The Daily Dish

Assessing the Tax Burden on Capital Investment

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Eakinomics: Assessing the Tax Burden on Capital Investment

The Biden Administration tax proposals have brought a lot of attention to the issue of taxing capital gains. Most of this discussion has been narrowly focused on the individual income tax provisions: (1) raising the rate from a maximum of 23.8 percent to the proposed top rate on ordinary income of 43.4 percent; and (2) treating transfers at death as *de facto* sales ("recognition events" in the lingo) so that gains are taxed. (This provision in the Treasury Green Book also includes this gem: "Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030." Nothing like involuntary taxation reaching back to the 1940s!)

All of this is fine, but fundamentally incomplete. The most common example of capital gains is the purchase and sale of stock in a publicly traded company. Let's look at the entire transaction. Start with providing $100 to the firm in exchange for shares. The $100 is used it for capital expenditures. Suppose these generate a 20 percent return annually. Given the current corporate rate of 21 percent, this will generate $4.20 in corporation income taxes and leave the company with $15.80.

But the company doesn't own the money; the shareholders own everything the company holds. That means that the shareholders who used to be able to return their shares for $100 can now turn them in and get $115.80. Since the shares give you the right to claim $115.80, they will trade for that amount in the market.

Viewed in isolation, the shares that were purchased for $100 can now be sold for $115.80, a capital gain of $15.80. Under current law, this would be taxed at a maximum of 23.8 percent, or tax of $3.76. Notice that the total taxes on the $20 return on capital investment are $7.96, for an all-in rate of 39.8 percent. This is only slightly below the top rate on wage income of 40.8 percent.

The all-in rate is what matters for the economy and growth. It does not matter if you *collect it* from the individual or *collect it* from the corporations that are owned by individuals – individuals in the economy pay the total either way.

Viewed from this perspective, the administration's proposals to raise the corporate rate to 28 percent would change the corporate liability to $5.60, lower the individual capital gain to $14.40, raise the individual gains tax to $6.25, and thus raise the all-in taxes paid to $11.85. The all-in tax rate on the $20 investment return is a whopping 59.3 percent. That creaking sound in the background is investment and growth grinding to a halt.

The lesson is simple. Tax systems are *systems* and the effective tax rate on wages, dividends, or capital gains should be measured comprehensively across the entire tax system in order to correctly assess the burden and resulting incentives.