from corporations is taxed twice. At the same time, corporate investors get to defer paying tax on their capital gains until those gains are realized. This is a significant tax benefit.

- Does the benefit of deferral outweigh the effect of the double tax? Is there a bias towards pass-through entities, or is the tax treatment of pass-throughs and corporations roughly equal?

I suspect that the tax treatment of pass-through entities is preferable to the tax treatment of corporations.

- If there is a bias towards passthrough entities, do you think this is a major problem?

Ideally, the tax treatment of business and investment activity would not depend upon the legal form in which the activities are undertaken. Having said that, it is not clear to me that the different treatment of pass-through entities and corporations is a major problem.

6. Reduced Arbitrage

Would the efforts of taxpayers or their attorneys to reclassify ordinary income as capital gains be eliminated if the rate differential were eliminated?

The efforts would not be eliminated because of the limitation on the deduction of capital losses and the limits on the deduction of investment interest would still motivate a certain amount of arbitrage activity, but they would be very substantially reduced.

Questions from Ranking Member Hatch

1. Under present law, corporations do not receive preferential tax treatment for capital gains. It seems that this would create a “lock-in” effect for corporations as well as possibly imposing an additional level of tax on corporate income. Should corporations also receive preferential tax treatment for capital gains?

Any regime that taxes gains on a realization basis rather than on an economic accrual basis, as is necessary as a practical matter, will create a lock-in effect, and the higher the rate the larger the lock-in effect. I believe that an attempt to deal with this issue by reintroducing a preferential rate of tax for corporate capital gains would be a very inefficient response to this issue and would be a severe step backwards in tax policy. A much better approach to my mind would be to reduce marginal rates on all corporate income, whether ordinary or capital, with the revenue loss offset with broadening the corporate tax base so that the effective rate of tax on corporate income was closer to the reduced nominal corporate income tax rate.

2. As part of Treasury I released in 1984, Treasury proposed a dividends paid deduction to integrate the individual and corporate level taxes. As you know, corporate integration was not enacted as part of the Tax Reform Act of 1986. If, as part of comprehensive tax reform, corporate integration was enacted, maybe a dividends paid deduction, a dividend exclusion or a shareholder credit, how would that affect how capital gains from the sale of stock would be taxed?

Somewhat surprisingly, there was relatively little push from the corporate community at that time for movement toward corporate/shareholder integration. Given that lukewarm response, the Administration and Congress concluded that the distributional impact, revenue cost, and complexity of integration was not justified under the circumstances. Given the erosion of the corporate tax basis since that time, however, the relative cost of corporate/shareholder integration may not be an insuperable burden at this time.

There are technical difference between the various approaches to corporate/shareholder integration, and no method is clearly preferable to the others. I do think that the relief, whichever form it takes, should be limited to situations in which the corporate income would otherwise be subject to U.S. tax at both the corporate and the shareholder level, perhaps by following the model of certain European systems that provide a nonrefundable shareholder credit with a compensatory corporate level tax for distribution that are derived from earnings that have not effectively been subject to tax at the corporate level.

Separate and apart from corporate/shareholder integration for portfolio shareholders in publicly-traded corporations, serious consideration should be given to mandatory integration of corporate/shareholder income for shareholders in closely-held corporations and direct investors with stock interests of more than, say, 10% of the stock of a corporation. The complexities of integration are considerably more manageable in regard to direct investors, and I am doubtful that the current regime of nominal double taxation in such situations raises any particular revenue as to the revenue that would be raised by a pass-through regime. In fact, since taxpayers can generally use self-help to avoid any effective double tax in such situations by operating through a limited liability company and electing partnership treatment under the check-the-box regulations, it is doubtful that the nominal double tax is materially worse for many non-electing closely-held corporations.

Questions for the Record

UNITED STATES SENATE
COMMITTEE ON FINANCE
UNITED STATES HOUSE
WAYS AND MEANS COMMITTEE

Senate Finance Committee Hearing
"Tax Reform and the Tax Treatment of Capital Gains"
September 20, 2012
Questions for Dr. Lawrence B. Lindsey

Questions from Chairman Baucus

1. Capital Gains Rates and Economic Growth

There has been much discussion in the Finance Committee and the Ways & Means Committee about tax reform – both the need for it and what it should look like.

I believe a 21st century tax code must advance America's security in the global economy. To do this, the code must promote jobs from broad-based growth, competitiveness, innovation, and opportunity.

- Would relatively lower or higher tax rates on capital gains advance those goals?

In 1996, the top, long term capital gains rate was 28%. Between 1996 and 2002, it was 20%. Since then it has been 15%.

- What information do we have that these rate changes changed how investors made investment decisions? How did those rate changes affect economic growth and job creation?

Answer: A tax code which is designed to promote jobs from broad-based growth, competitiveness, innovation, and opportunity should not consider the capital gains tax rate in isolation. The tax rates on ordinary income and on corporate income also need to be considered. Obviously, the lower the capital gains rate the better, but this needs to be balanced against these other rates and against the government's need for revenue. Although the issue is complex, on balance I believe that bringing the ordinary income rate down and in line with the capital gains tax rate would be the right mix for a revenue and distributionally neutral tax change.

The capital gain rate reduction of the late 1990s clearly moved investors toward a greater reliance on capital gains as a preferred form of return and was a major contributor to the rise in equity prices in the late 1990s. In concert with an overly loose monetary policy, this became too much of a good thing, creating a bubble, which ultimately popped. The 2002 cuts in dividend and capital gains taxes were designed to restore some growth to equity prices and they succeeded in doing so.

2. Capital Gains Taxes and Distributionally Neutral Reform?

In the Tax Reform Act of 1986, we raised taxes on capital gains in order to make sure that we maintained the progressivity of the tax code. We concluded that there was no way to maintain progressivity and cut the top marginal rate to 28 percent without raising taxes on investment income. We also raised taxes on corporations.

- How far can we lower top rates and maintain the progressivity of the tax code without raising taxes on capital gains?
- How else can we make sure that we maintain the progressivity of the tax code as part of tax reform?
- Recent CRS reports have found that changes in capital gains and dividends were the largest contributor to the increase in income inequality in recent decades. Should that conclusion affect how we move forward on tax reform?

A: On balance it would be difficult to lower the top rate of income taxation into the mid to upper 20 percent range without raising the capital gains rate if one wished to preserve revenue and distributional neutrality. On the other hand, one could easily design revenue and distributionally neutral tax codes with the top rate in the 25-28 percent range if the capital gains and ordinary rates were identical and other changes were made as well to broaden the base.

I do not concur that the changes in capital gains and dividend taxation were the largest contributor to income inequality. First and foremost I would ascribe that to the low interest rate environment designed to raise asset prices. Second I would point to the enhanced returns to education. In general tax changes have a relatively second order effect on the distribution of income in a society.

3. The Lock-In Effect of Capital Gains Taxes

One purpose of having a lower rate for long-term capital gains is to reward investors for investing long-term. However, some economists say that taxing capital gains on realization is inefficient because it encourages investors to hold assets for too long. This is called the "lock-in"

effect. The “lock-in” effect is exacerbated by the fact that the tax rate on long-term capital gains is lower than the tax rate on short-term capital gains.

- a) Is “lock-in” a drag on economic growth?
- b) Is encouraging longer-term investment an important consideration in setting capital gains tax rates?
- c) If both are important, how can we square these two goals?

A: The lock-in effect is well demonstrated in the tax literature. It is an indirect drag on economic growth because it inhibits market participants from moving funds from one investment to another – thus slowing the movement of capital to those projects that yield the highest return. I am not certain that taxes are the best way to promote “longer term” investment. We have a political and regulatory process with a decided short term focus. Although our public equity markets have only a slightly longer term perspective than Washington, there are many financial market arrangements that do have a longer term focus. Unfortunately these long term investors and the markets in which they operate are being suppressed by current economic policies – monetary, fiscal, and regulatory.

4. How Much Capital Gains Income is Double Taxed?

Under our current tax code, income from investments in corporate stock is taxed twice: once at the entity level, and once when that income is passed on to investors, either through dividends or through capital gains. However, most capital gains are not from gains in corporate stock.

- a) How concerned should we be about this double taxation?
- b) Should we attempt to remedy double taxation of capital gains? If so, how?
- c) Should Congress consider a different capital gains rate for the gain on the sale of C corporation stock than for other capital assets?

A: Double taxation is an inherent byproduct of capital gains taxation. When an income producing entity is taxed on its income and then the owners of that entity are taxed again, double taxation cannot be avoided. One should note that the National Income and Product Accounts do not even consider capital gains as “income” for just that reason – the “income” was generated and taxed at the entity level.

I believe that double taxation should be avoided because it creates a highly distortive environment for economic decision making. But, as I said before the Committee, the best way to do this is to move from income based taxation toward cash flow based taxation imposed exclusively at the entity level and not at the individual level.

5. Does the Deferral Benefit Remedy the Double Tax?

Unlike businesses organized as partnerships or other “pass-throughs”, income from corporations is taxed twice. At the same time, corporate investors get to defer paying tax on their capital gains until those gains are realized. This is a significant tax benefit.

- Does the benefit of deferral outweigh the effect of the double tax? Is there a bias towards pass-through entities, or is the tax treatment of pass-throughs and corporations roughly equal?
- If there is a bias towards pass-through entities, do you think this is a major problem?

A: The “deferral benefit” argument is not a valid one. It is based on the presumption that by leaving funds invested in the company and not realizing the gain that the income on those assets is deferred. In fact, the income continues to be taxed at the corporate level (in the case of stock) as long as the asset is held.

6. Reduced Arbitrage

Would the efforts of taxpayers or their attorneys to reclassify ordinary income as capital gains be eliminated if the rate differential were eliminated?

A: On balance, I support the equalization of the ordinary and capital gains rates at a rate in the mid to upper 20 percent range in part for this very reason

7. Reduce Bias for Debt vs. Equity

Dr. Lindsey, in your testimony you say that capital taxation should be as neutral as possible with regard to financial decisions. You also say that the current heavy taxation of equity and the generous taxation of debt helped create an overleveraged economy for which we are now paying a heavy price. You indicate that limiting the favorable tax treatment of debt relative to equity would allow the revenue that would be raised to pay for lower tax rates on equity.

- Can you clarify how you would structure limiting the favorable treatment of debt? Would you propose a straight limitation on interest deductions or use some other mechanism?
- Would you suggest using the revenue raised to help lower corporate tax rates, capital gains rates, or both?

A: As a first best alternative I would recommend moving away from income based taxation and toward cash-flow based taxation. A VAT would be one example of this. In that model it would not matter *how* the income of a firm was allocated – between labor

and capital or between debt and equity. These arbitrary distinctions are the reason why our tax code is so needlessly complicated.

However, short of that, if one is interested in taxing capital fairly there is no reason why interest should be treated any differently than dividends as a means of providing capital for firms. Ultimately, eliminating the deduction for interest – or alternatively eliminating the taxation at the corporate level for dividends paid – would accomplish this goal. If this latter approach were used then there would be no need for a separate capital gains rate to be used. If, unfortunately, the Congress were to simply do the former, then the total taxation of capital would rise quite sharply. Obviously a reduction or even the elimination of taxation of interest and dividends and the personal level would be a remedy to this.

Questions from Ranking Member Hatch

1. Much of the literature on the preferential tax treatment of capital gains views capital gains as simply one type of income that should be taxed the same as any other type of income. But our current tax system is not a pure income tax system – it is really a hybrid income and consumption tax system. For example, a large percentage of all savings is held in tax-preferred accounts. So if we look at our tax system from the lens of a consumption tax, would preferential tax treatment of capital gains be consistent with such a system. In fact, should preferential tax treatment be extended to all income from capital, which would be taxed at a zero rate?

A: Under a consumption tax system there would be no taxation of capital gains or any proceeds from the sale of one asset if that were used to purchase another asset. The other “asset” might even be a cash deposit in an investment fund.

2. Under present law, corporations do not receive preferential tax treatment for capital gains. It seems that this would create a “lock-in” effect for corporations as well as possibly imposing an additional level of tax on corporate income. Should corporations also receive preferential tax treatment for capital gains?

A: Special treatment of capital gains for corporations is a very complex subject. The reason is that it would be hard to differentiate between assets purchased in the ordinary course of doing business from those held for investment purposes – for which the capital gains rate might apply. This complexity is, in fact, one of the many reasons why the entire income based tax system is so needlessly complicated.

[Submissions For The Record follow:]

Alliance for Savings and Investment, statement



**THE ALLIANCE FOR SAVINGS AND INVESTMENT
STATEMENT**

**TO THE
COMMITTEE ON WAYS AND MEANS
AND THE SENATE COMMITTEE ON FINANCE
FOR THE SEPTEMBER 20, 2012 JOINT HEARING RECORD
REGARDING TAX REFORM AND THE TAX TREATMENT OF
CAPITAL GAINS**

SEPTEMBER 20, 2012

The Alliance for Savings and Investment (ASI) is a diverse coalition of dividend-paying companies, investor organization and trade associations, formed in support of a common goal: to promote economic recovery, growth and job creation through policies that foster private savings and capital investment. ASI members include: AGL Resources, Altria, American Forest & Paper Association, American Gas Association (AGA), AT&T, Capital Research & Management Company, CenturyLink, Charles Schwab, Edison Electric Institute (EEI), Frontier Communication, Investment Company Institute (ICI), Laclede Gas Company, MassMutual Life Insurance, National Association of Water Companies, New York Life, NYSE, RAI Service, Securities Industry and Financial Markets Association (SIFMA), Southern Company, Spectra Energy, The Coca-Cola Company, United Parcel Service (UPS), United States Telecom, Vanguard, Verizon, Windstream Corp, Xcel Energy

<http://www.theasi.org/>

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The Alliance for Savings and Investment (ASI) is a diverse coalition of dividend-paying companies, investor organizations and trade associations, formed in support of a common goal: to promote economic recovery, growth and job creation through policies that foster private savings and capital investment.

We thank Chairman Camp, Chairman Baucus, Ranking Member Levin and Ranking Member Hatch for the opportunity to comment on the impact of increased tax rates on investment income. The ASI's top legislative priority is making permanent today's current tax rates on capital gains and dividends to provide certainty to investors, stability to the economy and a strong foundation for long-term economic growth and job creation.

Background

Historically, the U.S. has provided preferential rates for investment income. Prior to 1986, a portion of long-term capital gains was typically excluded from income. While the Tax Reform Act of 1986 repealed the exclusion, the top income tax rate was also reduced from 50 percent to 28 percent. When top rates began to rise again, Congress decoupled capital gains and income, lowering the capital gains rate to 20 percent in 1997 and 15 percent in 2003.

The 2003 Act took two important steps to boost economic growth. First, it lowered the maximum rate on capital gains to 15 percent. Second, it tied capital gains and dividend income together, lowering the rate on dividends from the top income tax rate to 15 percent. Unfortunately, those rates will sunset – increasing the capital gains tax from 15 percent to 20 percent and more than doubling the dividend rate from 15 percent to 39.6 percent. In addition, beginning in 2013 investment income will be subject to an additional Medicare HI tax of 3.8 percent, raising the top rate on dividend income from 39.6 to 43.4 percent and capital gains to 23.8 percent.

Economic Impact

Allowing the rates to expire could have a significantly negative impact on economic growth. According to the Heritage Foundation, higher investment tax rates would lead to 270,000 fewer jobs in 2018.

In addition to harming the economy, the impact of capital gains tax increases would be borne by millions of Americans, across all income levels. According to IRS data, in 2009, more than 3 million returns with long-term capital gains were filed. Sixty-two percent of those returns were from taxpayers with adjusted gross income of less than \$100,000.

Farm and ranch owners are disproportionately impacted by capital gains tax increases. Nationwide, 40 percent of all agricultural producers report some capital gains; nearly double the share for all taxpayers. In addition, the average amount of capital gain reported by farmers is about 50 percent higher than the average capital gain reported by other taxpayers. The impact of

capital gains taxes on farming and ranching is also significant because production agriculture requires large investments in land and buildings that are held for long periods of time.

Higher capital gains taxes also make the U.S. less competitive. According to a report by Ernst & Young LLP, the U.S. capital gains tax rate compares unfavorably with that of many other major economies. Even with current rates, more than half of the countries surveyed have individual capital gains tax rates lower than that of the U.S. Allowing rates to increase would undermine efforts to keep the U.S. competitive with our trading partners.

Dividends

By synchronizing the tax rates of capital gains and dividends, Congress eliminated the tax bias toward investing in high growth-low dividend companies. Maintaining parity between the two rates is important to ensure that investors' decisions remain "tax neutral." A higher tax rate on dividends could lead investors to favor higher risk capital gains over lower risk dividend paying stocks.

Keeping tax rates low will encourage more companies to pay dividends. The Cato Institute found that 19 companies in the S&P 500 began paying dividends for the first time in the immediate aftermath of the tax reform enacted in 2003. The study also found that dividend payments by S&P 500 companies rose from \$146 billion to \$172 billion in the first year following the 2003 tax cut. The overall pay-out of dividends in 2005 was more than 36.5 percent higher than the payout before the 2003 tax cut, and dividend income reported by taxpayers increased by a similar margin.

In addition to promoting growth, lower dividend tax rates promote market stability. Keeping rates low helps to attract and keep shareholders who are interested in a more long-term buy and hold strategy, which benefits shareholders, companies and ultimately the economy.

When Congress reduced the rates on dividends in 2003, it took an appropriate step toward making U.S. dividend tax laws more competitive with the rest of the world. Taxes on dividends are simply a double tax on corporate income. Indeed, the U.S. fully eliminated the double tax from 1913 until 1953, with the exception of three years in the 1930s. Most other developed countries provide some relief from the double tax, and the lower rates help bring the United States into a comparable position with our major trading partners. Without Congressional action in 2013, the United States will have the highest integrated dividends tax rate.

Conversely, raising rates would have negative ramifications. Higher tax rates on dividends will encourage companies to use debt financing versus equity financing. As dividend-paying stocks become less valuable, publicly traded companies will find it more difficult to finance investments through stock offerings. Deductions for debt related interest will make debt financing more advantageous.

According to the bipartisan Tax Foundation, raising dividend tax rates will disadvantage the largest dividend-paying companies and could reduce the level of dividends paid to shareholders. If this happens, all taxpayers who receive dividend income would be affected, regardless of their income level, by discouraging investment in dividend-paying companies and potentially lowering dividend payouts.

Adverse Impact on Retirees

Lower investment tax rates don't just benefit direct shareholders; they benefit the tens of millions of Americans who own stock indirectly through mutual funds and the value of stock held through life insurance policies, pension funds or 401(k) plans.

According to a January 2010 study by Ernst & Young, of the 27.1 million Americans who received dividend payments from utility companies in 2007, 61 percent were taxpayers age 50 and older and 30 percent were taxpayers 65 and older.

Further, according to IRS data, older Americans and those saving for retirement would be disproportionately hurt by a tax increase on capital gains income. For 2009, among taxpayers with qualified dividend income, 63 percent were over the age of 50 and 68 percent were from returns with incomes of less than \$100,000.

Conclusion

If Congress does not act to extend or make permanent capital gains and dividend rates, the maximum tax rate on dividend income will surge by 164 percent, and the capital gains tax rates will increase by as much as 33 percent (and these increases do not include the additional 3.8 percent tax imposed by the Affordable Care Act).

Tax increases on investment income disproportionately affect seniors, farmers and ranchers, and manufacturers and will directly impact middle class tax payers. Undoubtedly, this looming tax increase on investment income will affect asset values. Congress should not assume that market values won't be affected until very near the date of expiration. Instead, the market will begin to price in the expiration months in advance. As the committee considers efforts to improve the tax code and promote economic growth, we urge members to maintain current low rates on both capital gains and dividends and provide certainty to taxpayers and the financial markets well in advance of the expiration dates of the current rates.

American Council for Capital Formation 1, statement

The Impact of Raising Tax Rates on Individual Capital Gains

By

Pınar Çebi Wilber, Ph.D.

Economist

American Council for Capital Formation*

**Testimony submitted for the record for the hearing on
“Tax Reform and the Tax Treatment of Capital Gains”
Joint Hearing House Committee on Ways and Means and
Senate Committee on Finance
September 20, 2012**

Introduction

Chairman Camp, Senator Baucus, and members of the Committees, my name is Pınar Çebi Wilber, economist, American Council for Capital Formation (ACCF),* Washington, D.C. I am pleased to submit this testimony for the hearing record to outline some possible economic consequences of increasing long-term capital gains tax rates on individuals.

The American Council for Capital Formation represents a broad cross-section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Democratic and Republican administrations, former members of Congress, prominent business leaders, and public finance and environmental policy experts. The ACCF is celebrating over 30 years of leadership advocating sound tax, energy, environmental, regulatory and trade policies that facilitate saving and investment, economic growth and job creation.

Background

Even though the recession has been officially over since 2009, the U.S. economy continues to struggle with high unemployment and sluggish economic growth. Decision makers face major uncertainties, including the scheduled expiration of decade old tax reductions for families and individuals at all income levels, the so-called “Bush Tax Cuts.” One component of the expiring tax cuts is the individual capital gains tax rate. Without any action, the top individual capital gains tax rate will increase to 20% from the current top rate of 15%. As a result of the recently passed 2010 health care legislation, there will be an additional 3.8% tax on unearned income beginning in 2013. Coupled with the 2013 scheduled restoration of the “Pease Limitation” on

* Founded in 1973, The American Council for Capital Formation is a nonprofit, nonpartisan organization advocating sound tax, energy, environmental, regulatory and trade policies that facilitate saving and investment, economic growth and job creation. For more information about the Council or for copies of this testimony, please contact the ACCF, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006- 2302; telephone: 202.293.5811; fax: 202.785.8165; e-mail: info@accf.org; website: www.accf.org

itemized deductions (which will impose roughly a 1.2% marginal rate on capital gains), individuals will face a top federal rate on capital gains of 25%. This sharp 67% increase on investment income will no doubt have negative consequences on an already struggling U.S. economy. This testimony presents evidence on the impact of capital gains taxes on entrepreneurial activity, discusses how the U.S. tax rate compares to our trading partners and how letting the tax rate rise will impact the overall U.S. economy and job growth.

Background on Capital Gains

Over the years, the maximum tax rate on long term individual capital gains has been changed a number of times (see Chart 1). In 1986, the rate was increased to 28% from 20% (a 40% tax hike) as part of the last major tax reform in the United States. Later, the long term capital gains rate was reduced to 20% in 1997 (Taxpayer Relief Act of 1997) and to 15% in 2003 (Jobs and Growth Tax Relief Reconciliation Act of 2003). The 15% tax rate has been extended until the end of 2012 and is scheduled to revert to 20% on January 1, 2013. Including the 3.8% tax surcharge and restoration of the “Pease Limitation,” the maximum long term individual capital gains tax rate will go up to 25% if Congress does not act.

State and Federal Capital Gains Tax Rates

Unfortunately, the majority of U.S. investors not only face the Federal long term individual capital gains tax rate, but also have to factor in state level capital gains tax rates. A 2012 survey¹ conducted by Ernst & Young LLP for the ACCF Center for Policy Research (CPR) analyzed three possible scenarios:

1. **2012 law:** Top effective tax rates on long-term individual capital gains under 2012 Federal and State tax laws. (Top Federal capital gains rate is 15%.)
2. **2013 law with extension of the 2001/2003 tax cuts (top Federal capital gains rate at 15%):** Top effective tax rates on long-term individual capital gains in 2013, assuming an extension of the 2001/2003 tax cuts in addition to the new 3.8% Medicare tax on unearned income scheduled for 2013 for married couples filing jointly (single filers) with \$250,000 (\$200,000) or more in income. State rates that are currently scheduled for 2012 are assumed to be the same for 2013.
3. **2013 law as scheduled (top Federal capital gains rate at 20%):** Top effective tax rates on long-term individual capital gains under 2013 Federal tax law (i.e., assuming the 2001/2003 tax cuts sunset on December 31, 2012 and the 3.8% Medicare tax takes effect as scheduled). State rates that are currently scheduled for 2012 are assumed to be the same for 2013. The

¹ “State and Federal Individual Capital Gains Tax Rates: How High Could They Go?,” Special Report by the ACCF Center for Policy Research, Conducted by Ernst & Young, March 2012, http://accf.org/wp-content/uploads/2012/04/ACCF_specialReport_2012_16.pdf

calculations also account for the reinstatement of the limitation of itemized deductions for high-income taxpayers (i.e., the “Pease” provision) in 2013.

Investors face State-level individual capital gains taxes in forty-one states. According to the survey, the average top individual State capital gains tax rate was 5.3% in 2012. Combined with the Federal capital gains tax rate, the average rate is 18.4%.² If Congress does not act and the capital gains tax reverts to 20%, the U.S. average tax rate will become 27.9% including the healthcare surcharge. Among the states, currently Hawaii has the highest combined State and Federal capital gains tax rate (22.2%) followed by California (21.7%). If the current capital gains tax rate expires, their rates will increase to 31.6% and 31.2% respectively (see Table 1). Given the current budget woes faced by many states, increasing the capital gains tax rate is likely to have a negative impact on budget receipts because higher tax rates make such investments less attractive and lengthen holding periods.

Why the Capital Gains Tax Rate is Important

A low capital gains tax rate has an important role to play in fostering economic growth and in promoting the entrepreneurial drive on which the U.S. economy thrives. Entrepreneurs are a major force for technological breakthroughs, new start-up companies, and the creation of high paying jobs. Combined with the State capital gains tax rates, the Federal capital gains tax rate substantially increases the difference between what an investment yields and what an individual investor actually receives (known as the “tax wedge”). The higher the tax wedge, the fewer the number of investments that will meet the “hurdle rate;” resulting in fewer investments being undertaken.

Impact on Entrepreneurs:

A recent study³ by Professor William M. Gentry conducted for the ACCF CPR, identifies mechanisms through which capital gains taxes can affect entrepreneurs’ decisions:

- Capital gains taxes may create an additional level of taxation on successful entrepreneurs.
- Asymmetric taxation of capital gains and losses (in which gains are taxed more heavily than losses) may be an especially important issue for entrepreneurs; the asymmetries in the tax system may discourage entrepreneurs from taking risk.⁴

² These calculations take into account the federal deduction for state and local income taxes paid, as well as any states that allow taxpayers to claim a deduction against their state taxes based upon their federal taxes paid.

³ “Capital Gains Taxation and Entrepreneurship,” William M. Gentry, Study Conducted for ACCF CPR, November 2010, http://accf.org/wp-content/uploads/2010/11/media_497.pdf

⁴ A Congressional Research Service report by Thomas L. Hungerford, “Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945,” claims that “Consequently, a rise in the capital gains top rate could increase investment because of reduced risk.” However, the CRS study (<http://graphics8.nytimes.com/news/business/0915taxesandconomy.pdf>), seems to ignore the fact that “gains are taxed more heavily than losses” and as mentioned in Prof. Gentry’s paper cited above “Unlike a symmetric tax on returns, an asymmetric tax does not necessarily provide insurance. In the extreme, the government takes part of the

- Entrepreneurs may become locked into closely-held businesses; this lock-in effect may distort whether firms are owned by the most efficient manager for the firm.
- Capital gains taxes can affect the cost of capital for entrepreneurs

To document the potential importance of capital gains taxation on entrepreneurs, Prof. Gentry analyzes household portfolios, the composition of unrealized capital gains held by households, and whether capital gains taxes are related to disbursements by venture capital partnerships. His analysis has three main findings: First, active business assets – the types of assets that are likely to be associated with capital gains for entrepreneurs – play an important role in the aggregate portfolio of household assets. According to the 2007 Survey of Consumer Finances (SCF), 11.1 percent of households hold active business assets, and these assets account for 19 percent of household portfolios; by comparison, stocks held directly or in mutual funds (but outside of retirement accounts) are 11.7 percent of household wealth.

Second, the stock of unrealized capital gains associated with privately held businesses is large. The SCF data suggest that aggregate unrealized capital gains on active business assets are almost six times larger than aggregate unrealized capital gains on corporate stock. The magnitude of unrealized capital gains on active business assets suggests that the capital gains tax rate could play an important role in whether and when these assets are sold. In fact, as shown in Chart 1, long term capital gains realizations in the economy plotted against historical capital gains tax rates seems to support this belief. In fact, a new analysis by the Congressional Budget Office⁵ measures how changes in the capital gains tax rate affects the decision to realize gains (called the “elasticity” of response to a change in the tax rate). According to their estimates, the persistent⁶ elasticity is estimated to be -0.79, while the transitory elasticity is estimated as -1.2, suggesting that capital gains realizations are quite responsive to tax rates. Understanding the elasticity of response by taxpayers to changes in tax rates helps policymakers understand the impact that changes in capital gains tax rates will have on investors, on the formation of new ventures and on both state and federal budget receipts.

Third, Prof. Gentry examines whether capital gains tax rates affect the disbursements of venture capital funds using state-aggregate data from 1969-2007. Regression analysis suggests that higher capital gains tax rates are associated with a reduction in state-level disbursements from venture capital funds. Since many of the sources of venture capital funding are not subject to capital gains taxation, Prof. Gentry interprets this finding as

upside of the venture but does not share in its losses.” (pg 22). See Gentry paper cited above, especially pages 22-25 for a discussion of the asymmetric treatment of capital gains and losses.

⁵ “New Evidence on the Tax Elasticity of Capital Gains,” A Joint Working Paper of the Staff of the Joint Committee on Taxation and The Congressional Budget Office, June 2012, <http://www.cbo.gov/publication/43334>

⁶ Authors describe “persistent” as “the effect of an increase in tax rate that has persisted over the previous year and is also expected to persist into the next year” (pg 4)

suggestive of a demand side effect: in states with higher capital gains tax rates, fewer entrepreneurs are starting businesses that seek venture capital funding.

Impact on the Overall Economy:

In order to analyze the impact of alternative capital gains tax rates on the economy, Dr. Allen Sinai, president and CEO of Decision Economics, Inc., simulated various rates, high and low, using the large scale Sinai-Boston macroeconomic model of the U.S. economy. The study⁷ was conducted in 2010 for ACCF. The results include:

- Raising the capital gains tax rate from the current 15% to 20%, 28% or 50%, reduces growth in real GDP, lowers employment and productivity and, after feedback effects, increases the federal budget deficit. For example, at a 20% capital gains rate, real economic growth falls by 0.05 percentage points per year and jobs decline by 231,000 a year, compared to the base case, which uses the 15% capital gains tax rate (see Table 2). When the rate is increased to 28%, real GDP growth declines by 0.1 percentage points per year and there are 602,000 fewer jobs created each year.⁸
- Reducing the capital gains tax rate to zero increases growth in real GDP by a little over 0.23 percentage points per year and there is an average of 1,323,000 more jobs created annually. The unemployment rate drops by an average of 0.5 percent, and productivity growth improves by 0.5 percentage points a year.
- Reducing capital gains taxes also causes realizations to rise as investors and businesspersons cash-in long-term capital gains. Consumer spending increases as capital gains realizations, aftertax, are “spent” or “saved.” The rise in asset prices, both in the values of equity and residential real estate, is reflected in a stronger household balance sheet and reductions in debt because of increased income and capital gains realizations. Household financial conditions improve; in turn, reducing the risk of lending to households and increasing the availability of credit.
- Lower and higher capital gains tax rates also affect the financial positions of household and corporations. When capital gains taxes are reduced, the after-tax return on equity rises, stock prices increase, household wealth is higher, some capital gains are realized, consumption increases, output and production rise, capital spending increases, household financial assets tend to rise, liabilities decline, debt service burdens are reduced, and household financial conditions improve (see Table 2). These financial effects support

⁷ “Capital Gains Taxes and the Economy,” Allen Sinai, Prepared for the ACCF CPR, September 2010.

http://accf.org/wp-content/uploads/2010/09/media_487.pdf

⁸ Contrary to a recent Congressional Research Service analysis “Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945,” <http://graphics8.nytimes.com/news/business/0915taxesandecconomy.pdf> which claims “The reduction in the top tax rates appear to have little or no relation to the size of the economic pie.”, Dr. Allen Sinai’s research suggests otherwise. Dr. Sinai’s detailed macroeconomic model captures how the taxation of capital gains reverberates through the economy and impacts investment, employment, GDP and other key variables.

additional spending out of disposable income and tend to sustain and raise for a longer time the multiplier effects from the reduction in capital gains tax.

A more recent Allen Sinai study⁹, confirms the results of previous study. The new study, using current data on U.S. economy analyzes the impact of increasing capital gains tax rate to 20% from 15% in combination with an increase in the dividend tax rate to 39.6% from the current 15%. Dividends, similar to capital gains, are subject to double taxation and taxing the dividend income has negative impact on financial markets. The combined increases in these two tax rates amplify the negative macroeconomic impact on the U.S. economy. Some results of the study are (see Table 3):

- Real GDP growth decreases 0.1%, on average, per year, which equates to a \$79.2 billion decrease per year over the 2013-17 time period. The results are similar in longer time period: Between 2013 and 2021 period, real GDP decreases \$80 billion on average, per year.
- Consumption spending is also weaker, averaging \$155 billion lower per year between 2013 and 2021 (see Table 3). Between 2013 and 2017 time period, the decrease in consumption is a little over \$122 billion.
- The job impact is worse between 2013 and 2017. The economy ends up losing 380,000 jobs on average per year. In the longer period, 2013-21, the loss is 344,000 per year. Nonfarm payroll jobs show a large loss of 561,000 persons in 2015 and then smaller losses in subsequent years.
- Spending for business investment declines when tax rates on capital gains and dividends revert to pre-Bush levels; on average \$20 billion yearly between 2013 and 2021 (see Table 2). The decrease is smaller for the shorter term, 2013-17, \$17.9 which is 1.1% lower than baseline.
- Both the S&P 500 Price Index and S&P 500 Earning per Share decline when the top tax rates on qualifying dividends and capital gains are increased compared to the Baseline. The index declines by an average of 16% and the S&P 500 Operating EPS is down an average of \$1.6 over 2013-17. Between 2013 and 2021, the index declines by an average of 14.5% and the S&P 500 Operating EPS is down an average of \$2.
- Higher taxes on capital gains and dividends significantly harm the economy and job growth and suggest that the increase in federal tax receipts may not be a worthwhile tradeoff. Despite all that damage to the economy, the overall impact on the budget deficit is only \$7.3 billion annually (see Table 3) between 2013-2017 and \$70.4 billion between 2013-2021 when the dynamic effects on economic activity and induced decreases in tax receipts from the higher tax rates are reflected.

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A new report¹⁰ by Ernst & Young LLP compares individual long-term capital gains taxes among major economies of the world as well as major trading partners of the U.S. The U.S. capital gains tax rate compares unfavorably with that of many other major economies (see Chart 2).

The tax increase in the 2010 health-care reform will bring the long-term U.S. capital-gains rate in 2013 to 18.8 percent. If the Bush tax cuts expire, as they are set to do in 2013, the rate will hit almost 24 percent combined with health-care surcharge. In his State of the Union address, President Obama suggested a minimum 30% tax rate on people making more than \$1 million, which would make U.S. rate fifth highest after Italy, Denmark, France and Sweden. Extension of the 15% rate is crucial to maintaining the U.S. competitive edge against its major trading partners.

Conclusions

Dynamic macroeconomic analyses show that raising capital gains taxes will slow overall economic and job growth. In addition, government tax receipts (U.S. and states) are likely to decline and entrepreneurial activity in the U.S. may be discouraged. Finally, our international competitiveness will be negatively impacted if the individual capital gains rate increases since our rate will be among the highest in the industrial world, thus making the U.S. a less attractive place to invest. When thinking about tax reform, policymakers should consider the negative consequences of taxing investment income. There need not be a binary choice between lower individual income tax rates and keeping tax rates on investment income at current levels.

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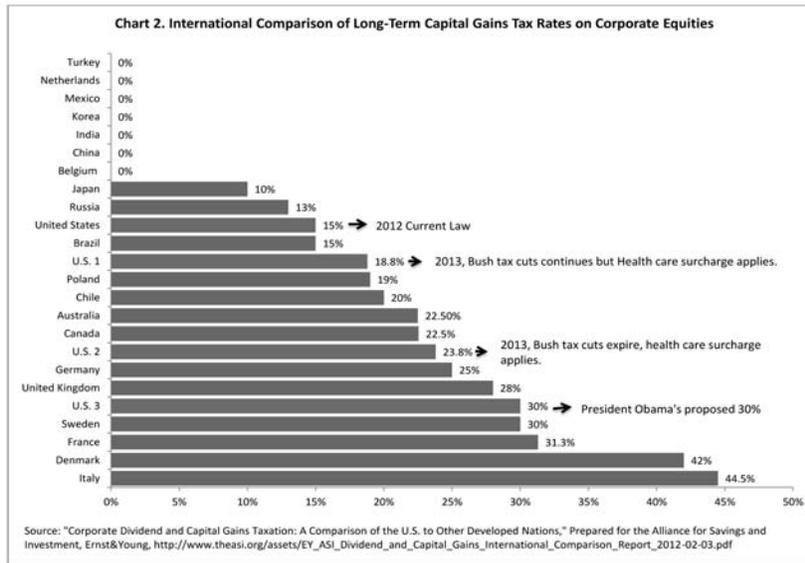
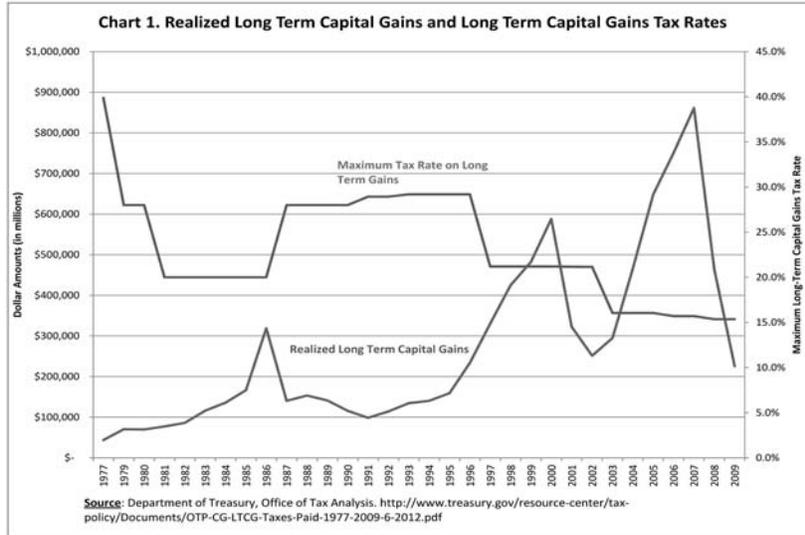


Table 1. Sample of States with Highest Rates for Combined State and Federal Individual Capital Gains Taxes

	Top effective long-term state tax rate	Including top federal marginal tax rate		
		2012 law	2013 law w/ extension of 2001/2003 tax cuts	2013 law as scheduled (tax cuts expire)
Hawaii	11.00%	22.2%	26.0%	31.6%
California	10.30%	21.7%	25.5%	31.2%
Oregon	9.90%	21.4%	25.2%	31.0%
Vermont	8.95%	20.8%	24.6%	30.4%
Washington, DC	8.95%	20.8%	24.6%	30.4%
New Jersey	8.97%	20.8%	24.6%	30.4%
New York	8.82%	20.7%	24.5%	30.3%
Maine	8.50%	20.5%	24.3%	30.1%
Minnesota	7.85%	20.1%	23.9%	29.7%
Iowa	8.98%	20.1%	23.9%	29.4%
U.S. Average	5.30%	18.4%	22.2%	27.9%

Source: "State and Federal Individual Capital Gains Tax Rates: How High Could They Go?," Special Report by the ACCF Center for Policy Research, Conducted by Ernst & Young, March 2012, http://accf.org/wp-content/uploads/2012/04/ACCF_specialReport_2012_16.pdf

Table 2: Macroeconomic Effects of Changes in the Capital Gains Tax Rate (Diffs. from Baseline, Avg. Per Year, 2011-16)*

Variables	Raised to 50 Pct.	Raised to 28 Pct.	Raised to 20 Pct.	Lowered to 10 Pct.	Lowered to 5 Pct.	Lowered to 0 Pct.
Real GDP Growth (Pctg. Pts.)	-0.3	-0.1	-0.05	0.10	0.16	0.23
Inflation (Pctg. Pts.)						
GDP Chain Price	-0.36	-0.13	-0.04	0.08	0.15	0.30
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Unemployment Rate (Pct.)	0.4	0.2	0.1	-0.1	-0.2	-0.5
Nonfarm Payrolls (Mils. Jobs)	-1,628	-0,602	-0,231	0,381	0,711	1,323
Productivity Growth (Pctg. Pts.)	-0.6	-0.2	-0.1	0.1	0.3	0.5
Federal Budget Deficit, Unified	-401.8	-174.5	-8.0	-33.5	-118.2	-143.4
Avg. per Year (Bils. \$)	-67.0	-9.8	-1.3	-5.6	-19.7	-23.9
Budget Chg., % of Baseline GDP	-2.4	-1.0	-0.0	-0.2	-0.7	-0.8
Receipts, Unified (Bils. \$)	-49.6	-6.2	-1.0	-7.7	-21.6	-32.8
Ex-Ante Cost (Static) (Bils. \$)	1148.9	551.6	272.0	-268.9	-435.6	-451.5
(Avg. per Year)	191.5	91.9	45.3	-44.8	-72.6	-75.2
% of GDP	1.1	0.5	0.3	-0.3	-0.4	-0.4
Ex-Post Cost (Dynamic) (Bils. \$)	-401.8	-37.2	-6.2	-46.4	-129.6	-196.7
(Avg. per Year)	-67.0	-6.2	-1.0	-7.7	-21.6	-32.8
% of GDP	-2.4	-0.2	0.0	0.0	-0.1	-0.2

*Simulations using the Sinai-Boston (SB) Model of the U.S. Economy. Monetary policy unchanged

Source: "Capital Gains Taxes and the Economy," Allen Sinai, Prepared for the ACCF CPR, September 2010. http://accf.org/wp-content/uploads/2010/09/media_487.pdf

American Council for Capital Formation 2, statement**The Impact of Raising Tax Rates on Individual Capital Gains**

By

Pinar Çebi Wilber, Ph.D.

Economist

American Council for Capital Formation*

**Testimony submitted for the record for the hearing on
“Tax Reform and the Tax Treatment of Capital Gains”
Joint Hearing House Committee on Ways and Means and
Senate Committee on Finance
September 20, 2012**

Introduction

Chairman Camp, Senator Baucus, and members of the Committees, my name is Pinar Çebi Wilber, economist, American Council for Capital Formation (ACCF),* Washington, D.C. I am pleased to submit this testimony for the hearing record to outline some possible economic consequences of increasing long-term capital gains tax rates on individuals.

The American Council for Capital Formation represents a broad cross-section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Democratic and Republican administrations, former members of Congress, prominent business leaders, and public finance and environmental policy experts. The ACCF is celebrating over 30 years of leadership advocating sound tax, energy, environmental, regulatory and trade policies that facilitate saving and investment, economic growth and job creation.

Background

Even though the recession has been officially over since 2009, the U.S. economy continues to struggle with high unemployment and sluggish economic growth. Decision makers face major uncertainties, including the scheduled expiration of decade old tax reductions for families and individuals at all income levels, the so-called “Bush Tax Cuts.” One component of the expiring tax cuts is the individual capital gains tax rate. Without any action, the top individual capital gains tax rate will increase to 20% from the current top rate of 15%. As a result of the recently passed 2010 health care legislation, there will be an additional 3.8% tax on unearned income beginning in 2013. Coupled with the 2013 scheduled restoration of the “Pease Limitation” on

* Founded in 1973, The American Council for Capital Formation is a nonprofit, nonpartisan organization advocating sound tax, energy, environmental, regulatory and trade policies that facilitate saving and investment, economic growth and job creation. For more information about the Council or for copies of this testimony, please contact the ACCF, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006- 2302; telephone: 202.293.5811; fax: 202.785.8165; e-mail: info@accf.org; website: www.accf.org

itemized deductions (which will impose roughly a 1.2% marginal rate on capital gains), individuals will face a top federal rate on capital gains of 25%. This sharp 67% increase on investment income will no doubt have negative consequences on an already struggling U.S. economy. This testimony presents evidence on the impact of capital gains taxes on entrepreneurial activity, discusses how the U.S. tax rate compares to our trading partners and how letting the tax rate rise will impact the overall U.S. economy and job growth.

Background on Capital Gains

Over the years, the maximum tax rate on long term individual capital gains has been changed a number of times (see Chart 1). In 1986, the rate was increased to 28% from 20% (a 40% tax hike) as part of the last major tax reform in the United States. Later, the long term capital gains rate was reduced to 20% in 1997 (Taxpayer Relief Act of 1997) and to 15% in 2003 (Jobs and Growth Tax Relief Reconciliation Act of 2003). The 15% tax rate has been extended until the end of 2012 and is scheduled to revert to 20% on January 1, 2013. Including the 3.8% tax surcharge and restoration of the “Pease Limitation,” the maximum long term individual capital gains tax rate will go up to 25% if Congress does not act.

State and Federal Capital Gains Tax Rates

Unfortunately, the majority of U.S. investors not only face the Federal long term individual capital gains tax rate, but also have to factor in state level capital gains tax rates. A 2012 survey¹ conducted by Ernst & Young LLP for the ACCF Center for Policy Research (CPR) analyzed three possible scenarios:

1. 2012 law: Top effective tax rates on long-term individual capital gains under 2012 Federal and State tax laws. (Top Federal capital gains rate is 15%.)

2. 2013 law with extension of the 2001/2003 tax cuts (top Federal capital gains rate at 15%): Top effective tax rates on long-term individual capital gains in 2013, assuming an extension of the 2001/2003 tax cuts in addition to the new 3.8% Medicare tax on unearned income scheduled for 2013 for married couples filing jointly (single filers) with \$250,000 (\$200,000) or more in income. State rates that are currently scheduled for 2012 are assumed to be the same for 2013.

3. 2013 law as scheduled (top Federal capital gains rate at 20%): Top effective tax rates on long-term individual capital gains under 2013 Federal tax law (i.e., assuming the 2001/2003 tax cuts sunset on December 31, 2012 and the 3.8% Medicare tax takes effect as scheduled). State rates that are currently scheduled for 2012 are assumed to be the same for 2013. The

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calculations also account for the reinstatement of the limitation of itemized deductions for high-income taxpayers (i.e., the “Pease” provision) in 2013.

Investors face State-level individual capital gains taxes in forty-one states. According to the survey, the average top individual State capital gains tax rate was 5.3% in 2012. Combined with the Federal capital gains tax rate, the average rate is 18.4%.² If Congress does not act and the capital gains tax reverts to 20%, the U.S. average tax rate will become 27.9% including the healthcare surcharge. Among the states, currently Hawaii has the highest combined State and Federal capital gains tax rate (22.2%) followed by California (21.7%). If the current capital gains tax rate expires, their rates will increase to 31.6% and 31.2% respectively (see Table 1). Given the current budget woes faced by many states, increasing the capital gains tax rate is likely to have a negative impact on budget receipts because higher tax rates make such investments less attractive and lengthen holding periods.

Why the Capital Gains Tax Rate is Important

A low capital gains tax rate has an important role to play in fostering economic growth and in promoting the entrepreneurial drive on which the U.S. economy thrives. Entrepreneurs are a major force for technological breakthroughs, new start-up companies, and the creation of high paying jobs. Combined with the State capital gains tax rates, the Federal capital gains tax rate substantially increases the difference between what an investment yields and what an individual investor actually receives (known as the “tax wedge”). The higher the tax wedge, the fewer the number of investments that will meet the “hurdle rate;” resulting in fewer investments being undertaken.

Impact on Entrepreneurs:

A recent study³ by Professor William M. Gentry conducted for the ACCF CPR, identifies mechanisms through which capital gains taxes can affect entrepreneurs’ decisions:

- Capital gains taxes may create an additional level of taxation on successful entrepreneurs.
- Asymmetric taxation of capital gains and losses (in which gains are taxed more heavily than losses) may be an especially important issue for entrepreneurs; the asymmetries in the tax system may discourage entrepreneurs from taking risk.⁴

² These calculations take into account the federal deduction for state and local income taxes paid, as well as any states that allow taxpayers to claim a deduction against their state taxes based upon their federal taxes paid.

³ “Capital Gains Taxation and Entrepreneurship,” William M. Gentry, Study Conducted for ACCF CPR, November 2010, http://accf.org/wp-content/uploads/2010/11/media_497.pdf

⁴ A Congressional Research Service report by Thomas L. Hungerford, “Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945,” claims that “Consequently, a rise in the capital gains top rate could increase investment because of reduced risk.” However, the CRS study (<http://graphics8.nytimes.com/news/business/0915taxesandecconomy.pdf>), seems to ignore the fact that “gains are taxed more heavily than losses” and as mentioned in Prof. Gentry’s paper cited above “Unlike a symmetric tax on returns, an asymmetric tax does not necessarily provide insurance. In the extreme, the government takes part of the

- Entrepreneurs may become locked into closely-held businesses; this lock-in effect may distort whether firms are owned by the most efficient manager for the firm.
- Capital gains taxes can affect the cost of capital for entrepreneurs

To document the potential importance of capital gains taxation on entrepreneurs, Prof. Gentry analyzes household portfolios, the composition of unrealized capital gains held by households, and whether capital gains taxes are related to disbursements by venture capital partnerships. His analysis has three main findings: First, active business assets – the types of assets that are likely to be associated with capital gains for entrepreneurs – play an important role in the aggregate portfolio of household assets. According to the 2007 Survey of Consumer Finances (SCF), 11.1 percent of households hold active business assets, and these assets account for 19 percent of household portfolios; by comparison, stocks held directly or in mutual funds (but outside of retirement accounts) are 11.7 percent of household wealth.

Second, the stock of unrealized capital gains associated with privately held businesses is large. The SCF data suggest that aggregate unrealized capital gains on active business assets are almost six times larger than aggregate unrealized capital gains on corporate stock. The magnitude of unrealized capital gains on active business assets suggests that the capital gains tax rate could play an important role in whether and when these assets are sold. In fact, as shown in Chart 1, long term capital gains realizations in the economy plotted against historical capital gains tax rates seems to support this belief. In fact, a new analysis by the Congressional Budget Office⁵ measures how changes in the capital gains tax rate affects the decision to realize gains (called the “elasticity” of response to a change in the tax rate). According to their estimates, the persistent⁶ elasticity is estimated to be -0.79, while the transitory elasticity is estimated as -1.2, suggesting that capital gains realizations are quite responsive to tax rates. Understanding the elasticity of response by taxpayers to changes in tax rates helps policymakers understand the impact that changes in capital gains tax rates will have on investors, on the formation of new ventures and on both state and federal budget receipts.

Third, Prof. Gentry examines whether capital gains tax rates affect the disbursements of venture capital funds using state-aggregate data from 1969-2007. Regression analysis suggests that higher capital gains tax rates are associated with a reduction in state-level disbursements from venture capital funds. Since many of the sources of venture capital funding are not subject to capital gains taxation, Prof. Gentry interprets this finding as

upside of the venture but does not share in its losses.” (pg 22). See Gentry paper cited above, especially pages 22-25 for a discussion of the asymmetric treatment of capital gains and losses.

⁵ “New Evidence on the Tax Elasticity of Capital Gains,” A Joint Working Paper of the Staff of the Joint Committee on Taxation and The Congressional Budget Office, June 2012, <http://www.cbo.gov/publication/43334>

⁶ Authors describe “persistent” as “the effect of an increase in tax rate that has persisted over the previous year and is also expected to persist into the next year” (pg 4)

suggestive of a demand side effect: in states with higher capital gains tax rates, fewer entrepreneurs are starting businesses that seek venture capital funding.

Impact on the Overall Economy:

In order to analyze the impact of alternative capital gains tax rates on the economy, Dr. Allen Sinai, president and CEO of Decision Economics, Inc., simulated various rates, high and low, using the large scale Sinai-Boston macroeconomic model of the U.S. economy. The study⁷ was conducted in 2010 for ACCF. The results include:

- Raising the capital gains tax rate from the current 15% to 20%, 28% or 50%, reduces growth in real GDP, lowers employment and productivity and, after feedback effects, increases the federal budget deficit. For example, at a 20% capital gains rate, real economic growth falls by 0.05 percentage points per year and jobs decline by 231,000 a year, compared to the base case, which uses the 15% capital gains tax rate (see Table 2). When the rate is increased to 28%, real GDP growth declines by 0.1 percentage points per year and there are 602,000 fewer jobs created each year.⁸
- Reducing the capital gains tax rate to zero increases growth in real GDP by a little over 0.23 percentage points per year and there is an average of 1,323,000 more jobs created annually. The unemployment rate drops by an average of 0.5 percent, and productivity growth improves by 0.5 percentage points a year.
- Reducing capital gains taxes also causes realizations to rise as investors and businesspersons cash-in long-term capital gains. Consumer spending increases as capital gains realizations, aftertax, are “spent” or “saved.” The rise in asset prices, both in the values of equity and residential real estate, is reflected in a stronger household balance sheet and reductions in debt because of increased income and capital gains realizations. Household financial conditions improve; in turn, reducing the risk of lending to households and increasing the availability of credit.
- Lower and higher capital gains tax rates also affect the financial positions of household and corporations. When capital gains taxes are reduced, the after-tax return on equity rises, stock prices increase, household wealth is higher, some capital gains are realized, consumption increases, output and production rise, capital spending increases, household financial assets tend to rise, liabilities decline, debt service burdens are reduced, and household financial conditions improve (see Table 2). These financial effects support

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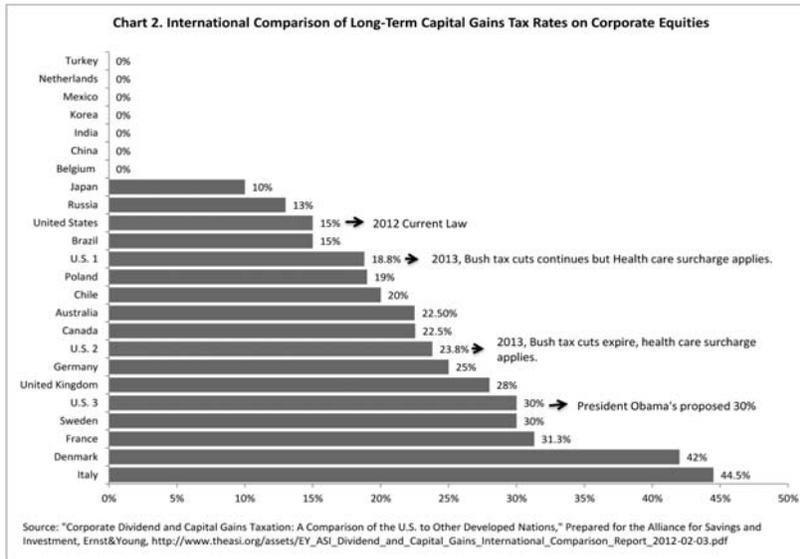
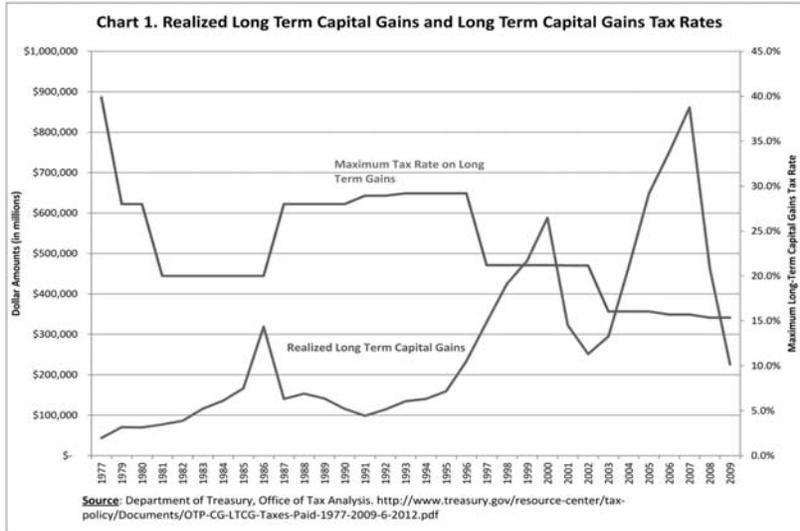


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Vermont	8.95%	20.8%	24.6%	30.4%
Washington, DC	8.95%	20.8%	24.6%	30.4%
New Jersey	8.97%	20.8%	24.6%	30.4%
New York	8.82%	20.7%	24.5%	30.3%
Maine	8.50%	20.5%	24.3%	30.1%
Minnesota	7.85%	20.1%	23.9%	29.7%
Iowa	8.98%	20.1%	23.9%	29.4%
U.S. Average	5.30%	18.4%	22.2%	27.9%

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Federal Budget Deficit, Unified	-401.8	-174.5	-8.0	-33.5	-118.2	-143.4
Avg. per Year (Bils. \$s)	-67.0	-9.8	-1.3	-5.6	-19.7	-23.9
Budget Chg., % of Baseline GDP	-2.4	-1.0	-0.0	-0.2	-0.7	-0.8
Receipts, Unified (Bils. \$s)	-49.6	-6.2	-1.0	-7.7	-21.6	-32.8
Ex-Ante Cost (Static) (Bils. \$s)	1148.9	551.6	272.0	-268.9	-435.6	-451.5
(Avg. per Year)	191.5	91.9	45.3	-44.8	-72.6	-75.2
% of GDP	1.1	0.5	0.3	-0.3	-0.4	-0.4
Ex-Post Cost (Dynamic) (Bils. \$s)	-401.8	-37.2	-6.2	-46.4	-129.6	-196.7
(Avg. per Year)	-67.0	-6.2	-1.0	-7.7	-21.6	-32.8
% of GDP	-2.4	-0.2	0.0	0.0	-0.1	-0.2

*Simulations using the Sinai-Boston (SB) Model of the U.S. Economy. Monetary policy unchanged

Source: "Capital Gains Taxes and the Economy," Allen Sinai, Prepared for the ACCF CPR, September 2010. http://accf.org/wp-content/uploads/2010/09/media_487.pdf

American Farm Bureau Federation, statement

Table 3. Macroeconomic Effects of Increases in Capital Gains Tax to 20% and Dividend Tax Rate to 39.6%: 2013 to 2021* (Changes Relative to Baseline, Unless Otherwise Indicated)

	2013	2014	2015	2016	2017	2019	2021	Avg. Per Year 2013-17	Avg. Per Year 2013-21
Economy									
Real GDP Growth (Pctg. Pts.)	-0.4	-0.3	unch.	0.2	-0.1	0.1	0.1	0.1	unch.
Real GDP (Bils. '00 \$)	-43.7	-88.3	-96.8	-74.1	-91.0	-89.4	-63.7	-79.2	-80.0
Real GDP (Pet. Diff. in Level)	-0.4	-0.7	-0.7	-0.5	-0.6	-0.6	-0.4	-0.6	-0.6
Consumption (Bils. '00 \$)	-47.0	-115.2	-145.9	-136.2	-166.1	-212.5	-175.0	-122.1	-155.1
Capital Spending (Bils. '00 \$)	-2.2	-12.2	-23.6	-27.2	-24.4	-25.1	-17.5	-17.9	-20.0
(Pet. Diff. in Level)	-0.3	-1.1	-1.6	-1.4	-0.9	-0.3	0.1	-1.1	-0.6
Employment and Unemployment									
Household Survey (Mils. Persons)	-0.139	-0.457	-0.561	-0.416	-0.326	-0.340	-0.203	-0.380	-0.344
Unemployment Rate (%)	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.1
Inflation									
Consumption Deflator (Pctg. Pts.)	unch.	-0.1	-0.1	-0.1	-0.1	unch.	unch.	-0.1	unch.
Consumption Deflator Ex-Food & Energy (Pctg. Pts.)	unch.	-0.1	-0.1	-0.1	-0.1	unch.	unch.	-0.1	-0.1
Savings									
Personal Savings Rate (NIPA, Pctg. Pts.)	-0.1	0.8	1.1	1.1	0.3	0.6	0.2	0.6	0.6
Flow-of-Funds Savings Rate (Pctg. Pts.)	-0.8	-1.0	unch.	0.6	0.2	0.7	0.3	-0.2	-0.1
Financial									
Altertax Weighted Average Cost-of-Capital (Diff. in Level)	0.03	0.06	0.06	0.04	0.03	0.04	-0.14	0.04	0.01
S&P500 Oper. EPS (Diff. in \$)	-0.9	-2.0	-2.4	-2.2	-3.1	-3.9	-3.9	-1.6	-2.0
S&P500 Price Index (Pet. Diff. in Level)	-8.1	-16.1	-19.6	-17.9	-16.7	-17.6	-4.3	-16.0	-14.5
Federal Government Budget Deficit (\$ Bils., Unified)	22.4	-9.7	-34.9	-24.0	82.7	151.9	142.0	7.3	70.4
Deficit/GDP (Ratio)	0.1	-0.1	-0.2	-0.1	0.4	0.6	0.5	unch.	0.3
Gross Federal Government Debt/GDP (Ratio)	0.1	0.5	1.0	1.1	0.9	0.1	-0.9	0.7	-0.2

Source: "The Fiscal Cliff: Impact on U.S. Economy and Employment if Bush Tax Cuts Expire," Allen Sinai, Report Prepared for ACCF CPR, June 2012. <http://accef.org/unecategorized/macroeconomic-effects-of-coming-tax-increases-2013-22>

Associated Builders and Contractors, statement

September 20, 2012

The Honorable Max Baucus
Chairman
Senate Finance Committee
511 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member
Senate Finance Committee
104 Hart Senate Office Building
Washington, D.C. 20510

The Honorable Dave Camp
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
1139E Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Baucus, Chairman Camp, Ranking Member Hatch and Ranking Member Levin,

On behalf of Associated Builders and Contractors (ABC), a national association with 74 chapters representing 22,000 merit shop construction and construction-related firms, I am writing in regard to the joint hearing on the tax treatment of capital gains. ABC strongly opposes the expiration of the current 15 percent statutory rate, and encourages its extension as a bridge to comprehensive reform.

Favorable treatment of investment income is imperative to the efficient allocation and flow of capital, and any increase in the rate on long-term gains would have serious repercussions. Higher taxes on the appreciation of assets inherently increase the cost of capital and create a drag on the broader economy. In a capital-intensive business such as construction, the impact on already sclerotic credit markets would be devastating.

Beyond this general chilling effect on private investment, a higher capital gains rate would mean significantly increased taxes on everything from the liquidation of equipment (limiting the capacity for reinvestment or replacement) to the sale of a small business (eroding any accrued retirement nest egg).

Simply put, raising taxes on capital investment is the last thing that should be done in a flagging economy. Whatever limited revenue such an increase could be expected to raise would be outstripped by lost GDP growth and diminished productivity. If anything, Congress should look for opportunities to reduce rates through comprehensive reform in order to encourage capital formation, entrepreneurship and economic growth. We appreciate your consideration of this important matter, and look forward to working with your respective committees as we look toward fundamental reform of the code.

Sincerely,

Liam P. Donovan
Director, Legislative Affairs

Center for Fiscal Equity, statement

Comments for the Record
U.S. House of Representatives Committee on Ways and Means
U.S. Senate Committee on Finance
Joint Hearing on Tax Reform and the Tax Treatment of Capital Gains
 Thursday, September 20, 2012, 10:00 AM

By Michael G. Bindner
 Center for Fiscal Equity

Chairmen Camp and Baucus and Ranking Members Levin and Hatch, thank you for the opportunity to submit these comments for the record to this joint hearing. As an addendum to the comments to this topic, please see a brief treatment of two prior hearings for which the record has already closed having to do with the implementation of the Affordable Care Act. As always, our comments are in the context of our proposed comprehensive tax reform. As you know, the Center for Fiscal Equity proposal includes four major provisions:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure that every American family pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of \$100,000 and single filers earning \$50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

As we pointed out to the Senate Finance Committee one year ago and as Bruce Bartlett points out in his recent book, *The Benefit and the Burden*, in other OECD countries, all of whom have consumption taxes, capital gains taxes can be lower, since a portion of the taxation of capital already occurs as part of the VAT. The logic to enact lower capital gains and dividend taxes outside of a consumption tax environment is not as strong.

The Center for Fiscal Equity believes that lower dividend, capital gains and marginal income taxes for the wealthy actually destroys more jobs than they create. This occurs for a very simple reason – management and owners who receive lower tax rates have more an incentive to extract productivity gains from the work force through benefit cuts, lower wages, sending jobs offshore or automating work. As taxes on management and owners go down, the marginal incentives for cost cutting go up. As taxes go up, the marginal benefit for such savings go down. It is no accident that the middle class began losing ground when taxes were cut during the Reagan and recent Bush Administrations, both of which saw huge tax cuts. Keeping these taxes low is also part of why we are experiencing a jobless recovery now.

As long as management and ownership benefit personally from cutting jobs, they will continue to do so. Tax reform must reverse these perverse incentives.

In order to preserve vertical equity in a given tax year in a consumption tax environment, some form of progressive income and inheritance taxation is essential, otherwise the debt crisis cannot be avoided as consumption taxes will never be adequate to replace the lost revenue.

The Center suggests retaining surtaxes on high income earners and heirs. These would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan. This proposal applies to inherited income, where not only the capital gain from the asset but the sales price of the asset itself will be considered income upon liquidation – but only to the extent that it increases income over the \$100,000 floor. No family farm or business need be sold to pay taxes – indeed, the opposite incentive will operate since unsold inherited assets will remain untaxed under our proposal.

Identifying deficit reduction with income and inheritance surtaxes recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

In testimony earlier this year before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.

To summarize, we propose that capital gains be fully taxed as normal income, however the vast majority of tax paying units will not pay taxes on such gains at all because they report less than \$100,000 in income (after gross income is reduced to account for the shift of most taxation to consumption taxes). We believe that unless dividend, capital gains and high wage taxes are all the same that a variety of economically inefficient schemes to avoid taxes will continue. Only parity takes away the incentive to income in one category or another (for example, manipulation of share price rather than paying dividends).

Thank you for the opportunity to share these views with both Committees. Now, please indulge us in putting our comments into the record regarding taxation issues related to the implementation of the Democrat's Health Care Law, more politely referred to as the *Affordable Care Act*.

On the issue of the extension of the Hospital Insurance Tax and additional payroll taxes to high wage income over \$250,000 per year for families, such taxation essentially imposes a consumption tax. This is especially the case because the vast majority of this type of income eventually goes to families in these income strata. Whether this is a clever way to only make the benefiting households pay or will turn into an inflationary tax on workers and consumers depends upon the market power of investors to preserve their level of personal income by either raising prices on the commodities that produce this income or cutting wages for their employees to make up the difference.

Recent analysis by the Tax Policy Center estimates that 20% of the burden of paying corporate income taxes actually apply to wages, with 60% being born by shareholders. We suggest that the same rationale might be applicable here, although TPC ignores the impact of the corporate income tax on market prices, which we believe is mistaken due to the degree of market concentration in the consumer economy.

The bottom line is, the new surtax in the Affordable Care Act will work its way into the labor and product markets, although in an economy where deflation is under reported, this is probably not a bad thing.

On the issue of the implementation of health insurance exchanges, I believe some degree of delay can be pardoned. Until the recent Supreme Court case was resolved affirming the constitutionality of the Act, efforts to create exchanges would have been a vast waste of time had the Court ruled the other way. Indeed, they may still well be, as we believe that the stock market has not yet priced in the implementation of pre-existing condition reforms in relation to the weakness of the mandates in the law.

At some point, analysts will ask the following question: *“Who is more risk averse, investors or the uninsured?”* If the answer is the uninsured, then the provisions of the law will indeed work as planned and exchanges are a necessary part of the deal. On the other hand, if the answer is investors, then the market for health insurance stocks is about to tumble, sending these companies into receivership which will likely resolve itself into some form of single-payer health plan which will make the efforts to set up exchanges a colossal waste.

Of course, Congress could act prior to such a stampede and set up a tax subsidized public option for those who either cannot afford coverage or cannot obtain it due to pre-existing conditions in exchange for the repeal of mandates and guaranteed issue. Eventually, as the demand for ever increasing profits will force more and more people into the public option, as such demands are endemic to modern capitalism. At some point, all of the people who need insurance will be in the public option and the private insurance market will be a luxury item.

In both cases, single-payer insurance and a public option are best funded by the Net Business Receipts Tax described above and in greater detail over the last two years in comments to both revenue committees.

We expect that because of the election recess and the fast pace of any *Lame Duck* session this will be the last time the Center has to opportunity to provide comments to both of these committees. We wish to congratulate the both for an exiting exploration into the possibilities of tax reform. In a Congress which the media has reported as being mired in gridlock, your agendas have provided a ray of hope for continuing bipartisanship. We would hope that while Members and Senators are out on the political circuit, as they must be to enliven our democracy, staff can hold serious discussions on tax reform with the Administration, just in case a deal can be made after November 6th.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Contact Sheet

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**U.S. House of Representatives Committee on Ways and Means
U.S. Senate Committee on Finance
Joint Hearing on Tax Reform and the Tax Treatment of Capital Gains
Thursday, September 20, 2012, 10:00 AM**

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.

Edison Electric Institute, statement

JOINT HEARING BEFORE THE SENATE COMMITTEE ON
FINANCE AND THE HOUSE COMMITTEE ON WAYS AND MEANS

United States Congress

“Tax Reform and the Tax Treatment of Capital Gains”

September 20, 2012

Statement for the Record by
The Edison Electric Institute
701 Pennsylvania Avenue, NW
Washington, DC 20004

Introduction

The Edison Electric Institute (EEI) is pleased to submit these comments for the record with respect to the joint hearing regarding tax reform and the tax treatment of capital gains, which was held by the Senate Committee on Finance and the House Committee on Ways and Means on September 20, 2012.

EEI is the association of U.S. shareholder-owned electric utilities, international affiliates, and industry associates worldwide. Our U.S. members serve 95 percent of the ultimate customers in the shareholder-owned segment of the industry and represent approximately 70 percent of the U.S. electric power industry.

The electric power industry is a \$790-billion¹ industry that powers our nation’s economy and enhances our everyday lives. The electric power industry’s 2011 revenues of \$373 billion represent 2 percent of real GDP.² As of December 31, 2011, U.S. shareholder-owned electric utilities employed more than 500,000 full-time employees.

EEI commends the Chairmen, Ranking Members, and Members of the Committees for holding this hearing, and similar hearings, on the critical issue of tax reform. Retaining low tax rates on dividends is one of the most important issues for EEI and its member companies. As outlined herein, EEI strongly urges Congress to maintain parity between the tax rates for dividends and the tax rates for capital gains and to extend the current dividend tax rates until Congress addresses comprehensive tax reform.

EEI also believes that it is absolutely critical to our nation’s recovering economy and to the stability of financial markets that Members of Congress act this year to stop a dividend tax hike. We look forward to working with the Members and staff of the Committees as legislation develops.

¹ Edison Electric Institute, *2011 Financial Review*, May 2012. Industry size as measured by net property, plant and equipment as of December 31, 2011.

² Edison Electric Institute, *2011 Financial Review*, and U.S. Department of Commerce, Bureau of Economic Analysis.

Background

In 2003, Congress passed the Jobs and Growth Tax Reconciliation Act, which *temporarily* reduced the maximum tax rate on qualified dividends from almost 40 percent to 15 percent. The law also cut the maximum tax rate on capital gains from 20 percent to 15 percent. Extended twice on a bipartisan basis, in 2006 and 2010, the current tax rates on both dividends and capital gains are set to expire on December 31, 2012.

The current tax rates for both dividends and capital gains are either 0 percent or 15 percent, depending on a taxpayer's income level. If the current tax rates expire, dividends would be taxed as ordinary income, at a maximum rate of 39.6 percent, while the maximum tax rate for capital gains would increase to 20 percent.

The 2010 health care law imposes an additional 3.8-percent Medicare tax on all investment income beginning in 2013 for households earning more than \$250,000 (\$200,000 single). This effectively raises the maximum tax rate on capital gains from 15 percent to 23.8 percent; on dividends, from 15 percent to 43.4 percent—a 189-percent increase.

Electric Utilities and Dividends

Dividends are a key component for companies to provide a return on capital to investors and to attract new shareholders. Electric utilities and other businesses that pay dividends do so because it makes their stocks more attractive to investors. And through their stock sales, these companies can achieve the appropriate balance of debt and equity in their capital raising efforts.

Electric utilities paid out 57.9 percent of their earnings in the form of dividends last year—the most of any business sector. The next highest payout ratios were the S&P's Consumer Staples sector at 44.6 percent, and Industrials at 31.3 percent. And since the 2003 law lowering dividend tax rates took effect, electric utility capital expenditures have increased 84 percent—from \$43.0 billion in 2003 to \$79.3 billion in 2011.

The electric power sector is one of the most capital-intensive industries, and the annual capital expenditures for U.S. shareholder-owned electric utilities are projected to remain at historically high levels of approximately \$85 billion for the next several years. The tax treatment of dividends and the cost of capital are important considerations for electric utilities making significant investment decisions.

Today's low dividend tax rates help utilities lower their cost of equity capital and maintain a stronger financial condition. A financially strong company is more likely to receive favorable terms when issuing debt, which is critical for electric utilities, especially at this time of elevated capital expenditures.

By attracting new investment in their shares, electric utilities are able to raise the capital they need to finance major infrastructure and other investment projects. This capital is needed to build new generation, transmission, and distribution systems and to upgrade existing facilities; to

meet environment requirements; to modernize the grid; and to improve the ability of the electric system to respond to cyber threats. And it should be noted that these infrastructure investment projects and upgrades offer an important source of much-needed, high quality job creation in states across the country.

Tax Policy Considerations

If current dividend tax rates expire and the parity between dividends and capital gains tax rates is lost, federal tax policy will distort investment decisions by favoring growth stocks and debt investments over dividend-paying investments. Such a decoupling of the dividend tax rate from the capital gains tax rate would be harmful not only to dividend-paying companies and their shareholders, but also to the economy as a whole.

As of December 31, 2011, the capital structure of shareholder-owned electric utilities was roughly 57 percent long-term debt and almost 43 percent common equity. Should the current dividend tax rates expire, tax policy would revert to favoring debt over equity in order to raise capital—an outcome that could make investors hesitant to provide financing for major new projects and disrupt companies' ability to implement long-term strategic plans. Increasing the tax rates on dividends and making equity capital more expensive would further exacerbate the perverse economic incentives for corporations to utilize excessive debt financing.

In addition, it is important to remember that if a company decides to pay dividends, the earnings are taxed twice—first at the corporate level when the company pays taxes on these earnings (at a statutory rate of up to 35 percent), then later at the individual level when shareholders receive the dividends. According to a February 2012 study prepared by Ernst & Young for the Alliance for Savings and Investment, the top U.S. integrated dividend tax rate is currently 50.8 percent (when both corporate and individual tax levels, as well as state taxes, are factored in). If the current rates expire, the top U.S. integrated dividend tax rate will rise to 68.6 percent—the highest level among developed nations. In other words, if a company has \$100 of available earnings to pay in dividends, the investor would receive only \$31 after all taxes are paid.

Dividends suffer from double taxation to a much greater extent than capital gains. The tax on capital gains is deferred until realization (e.g., the investor sells the stock). Dividends, in contrast, are taxed annually as they accrue, not just when the stock is sold.

Raising Dividend Tax Rates For Anyone Would Hurt Everyone

Millions of Americans—from all income levels and age groups—directly own stocks that pay dividends. Dividend-paying stocks are also held by the tens of millions of Americans who own stocks indirectly through mutual funds, and they support the value of stocks held in employer and union pension plans, life insurance policies, 401(k) plans, or individual retirement accounts.

Raising dividend tax rates will hurt all investors, regardless of their income level. That's because higher-income investors, when faced with such a staggering tax hike, likely would sell

their dividend-paying stocks, turning instead to investments with a lower tax burden that offer more attractive rates of return. A retreat from dividend-paying stocks would depress stock prices for dividend-paying companies, which ultimately will hurt all shareholders.

Raising Dividend Tax Rates Would Disproportionately Hurt Seniors and Retirees

Older investors who are at or nearing retirement age are likely to be hurt the most by a dividend tax hike. Unfortunately, with interest rates now so low, and expected to remain low for several more years, interest-bearing investments (e.g., certificates of deposit) have failed to keep pace with inflation. As a result, older investors increasingly are turning to dividend-paying investments that produce supplemental income. For those living on fixed incomes and counting on dividends to help pay their bills, a reduction in these dividend payments could be devastating.

According to a 2012 study by Ernst & Young, taxpayers age 50 or older represent a majority of tax filers claiming dividends. In fact, in 2009, the latest year for which complete IRS data are available, Ernst & Young found:

- 63 percent of tax returns with qualified dividends were filed by taxpayers age 50 and older;
- 32 percent were from taxpayers age 65 and older;
- 68 percent were from returns with incomes less than \$100,000; and
- 40 percent were from returns with incomes less than \$50,000.

Raising Dividend Tax Rates Would Hinder Economic Growth and Job Creation

Discouraging investment in dividend-paying companies will hurt huge sectors of the economy—including manufacturing, utilities, telecommunications firms, retailers, drug companies, and food producers—that are all critical to economic growth and job creation. Reducing the capital these sectors can raise in equity markets will force them to increase their debt financing, thereby creating more leveraged balance sheets and injecting unnecessary risk into already nervous financial markets.

Conclusion

EEI strongly urges Congress to maintain parity between the tax rates for dividends and the tax rates for capital gains and to extend the current dividend tax rates until comprehensive tax reform is addressed. We also urge Congress to act before the end of this year to help prevent the potentially dire impact on economic growth, job creation, and financial markets that could happen if the 2001/03 tax provisions expire and the nation goes over the so-called “fiscal cliff.”

Taxing dividends at the higher marginal rates applicable to ordinary income would have significant negative consequences at a time when the U.S. economy is still struggling to recover. The current dividend tax rates benefit investors, consumers, American businesses, and the U.S. economy. And they have helped the electric power industry to attract the capital necessary for crucial infrastructure investments and job creation. A lower cost of capital allows utilities to

maintain a stronger financial condition and helps to decrease the costs of utility services to consumers and businesses.

Thank you for the opportunity to provide this testimony. If any of the Members of the Committees or their staffs have any questions or comments, please contact:

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Investment Company Institute, statement

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**Statement of the Investment Company Institute
United States House of Representatives Committee on Ways and Means
United States Senate Committee on Finance
Joint Hearing on
Tax Reform and the Tax Treatment of Capital Gains**

September 20, 2012

The Investment Company Institute¹ appreciates the opportunity to provide comments to the House Committee on Ways and Means and the Senate Committee on Finance on the tax treatment of capital gains. The Institute urges the Congress to extend permanently the current tax rates on capital gains and dividends. Maintaining these rates, the Institute believes, will encourage savings and foster economic growth.

As the Committees are aware, current tax rates on ordinary income, dividends, and capital gains are scheduled to expire on January 1, 2013. These impending changes have significant implications for mutual fund shareholders. Currently, the top federal tax rate on both capital gains and dividends is 15 percent. Unless Congress acts, the top federal tax rate on capital gains will increase to 20 percent, and dividends will be taxed as ordinary income, resulting in a maximum federal tax rate of 39.6 percent.² In addition, beginning in 2013, both capital gains and dividends will be subject to an additional 3.8 percent tax dedicated to funding Medicare. Furthermore, the 2013 scheduled restoration of the "Pease limitation" on itemized deductions could impose an additional tax of roughly 1.2 percent on capital gains and dividend income. Not only would these changes increase taxes for millions of mutual fund investors, they likely would be a drag on economic growth.

Capital Gains and Dividend Income are Subject to Double Taxation

Individual shareholders of a corporation own the firm and the profits that are generated. Under the U.S. income tax, these profits are taxed twice: once at the corporate level and again when received as income by shareholders, either as dividend payments or as capital gains attributable to retained earnings. As discussed below, such double taxation reduces economic efficiency and undermines long-term growth.

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.5 trillion and serve over 90 million shareholders.

² The current top tax rate for ordinary income is 35 percent, but this rate also is set to revert back the higher rate of 39.6 percent in 2013.

The current maximum tax rate on corporations is 35 percent. If a corporation's profits are distributed to shareholders in the form of dividends, they are taxed a second time, at the rate applicable to each shareholder. If the profits are retained, they are later reflected in the value of the stock when sold. Those profits similarly are taxed a second time, at the capital gains rate applicable to each shareholder.

In the mutual fund context, a regulated investment company, or "RIC," is not taxed at the fund level so long as the fund distributes all of its net capital gains and income to shareholders. The dividends and short-term capital gains that a fund receives and then distributes to its shareholders are subject to tax at the shareholders' applicable rates. Similarly, the long-term capital gains that a fund receives and distributes are taxable to the fund shareholders as long-term capital gains. Thus, corporate profits still are subject to double taxation when they flow through a mutual fund to the fund's shareholders.

In 2003, Congress lowered tax rates on dividends and capital gains to help reduce the harmful impacts of double taxation. The top federal tax rate on capital gains was reduced from 20 percent to 15 percent, and the top rate on "qualified dividend income" was reduced from the top ordinary income tax rate of 39.6 percent to 15 percent. Importantly, this change in law also harmonized the treatment of dividends with that of capital gains.

Even with the current top rate of 15 percent on dividends and capital gains, the combined federal tax rate on corporate profits can be as high as 45 percent. If the current rates are not extended, the combined federal tax rates would be substantially higher. The top federal tax rate on capital gains would increase to 20 percent, and dividends would be taxed as ordinary income at a maximum marginal rate of 39.6 percent. Furthermore, the 2013 scheduled restoration of the "Pease limitation" on itemized deductions could impose an additional tax of roughly 1.2 percent on capital gains and dividend income. In addition, beginning in 2013, investors will be subject to the new 3.8 percent Medicare tax on investment income enacted as part of the Patient Protection and Affordable Care Act of 2010. This means that, absent Congressional action, the federal individual income tax rate on capital gains could be as high as 25 percent, and the federal individual income tax rate on dividends could be as high as 44.6 percent. All together, these changes would lead to a combined federal tax rate (inclusive of both corporate and individual income taxes) as high as 51.25 percent on capital gains and 63.99 percent on dividends.

Even without these pending rate increases, the United States' integrated tax rate on corporate profits – meaning the combined federal, state and local taxes on corporations and capital gains and dividends – is higher than most all other industrialized nations, including both the G-7 and members of the Organisation for Economic Cooperation and Development (OECD).³ This high level of double taxation on corporate profits thus raises real concerns about the United States' ability to compete internationally for investment.

³ See Robert Carroll, "The Economic Effects of the Lower Tax Rate on Dividends," *Tax Foundation Special Report*, no. 181, June 2010, p. 10, Table 3.

Impact on Economic Growth

Because of the double taxation on corporate profits, income derived from owning corporate stock is taxed at rates far in excess of the tax imposed on other investments. This treatment causes investment decisions to be made on the basis of tax treatment rather than market fundamentals and, in doing so, reduces economic efficiency.⁴

For example, taxing dividends more heavily than capital gains discourages corporations from distributing profits as dividends, as opposed to retaining the profits within the company or distributing the profits by repurchasing shares. Reducing the amount of profits that are retained within the firm increases the pressure on corporate managers to undertake only the most productive investments.

Double taxation also encourages the use of debt financing rather than equity financing because corporate interest expenses are deductible, but dividend payments are not. Firms with excessive debt are more vulnerable during economic downturns.

Further, taxing corporate profits twice discourages investment in the corporate sector and encourages less productive investment in sectors not subject to the double tax – that is, investments in real estate and the noncorporate sector, such as partnerships and limited liability companies.

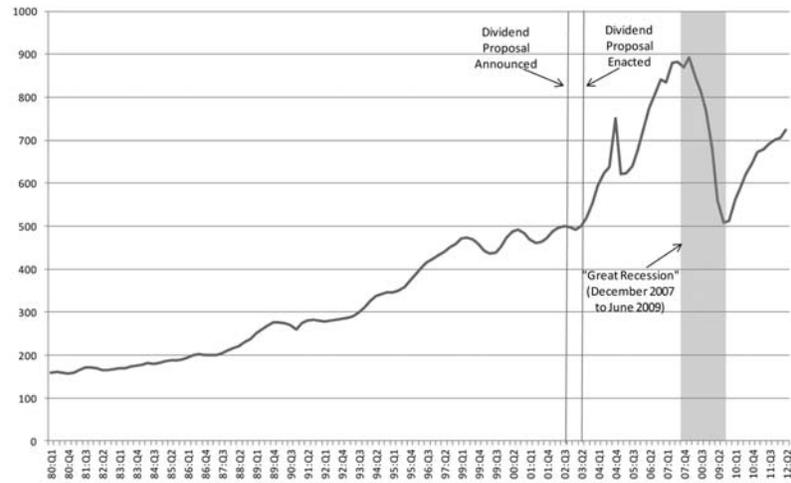
Raising tax rates on capital gains and dividends will exacerbate the effects of double taxation and undermine long-term growth. Many of the beneficial effects of reducing the double tax on corporations – such as the shifting of more investment into the corporate sector or a shift away from debt finance toward equity finance – only will be realized in the long run. There already is evidence, however, to suggest that corporations have responded to the reduction in the dividend tax rate by increasing dividend payouts.

The attached chart plots personal dividend income from the National Income and Product Accounts (NIPA). The aggregate data show an increase in dividend payments that begins in the third quarter of 2003, immediately following the enactment of the lower tax rate on dividends. In the two years following the tax cut (mid-year 2003 to mid-year 2005), aggregate dividend payments were 26 percent higher than in the two years prior to the tax cut (mid-year 2001 to mid-year 2003). Dividend payments declined during the “great recession” (December 2007 to June 2009), but have recovered rapidly in recent years. For example, in the second quarter of 2012, dividend payments were 45 percent higher than in the second quarter of 2003, adjusted for inflation.

⁴ For an in-depth explanation of the beneficial economic effects of reducing the double tax on corporate profits, see *id.*

NIPA Personal Dividend Income, 1980:Q1 to 2012:Q2

Quarterly data, billions of 2012 dollars, seasonally adjusted at annual rates



Source: U.S. Department of Commerce, Bureau of Economic Analysis

Although these data are suggestive, caution with regard to conclusions drawn from aggregate data is warranted for a number of reasons. For example, it is hard to disentangle the effect of taxes from the effect of other factors, such as the business cycle. Also, a relatively small number of large corporations account for a large proportion of total dividends paid, and the aggregate data include special dividend payments, which tend to be more volatile than regular dividend payments.⁵ Finally, the data often are revised as more complete data are collected.

More convincing evidence on the effect of the cut in dividend rates comes from a series of academic papers that use firm level data which allow the authors to examine the behavior of individual firms over time.⁶ Using data on approximately 5,000 publicly traded firms, the

⁵For example, the spike in dividend income in the fourth quarter of 2004 is due to a \$32 billion (\$128 billion at an annual rate) special dividend paid by Microsoft.

⁶Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," *Quarterly Journal of Economics*, vol. 120, no. 3, 791-833, 2005; Raj Chetty and Emmanuel Saez, "The Effects of the 2003 Dividend Tax Cut on Corporate Behavior: Interpreting the Evidence," *American Economic Review Papers and Proceedings*, vol. 96, no. 2, 2006; and Raj Chetty and Emmanuel Saez, "Dividend and Corporate Taxation in an Agency Model of the Firm," *American Economic Journal: Economic Policy*, forthcoming.

authors show that the number of firms initiating regular dividend payments spiked after the tax cut, and many firms that were already paying regular dividends increased payments substantially.⁷ These results hold even when the authors control for other factors, such as profits. The authors also find evidence consistent with the hypothesis that lower dividend taxes improve the allocation of capital. For example, firms with lower expected earnings growth were more likely to increase dividend payments than were firms with higher expected earnings growth (which presumably had more productive uses for retained earnings).

The Congress should pass legislation that encourages growth, particularly as the United States continues to face challenging economic conditions. Therefore, it is critical that the Congress extend the current federal tax rates on capital gains and dividends.

Permanent, not Temporary, Extension

The 2003 tax cuts for capital gains and dividends originally were set to expire in 2011. After much discussion and political negotiation over whether and the extent to which such rates would be extended, the Congress extended the current rates for two more years, through the end of 2012. This level of uncertainty and the temporary nature of certain tax benefits can affect the behavior of corporations and investors. It thus is imperative that the Congress provide certainty to corporations and investors, again permitting them to make decisions based on market fundamentals rather than tax consequences. Also, the benefits of reducing the double taxation on corporate profits can take some time to materialize, and temporary fixes may not fully allow for this to occur. Therefore, the Institute urges the Congress to extend the current rates permanently.

Conclusion

The Institute urges the Congress to extend permanently the current tax rates on capital gains and dividends. The Institute believes that retaining the current rates would encourage savings and foster economic growth. We believe that, at a minimum, taxes imposed on qualified dividends and capital gains should not be increased, especially when our economy remains so fragile.

⁷ Changes to regular dividend payments are considered more significant than special dividend payments, as firms appear reluctant to reduce regular dividend payments once they are established.

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National Small Business Network, statement

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

20 September 2012

Submitted By the National Small Business Network

233 SW Second Street, Corvallis, Oregon 97333

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 collectibles, 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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Sidman, statement

Statement for the Record
Joint Hearing on Tax Reform and Tax Treatment of Capital Gains
United States Senate Committee on Finance
United States House Committee on Ways and Means
September 20, 2012

Submitted September 26, 2012 to the

Senate Committee on Finance
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By

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Thank you for this opportunity to contribute a Statement for the Record of the September 20, 2012, Joint Hearing on Tax Reform and Tax Treatment of Capital Gains by the United States Senate Committee on Finance and the United States House Committee on Ways and Means. As introduction, although one of the national organizations to which I belong (the Angel Capital Association, or ACA) appeared before you at the hearing, the testimony offered was arrived at through closed-door, back-room consultations and deliberations rather than any form of open debate and voting, and thus represents the sentiment of only an undefined portion of that organization's membership. As will be clear below, the ACA's recent testimony does not speak for me. I contribute these remarks as an individual citizen, investor and professional investment manager.

In full concord with my ACA colleagues, I agree that there is little or no doubt about the economic contributions and significance (including jobs, value and wealth creation) of Angel and Venture Capital investments in early-stage entrepreneurial enterprises. Furthermore I, like almost every other individual making such investments and realizing capital gains, will routinely and gladly take advantage of any preferential tax treatment made available. Nonetheless, addressing the topic of this hearing, I write to express the view, perhaps unusual among those in my position (but supporting the testimony of Mr. Stanfill at the hearing), that preferential capital gains tax rates are unnecessary, misguided and unwise public policy, and that their elimination rather than continuation would contribute significantly toward improving the fairness and justice of America's social fabric, as well as to an urgently needed solution for our pressing budgetary and fiscal dilemmas.

The gist of the present statement is that arguments (such as the ACA's) supporting the maintenance of preferential capital gains tax rates represent primarily the self-interest of the wealthiest few percent of our population masquerading and being presented as the public interest of the majority; in other words, the embarrassing and shameful rationalizations of a narrow and privileged special interest for continued favoritism and hand-outs from a public purse already burdened past the breaking point by other needs. The following are some of the salient arguments advanced by proponents of continued preferential capital gains tax rates, and the fallacies underlying each.

1. Investing in general, and early-stage private equity investments in particular, are so beneficial to the public good that they deserve to be specially incentivized by preferential capital gains tax rates. In response, does anyone really believe that investing is more beneficial to the overall public good, and more in need of incentivizing, than the work of teachers, health professionals, firefighters, truck drivers, etc., none of whose income is accorded such preferential tax treatment? All of these activities are worthwhile and necessary, but a dollar of income is a dollar of income, and should be taxed equally if in the same income bracket of a progressive tax system.
2. Early-stage private equity investing is so risky that it needs to be specially incentivized by preferential capital gains tax treatment in order for investors to undertake the risk. Indeed, there are individuals who say that they will choose to redirect their risky early-stage equity investments into safe and completely tax-sheltered bonds if capital gains should again become taxed at ordinary income rates. However, as the ACA is aware and has presented for years, aggregate data from at least eight academic studies (including some that the ACA itself has commissioned) report that the average return from Angel investing in groups is 27% per year. Even factoring in taxes, is it sensible or believable that sophisticated investors would choose a tax free 6% vs. a fully taxed 27% annual return, and should average citizens feel bad for and subsidize them so that they will not do so? If some investors do make this choice, both the tax-free bond market and the taxable equity market will undoubtedly each adapt and in some ways even benefit. Finally, the proposition that businesses with risky individual transactions deserve to be tax advantaged does not lead to beneficial tax treatment for the gambling industry.
3. Preferential tax treatment of capital gains is not new policy, but merely a time-honored part of the tax code that should be continued as status quo. While partially true about being a time-honored part of the tax system (preferential capital gains tax rates have come in and out historically), our country has reached a dangerous and unsustainable fiscal and budgetary impasse by enacting all expenditures, while resisting all income measures, that are favored or resisted individually by a politically sufficient set of self-interested advocates pro or con. In other words, the sustainability and health of the entire system are usually not addressed when making decisions about individual programs or choices, or if made, the painful tradeoffs are not honored in fact.

Preferential capital gains tax treatment has played a clear role in bringing us to the present crisis, and reflexively maintaining it will only worsen rather than help ameliorate our current unsustainable situation.

In summary, preferential income tax rates on capital gains are inherently the narrow self-interest of the already wealthy, are unnecessary for inducing ambitious and energetic investors to reach for the more-than-sufficient returns of early-stage private equity, and have played a significant role in creating both the growing social inequity and current fiscal disaster in our country. In the name of our children and grandchildren, please consider eliminating preferential capital gains tax rates (and a number of their derived problems) entirely, for the broadest and long-term public good of all our citizens. I thank you in advance for your attention.

Small Business Investor Alliance, statement

September 20, 2012

**Statement for the Record, submitted by email
Joint Hearing on Tax Reform and the Treatment of Capital Gains
House Committee on Ways & Means and Senate Committee on Finance**

Dear Chairman Camp, Chairman Baucus, and Members of the Committees:

On behalf of the Small Business Investor Alliance, the trade association representing private equity firms investing in domestic small business, thank you for holding a joint hearing on the tax treatment of capital gains in the context of comprehensive tax reform.

As you consider the impact of changing the capital gains rate, we urge you to take great care in rewriting the tax rules that could so fundamentally change the way capital is invested. The capital gains rate is a critical factor for small business investors. Policies encouraging small business investment are essential to a robust economy, but poor policy will be a job killer. For private equity funds that invest in domestic small businesses, the capital gains rate is not an ideological concept or academic exercise. It is very real tax that affects their ability to invest. Higher capital gains rates discourage investment in all businesses – including in small businesses. On the other hand, a lower rate on capital gains increases the amount of capital available that is so crucial for growing businesses and creating jobs.

Scale Matters for Small Private Equity Firms

Clearly the tax code needs massive reform. It is too complex, burdensome, and moves investment decisions from decisions based on the underlying business and economics to decisions based on tax implications. Investors want to spend their time and money investing and growing businesses, not spending time on how to survive in spite of the tax code.

Too often the national policy discussions on taxes are about the overwhelmingly big, aggregate numbers. There is inadequate discussion of how changes in policy will affect small business investing. *Scale matters* for private equity firms and Congress must specifically consider the policy implications on small business investing and not let job creators get overlooked in the complexities of multibillion dollar

multinational corporate tax policy. Small businesses employ half of the workforce and small firms accounted for 67 percent of the net new jobs since the latest recession, from mid-2009 to 2011.¹

It is a fact that the larger the entity, the harder it is for that entity to invest in small business. For example, a \$10 billion dollar fund simply cannot deploy its capital in sizes that small businesses can absorb. It is simply impractical to make 10,000 \$1 million dollar investments. Private equity and venture funds must put their money to work to make money for their investors. A \$10 billion dollar fund must deploy capital in sizes larger than \$50 or \$100 million. How many small businesses can absorb that type of investment?

The smaller the fund the more likely that fund is to invest in small business because it deploys capital in sizes they can absorb. It is nearly impossible for small private equity funds to invest in large publicly traded companies. There is nothing wrong with large funds investing in big businesses, investment of all types is good, but there are very big differences caused by scale that must be factored into any new tax policy.

To see how small funds and large funds could be impacted very differently by changes in capital gains rates take a look at who provides the capital to the funds. Private equity firms pool capital from several funding sources. These sources include institutional investors (i.e. pension funds) as well as individual investors. Pension funds do not pay capital gains taxes, but individuals do pay them. Larger private equity funds are much more likely to pool their funding from institutional investors and not from individual investors (pension funds are often too big to deploy capital to most small funds). However, smaller private equity fund have a higher percentage of investors as individuals – many small funds are entirely funded by individuals. Any tax measure which hinders individual investors will disproportionately and negatively affect small business investment.

Higher Tax on Capital Gains Discourages Small Business Investment

The economy needs jobs. Jobs are created when individuals and firms take risks by investing their capital in emerging enterprises and expanding businesses. Investors work hard to understand risk, spending months or even years getting to know a potential business. They put their capital to work seeking returns commensurate with the risk they are taking. The economy needs and thrives on business risk. However, political risk is completely alien to the investing equation. The uncertainty in the tax code leads many investors turning to Washington, turning to lobbyists, turning to political analysts before they invest. Congress needs to remove this political risk and provide certainty that there will be a long term, pro-investment, pro-growth, and pro-small business investment tax policy.

At the end of 2012, small business investors will not only face a tax hike on ordinary income rates, but on investment income as well. If Congress does not take action, the maximum statutory capital gains rate will return to 20% and the scheduled “Pease limitation” on itemized deductions will impose an additional 0.9% marginal rate on capital gains. In addition, Section 1411 of the Patient Protection and Affordable Care Act (PPACA), effective on January 1, 2013, imposes a new payroll tax on “investment income” which includes capital gains. This tax provision – which also applies to dividends, rents, and royalties – is a new 3.8% Medicare tax on investment income for couples earning more than \$250,000

¹ Bureau of Labor Statistics: www.bls.gov/bdm

(\$200,000 for single filers). Combining this new 3.8% Medicare surtax with the end of the year expiration of the statutory capital gains rates will mean that the top marginal capital gains rate will increase from 15% to 24.7%. This means that small business investors will be paying a staggering 66% increase above what they are paying today. This does not encourage investment in small businesses.

The potential impact of an increase in the capital gains rate to 24.7% will be harmful to the economy. A study by the Institute for Research on the Economics of Taxation shows the effect of the capital gains tax rate on economic activity and total tax revenue. The study looks at the impact on certain macroeconomic data if the top capital gains rate is increased from 15% to 24%. According to the results of the study, this capital gains rate increase from 15% to 24% would impact the following macroeconomic measures: Gross Domestic Product would fall by 2.4%; private business capital stock would decrease by 6.8%; and wages would fall by 2.2%.² Even CBO stated that real GDP will be 3.9% less in 2013 if we hit the fiscal cliff.³ Granted this CBO estimate factored both taxes and sequestration, but sequestration is another avoidable political risk being thrust upon a struggling economy.

Historically, capital gains tax increases point not only to reductions in revenues to the Treasury but also to reductions in the ability of private equity firms to attract new commitments. According to IRS data on revenue generated from capital gains taxes, the amount of revenues brought into the Treasury from capital gains is inversely related to the top capital gains rate. During the four year period before the Tax Reform Act of 1986 was enacted (Tax Years 1983-1986), when the top capital gains rate was 20%, the Treasury brought in an average of \$11.7 billion in capital gains tax revenues. Conversely, during the four year period after the Tax Reform Act of 1986 (Tax Years 1987-1990), when the top capital gains rate bounced as high as 28%, the Treasury brought in an average of \$8.1 billion in capital gains tax revenues. There is a clear difference between the revenue generated from a higher tax on capital gains versus a lower tax.

The increase in the top capital gains rate to 28% from 20% starting in 1987 may have negatively impacted new commitments to private equity firms. During the mid-1980s, new commitments to private equity partnerships trickled up each year from around \$2 billion in 1984 to over \$14 billion by 1987. However, new commitments to private equity declined by 27% the following year (1988) and were cut by 67% by 1990. Commitments slowly recovered back to the 1987 level by 1997⁴, almost ten years after the top capital gains rate was increased from 20% to 28%.

Permanently Make Capital Gains Rates Low to Remove Tax Uncertainty

Tax uncertainty, especially in recent years, is a major problem for private equity firms that invest in domestic small businesses. Because higher future capital gains rates ultimately and disproportionately affect small business investors return on their investment, uncertainty about these rates can prevent firms from making the best long term investment decisions. In addition, many small investment funds may struggle with the decision to unload their long term gains on capital assets in 2012 to prevent a

² Stephen Entin, *The Effect of the Capital Gains Tax Rate on Economic Activity and Total Tax Revenue*, The Institute for Research on the Economics of Taxation, October 9, 2009 <http://iret.org/pub/CapitalGains-1.pdf>

³ Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint that is Scheduled to Occur in 2013*, May 22, 2013. <http://cbo.gov/publication/43262>

⁴ Stephen N. Kaplan, Private Equity Analyst, *Commitments to Private Equity Partnerships*. University of Chicago Booth School of Business.

severe tax increase on these investments next year. If the fiscal cliff encourages companies to unload these long term investments in order to avoid paying higher taxes, this may have a problematic outcome for long term business investments. The sale of investments should be based on efficient business decisions not tax avoidance strategies.

Small business investing is very sensitive to changes in capital gains rates, more so than investments in other types of business. Private equity investing involves the pooling of capital from multiple sources, often 10 or more years, and then investing from this capital pool. Without certainty in the long term capital gains rate, it will be more difficult for small private equity funds to acquire funds from new and established investor sources. Potential investors will seek other places to put their money because higher capital gains rates will reduce their return on investment in small private equity funds.

In order to foster the most efficient business environment, Congress needs to permanently keep capital gains rates low, particularly for small business investment. A more predictable tax code provides for a more favorable business environment, and low capital gains taxes will encourage outside investors to get involved as well.

Carried Interest Should Not Be Taxed as Ordinary Income

The debate over the treatment of carried interest is a painful example of tax policy discussions that are devoid of an analysis on the impacts to small business investing. Punitive proposals to increase taxes on private equity funds by changing the treatment of carried interest (from capital gains to ordinary income) will damage the ability of small funds to continue investing in small business. Carried interest is equal to 20% of the fund's profit on investment returns, and small funds rely on this performance-based revenue to make their operations sustainable.

Small private equity funds, who invest most of their funds in small business, are much more likely to have a performance-based revenue structure because they aren't large enough to be sustainable with a fee-based structure. Almost 90% of a small business investor's performance-based compensation comes from the carried interest after 10 years of successfully growing small businesses – and this is only if the fund has exceeded performance goals established over 10 years prior to the housing bubble, the tech bubble, or any myriad of macroeconomic shifts that were completely beyond the control of the fund managers.

It is certain that if carried interest is taxed as ordinary income the impact on small fund managers would be much greater and painful than for large funds. Changing the treatment of carried interest would cause small funds to change their revenue structure from performance-based revenue and towards a fee-based revenue structure. Thus, the consequence of this tax increase would be that smaller funds would force an end to their performance-based structure or grow larger and change to a fee-based structure. It is critical that smaller funds retain performance-based structures such as carried interest. This structure aligns interests of fund managers and investors and creates more opportunity for success.

As Congress rewrites the tax code, it is imperative that small investors are able to keep performance-based compensation structures like the carried interest model so that they are encouraged to make long term investments in small business. Decoupling performance from profit runs counter to good public policy and to common sense. If Congress wants to create jobs and it must recognize the impact that a

tax increase on the carried interest will have on small business investors and the businesses that they grow.

Conclusion

A healthy economy needs the entire investing spectrum to be healthy – from venture through buyout, both large and small funds. There are many lessons learned from the last time Congress enacted a tax overhaul package, and we encourage you to make important changes to the tax code that do not penalize investment. A tax code that favors investing will have an important impact on the ability of small businesses to attract capital and create jobs.

Thank you for holding this joint hearing on tax reform and the tax treatment of capital gains, and we look forward to working with you to provide a favorable environment for the small business investor community.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance



Tomcich, statement

This is a statement for the record in reference to the September 20, 2012 hearing: "Tax Reform and Treatment of Capital Gains" submitted by Ken Tomcich, EA, MBA (KLT Services, LLC) 6411 N 16th St, Arlington, Virginia 22205; 703 532-3723.

I agree with Mr. Stanfill, tax reform should include taxing all income alike. As an independent self-employed tax preparer, since 1980 I have been preparing over 100 tax returns a year, mostly personal (Form 1040) tax returns for individuals needing assistance reporting matters such as a business (Schedule C), capital gains, (Schedule D), rental income (Schedule E), other unearned income such as interest (Schedule B), pass-through income from Schedule K-1s and other complexities requiring professional tax preparation assistance. I also prepare returns for small corporations and nonprofits.

As a member of the National Association of Enrolled Agents, I have been advocating the need for tax stability; people cannot do long range business planning facing legislated short term tax law adjustments. It takes long term planning to focus on expanding a business with new hiring and investment. Short term tax code fixes tend to further confuse those who do not understand tax law and frustrates those who do. It is time to put partisan and special interests aside. Legislators need to show political courage to work with, and listen to, tax and business professionals to stabilize tax code.

Capital gains tax is a tax on the gain from sale of a capital (income producing) asset. Businesses do not sell their income producing assets when they plan to stay in business. When a business expands, it generally trades-in the old capital assets for new, or simply disposes them if they are worn out or obsolete, with no capital gain, therefore no capital gains tax. Dividends from qualified stock (held more than one year to qualify as a capital asset) is an exception to capital gains tax rules that perhaps gets the most attention since it provides a very visible source of reinvestment capital. But the investment of a capital gain has no different impact on capital investment than investment of any other type of income: income from wages, interest, rent, net self-employment income, awards or other types of non-earned income. Income in excess of immediate personal or business needs becomes investment capital. The gain from the sale of a capital (income producing) asset remains income like any other income and needs to be taxed accordingly. Special tax code provisions to address capital gains as something different, from other investment capital, simply adds to tax complexity. In the interest of tax stability, all taxable income should be taxed at the same scalable rates.

In a move to taxing consumption, as opposed to income, a value added tax (VAT) would help U.S. produced goods compete with foreign produced goods where countries use the VAT as a tariff substitute; imposing a VAT on imports (making the cost of imported goods higher) and providing a VAT credit for goods exported (making exports cheaper). It is time to level the import/export playing field with a U.S. VAT to help offset tax on incomes at the subsistence, as well as mid capital investment, levels to encourage U.S. job growth. I will submit that too much of the top level capital investment flows to foreign developing economies (where promise of return on investment is greater) thereby further eroding the U.S. income tax base.

Submitted By: Ken Tomcich



September 25, 2012



US Chamber of Commerce, statement



100 Years Standing Up for American Enterprise
U.S. CHAMBER OF COMMERCE

**Statement
of the
U.S. Chamber
of Commerce**

**ON: Joint Hearing on Tax Reform and the Tax Treatment of
Capital Gains**

**TO: Senate Finance Committee and House Committee on Ways
and Means**

DATE: September 20, 2012

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

INTRODUCTION

The Chamber thanks Chairmen Camp and Baucus, and Ranking Members Levin and Hatch, for the opportunity to comment on the tax treatment of capital gains in the context of comprehensive tax reform.

The Chamber commends the Committees for their considerable efforts in pursuing the daunting task of fundamental tax reform. We particularly appreciate the number and scope of the public hearings the Committees have held on many of the difficult and important issues that must be addressed in tax reform.

The Chamber applauds your continuing work toward comprehensive reform but believes that true fundamental tax reform is still a long way down the road. Thus, the Chamber urges the Committees and Congress to act immediately to extend all expiring 2001 and 2003 tax rates, including the current capital gains tax rate, along with all other expired and expiring tax provisions, to prevent the negative impact on jobs and the fragile economy that is likely to result from inaction.

THE NEED FOR IMMEDIATE ACTION

As noted in the Advisory for this hearing, unless Congress acts, the maximum statutory capital gains rate will automatically increase from 15 percent to 20 percent on January 1, 2013. The "Pease" limitation on itemized deductions also automatically occurs at the beginning of 2013, which will raise the top capital gains rate an additional 1.2 percent. Further, in 2013, capital gains will be subject to the Medicare HI tax, adding another 3.8 percent tax to the capital gains tax rate. In short, absent Congressional action, the top federal capital gains tax rate will increase to 25 percent in 2013.

Further, many other tax increases, as well as spending cuts, will automatically occur on January 1, 2013 unless Congress acts to extend them. The Congressional Budget Office ("CBO") estimates that failure to address these expired and expiring provisions, including the current capital gains tax rate, combined with looming spending cuts will result in an estimated \$500 billion fiscal policy reduction in 2013.¹

The negative impact of Congress's inaction on the weak economy could be devastating. According to CBO, if Congress fails to act, growth is expected to slow from 2.2 percent in the fourth quarter of 2012 to -.5 percent in the fourth quarter of 2013 and to remain below its potential rate until 2018.² Slower projected growth would result in a weaker labor market and a higher unemployment rate. CBO projects that the unemployment rate would increase from 8.2 percent in 2012 to 9.1 percent in 2013, which means that an additional 1.3 million people will become unemployed in 2013 if Congress fails to act. According to CBO, "in light of the way it has identified past recessions, the National Bureau of Economic Research would probably view

¹ See http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf

² See id.

such a contraction in output in the first half of 2013 as a recession (similar in magnitude to the recession in the early 1990s).³

Similarly, Mark Zandi, from Moody's Analytics, estimates that without changes to fiscal policy, the fiscal drag will subtract more than 3.0 percentage points from GDP in 2013 while former Federal Reserve Vice Chairman Alan Blinder believes the "resulting fiscal contraction – consisting of both tax increases and spending cuts – would be about 3.5 percent of gross domestic product" and would be a "disaster for the United States."

The Chamber believes that Congress needs to act immediately to prevent the negative impact on jobs and the fragile economy that is likely to result from failure to extend the current capital gains tax rate and the other expired and expiring tax provisions. We believe that the best way to get the economy growing fast enough to create jobs and drive the unemployment rate down is to ensure that taxes do not increase for consumers and businesses.

The Chamber appreciates that all tax policies, including the taxation of capital gains, must be carefully examined in the context of fundamental tax reform. However, we must not delay extending the current capital gains rates and other expired and expiring provisions while we engage in that debate.

CAPITAL GAINS AND COMPREHENSIVE TAX REFORM

As the Committees and Congress consider comprehensive tax reform, the Chamber believes that taxes on capital gains should be as low as possible. Capital gains represent the rewards for placing capital at risk and, accordingly, are a critical element in capital formation. Higher capital gains taxes inhibit capital formation and mobility. Further, capital gains often consist of illusory profits created by inflation, taxation of which erodes our capital base. Low capital gains rates increase federal revenues because of the negative effect high rates have on the rate at which gains are realized.

The impact of taxing capital gains is vast.

According to the IRS SOI,⁴ in 2009, 5 million tax returns reported \$240 billion of long-term capital gains. Taxpayers with adjusted gross income (AGI) of less than \$100,000 accounted for 62 percent of those returns, while taxpayers with AGI of less than \$50,000 accounted for 35 percent of those returns.⁵

According to the Tax Foundation (in reliance on IRS SOI data),⁶ older Americans and those saving for retirement would be disproportionately hurt by a tax increase on capital gains income. Older Americans rely on income from capital gains. For 2009, among taxpayers with

³ See *id.*

⁴ See IRS Statistics of Income (SOI), Individual Income Tax Returns, 2009, available at <http://www.irs.gov/pub/irs-soi/11infallbulincome.pdf>.

⁵ See *id.*

⁶ See Tax Foundation, Older Taxpayers Earn Lion's Share of Capital Gains Income, available at <http://www.taxfoundation.org/blog/show/26525.html>.

capital gains income, 31 percent were over age 65.⁷ Further, 41 percent of taxpayers reporting capital gains income were between ages 45 and 65, saving for retirement. This age group earned nearly 50 percent of all capital gains income.⁸

In addition to harming older Americans and those saving for retirement, increasing capital gains tax rates would hurt investment. According to CBO⁹ and other studies,¹⁰ increasing capital gains tax rates could create a "lock-in effect" where investors avoid higher taxes by not selling assets. If investors are unwilling to sell taxable assets, the lock-in effect can reduce economic growth by preventing the reallocation of capital to more efficient investments. Further, as the CBO notes, "reductions in capital taxation increase the return on investment and therefore the formation of capital. The resulting increase in the capital stock yields greater output and higher incomes throughout much of the economy."

Finally, lower capital gains taxes have significant economic effects on economic growth, jobs and unemployment, inflation, savings, the financial markets, and debt. A 2010 study by Allen Sinai,¹¹ indicates that the net effect of lower capital gains taxation is a significant plus for U.S. macroeconomic performance. The study found that hiking capital gains tax rates would cause significant damage to the economy, reducing growth in real GDP, raising the unemployment rate, and significantly reducing productivity. The study concluded that these losses outweigh any gains in tax receipts from an increased capital gains rate. Further, the study concluded that higher capital gains taxes would not substantially reduce the deficit.

In sum, raising capital gains rates poses serious risks to the entire economy. Accordingly, the Chamber strongly opposes any increase in these tax rates due to the adverse impact it would have on investment, economic growth, unemployment rates and productivity.

CONCLUSION.

The Chamber thanks the Committee for the opportunity to comment on the taxation of capital gains. The Chamber believes that as the Committee considers fundamental tax reform, the detrimental effects of increased rates must be given the utmost consideration to ensure changes to the tax code allow businesses the opportunity to grow, compete, and innovate. We look forward to working with the Committee and Congress on this vital issue.

⁷ See IRS SOI, available at <http://www.irs.gov/pub/irs-soi/09in15ag.xls>.

⁸ See id.

⁹ See CBO, Capital Gains Taxes and Federal Revenues (October 2002), available at <http://www.cbo.gov/doc.cfm?index=3856&type=0>.

¹⁰ See Heritage Foundation, Web Memo 1891, Economic Effects of Increasing the Tax Rates on Capital Gains and Dividends, available at <http://www.heritage.org/research/reports/2008/04/economic-effects-of-increasing-the-tax-rates-on-capital-gains-and-dividends#ftn2>.

¹¹ See Sinai, Capital Gains Taxes and the Economy, available at http://www.accf_org/publications/139/capital-gains-taxes-and-the-economy.