Tax Corporations Less, and Capital Gains More?

By Eugene Steuerle Fri, Feb 13, 2015

Effective tax reform will undoubtedly require some difficult compromises. In this opinion piece, retirement expert Gene Steuerle of the Urban Institute describes a potential trade-off that is bound to might make some cheer and others wince.

In his budget proposal, President Obama would raise capital gains taxes as a way to finance middle class tax relief. Along with many Republicans, he also supports tax rate cuts for business and efforts to prevent multinational corporations from avoiding U. S. taxation.

This raises an intriguing possibility. Why not pay for at least some corporate tax cuts with higher taxes on individuals on their receipts of capital gains or similar returns? In effect, as it becomes increasingly difficult to find a workable way to tax profits of the largest businesses, largely multinational companies, why not tax shareholders directly?

Most proposals to deal with the complexities of international taxation wrestle with how to tax corporations based on their geographical location. But as Martin Sullivan of Tax Notes said years ago, what does it mean to base taxes on a company's easily-reassigned mailing address when its products are produced, consumed, researched, and administered in many places?

By contrast, individuals usually do maintain residence primarily in one country. Thus, reducing corporate taxes while increasing shareholder taxes on U.S. residents largely avoids this residence problem. Indeed, many proposals, such as a recent one by Eric Toder and Alan Viard, move in this direction. While such a tradeoff is not a perfect solution, it makes the taxation of the wealthy easier to administer and less prone to today's corporate shelter games.

Many have made the case for why cutting corporate rates is sound policy. On what policy grounds can Obama's plan for raising taxes on capital gains fit into this story?

Much of the publicity about taxing the rich focuses on their individual tax rate. But many very wealthy people avoid paying individual taxes on their capital income simply by never selling stock, real estate, or other assets on which they have accrued gains. That's because, at death, the law forgives all capital gains taxes on unsold assets.

The very wealthy, moreover, tend to realize a fairly small share of their accrued gains and

an even smaller share than those who are merely wealthy. It makes sense: the nouveaux riche seldom become wealthy unless they continually reinvest their earnings. And when they want to consume more, they can do so through means other than selling assets, such as borrowing.

Warren Buffett was famous for claiming that he paid lower tax rates than his secretary, alluding in part to his capital gains rate versus her ordinary tax rate on salary. But Buffett doesn't just pay a modest capital gains tax rate (it was 15 percent when he made his claim and about 25 percent now). On his total economic income, including unrealized gains, it's doubtful that his personal taxes add up to more than 5 percent.

At the same time, many of the wealthy do pay significant tax in other ways. If they own stock, they effectively bear some share of the burden of the corporate tax. Real estate taxes can also be significant and not merely reflect services received by local governments. Decades ago I found that more tax was collected on capital income through the corporate tax than the personal tax. Today, the story is more complicated, since many domestic businesses have converted to partnerships and Subchapter S corporations, where partners and shareholders pay individual income tax on profits.

The President would raise the capital gains rate and tax accrued gains at death. This would encourage taxpayers to recognize gains earlier, since waiting until death would no longer eliminate taxation on gains unrealized until then. The proposal would effectively capture hundreds of billions of dollars of untaxed gains that forever escape taxation under current law.

Trading a lower corporate tax rate for higher taxes on capital gains could also result in a more progressive tax system since many corporate shares sit in retirement plans and charitable endowments. It would reduce the incentive to hold onto assets—in tax parlance, lock-in—and the incentive to engage in tax sheltering. There's also a potential one-time gain in productivity, to the extent that the proposal taxes some past gains earned but untaxed, as such taxes would have less effect on future behavior than the taxation of current and future returns from business.

Tough issues would remain. Real reform almost always means winners and losers. For instance, how would a proposal deal with higher capital gains taxes for non-corporate partners and owners of real estate? Toder and Viard, for instance, would apply higher individual taxes only on owners of publicly-traded companies.

Still, some increase in capital gains taxes could help finance corporate tax reform without reducing the net taxes on the wealthy. It is exactly the type of real world trade-off that both Democrats and Republicans must consider if they are serious about corporate tax reform.

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