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THE DANGERS OF RAISING TAXES ON INVESTMENT INCOME

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As Tax Day approaches, President Obama is traveling the country promoting his Buffett Rule, a 30 percent tax on millionaires. Yet, according to the Joint Tax Committee, this will raise only $47 billion over the next decade, a fraction of America's $6.7 trillion 10-year deficit.

In addition, in its fiscal year 2013 budget proposal, the Obama administration has proposed a series of tax law changes designed to raise more revenue from higher-income earners. The administration has suggested increasing the tax rate on two major categories of investment income. Long-term capital gains tax rates would rise from 15 to 20 percent, and the tax rate on income from corporate dividends would rise from 15 percent to a top rate comparable to that of the highest "ordinary" income bracket, or 43.4 percent (including the 3.8 percent surtax to fund the new health care program).

These proposals follow the argument known as the "Buffett Rule," advanced by the president in a series of speeches this month. Obama deems it "common sense" for the wealthiest Americans to pay tax rates at least comparable to those of their salaried employees—a reference to the observation by famed investor Warren Buffett that he pays taxes at a lower tax rate than his secretary.

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It has been widely noted that passage of the "Buffett Rule" will not change Mr. Buffett's tax rate. His company, Berkshire Hathaway, is set up as an insurance company, using insurance company reserve rules. Assets in Berkshire Hathaway build up free of tax, and Mr. Buffett gets his earnings from selling shares in the company. He generously gives away shares to charity, pays no tax on these shares' capital gains, and legally writes off his charitable contributions against his income. Since he can give away approximately as many shares as he pays himself, he pays little tax.

Political posturing about a 30 percent tax rate for millionaires and proposals for higher taxes on capital serve the administration's purpose of raising tax rates on investment income in the name of its view of tax fairness or justice. If, however, the administration is concerned that capital investment in U.S. firms continues at a time when economic recovery remains fragile, these proposals will harm the U.S. economy.

There is good reason to believe that higher rates on capital gains and dividend income would have negative effects on the U.S. economy by reducing the overall level of U.S. investment and by driving such investment to overseas markets. Higher tax rates would reduce economic activity and, thus, economic growth, by reducing available financing for private companies, innovators, and small firms just getting started.

Here are a series of reasons why this would be the case:

1) Taxes on U.S. investment would be higher compared to taxes abroad, so some investment capital is likely to move offshore. This would occur both because of the rate increase itself and because it would build on a system which already taxes capital gains at a rate higher than the international average. The statutory corporate tax rate is 35 percent, although effective tax rates vary by firm, depending on the amount of plant and equipment purchased, among other factors. The tax is taken out of gains

Table I: OECD Corporate Income Tax Rates (Top or Flat) by Country, as of April 1, 2012

Country	Corporate Income Tax Rate
Canada	26.1
France*	34.4
Germany*	30.2
Italy*	27.5
Japan	38.01
Spain	30.0
United Kingdom*	24.0
United States*	39.2

Notes: These data represent basic combined central and sub-central (statutory) corporate income tax rate given by the adjusted central government rate plus the sub-central rate. France: The rates include a surcharge, but do not include the local business tax (Contribution économique territoriale, a new tax replacing the former Taxe professionnelle from January 1st 2011) or the turnover based solidarity tax (Contribution de Solidarité). Germany: the rates include the regional trade tax (Gewerbesteuer) and the surcharge. Italy: these rates do not include the regional business tax (Imposta Regionale sulle Attività Produttive; IRAP). United Kingdom: has a non-calendar tax year, the rates shown are those in effect as of 5 April. United States: the sub-central rate is a weighted average state corporate marginal income tax rate.

Sources: OECD Centre for Tax Policy and Administration. *Corporate and capital income taxes*, 2011; Canada Revenue Agency, Corporate tax rates, accessed April 13, 2012, http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/rts-eng.html; HM Revenue & Customs *Corporate tax rates*, accessed April 13, 2012, http://www.hmrc.gov.uk/rates/corp.htm; Japan Ministry of Economy Trade and industry, Points of FY 2012 METI Related Tax Reform, 2012, http://www.meti.go.jp/english/aboutmeti/policy/fy2012/fy2012tax_02.pdf;

distributed to shareholders. A 20 percent effective corporate tax rate on top of a 15 percent individual tax rate means the capital is taxed at 32 percent. Table 1 shows corporate tax rates for a group of OECD countries. In April, Japan lowered its corporate tax rate, leaving America with the highest tax rate in the world.

2) Increased capital gains rates presume a steady appetite for risk on the part of investors, notwithstanding the prospect of decreased returns on investment capital. In other words, investments can just as easily lead to losses as gains—and higher tax rates on capital gains will inevitably discourage some percentage of investors.

3) Investors cognizant of the risk of inflation (a risk many observers agree has been increased by the Federal Reserve policy of near-zero interest rates and money supply growth) will have, in higher tax rates, yet another reason to limit new investment. Higher tax rates, unindexed, would not distinguish between that portion of a capital gain or increased dividend income attributable to inflation rather than an increase in absolute value.

More broadly, the administration's proposals fail to recognize the complexity of the question of how much Americans should—and do—pay in taxes. This larger issue cannot be avoided in light of the additional administration proposal to raise tax rates for individual filers earning more than $200,000 and joint filers earning more than $250,000 from 33 to 36 percent, and 35 to 39.6 percent, respectively. Simply put, the idea that high income earners are paying less than those at lower income levels is not supported by the facts.

An analysis of estimated average tax rates, as reported by the staff of Congress's Joint Committee on Taxation, shows that millionaires currently pay higher tax rates than salaried employees such as secretaries. (The Committee calculated average tax rates by dividing taxes owed by adjusted gross income. The results are shown in Table 2.)

Taxpayers with adjusted gross incomes between $50,000 and $75,000 pay a federal income tax rate of 4.5 percent, compared with 22 percent for those earning over $1 million. Including payroll and excise taxes, middle income Americans pay an average rate of 12.8 percent, compared to 24 percent for millionaires.

The administration, in effect, is taking the position that, notwithstanding such figures, it should raise additional revenues from upper-income earners—and that it can do so without dampening levels of investment. For the reasons cited above, this is unlikely. Historically, increases in capital gains taxes have been associated with declines in revenues from capital gains, and vice versa, because those who hold capital can choose when to time their gains. It is correct, however, that implementation of such a policy requires raising tax rates on dividends and capital gains, the source of a substantial portion of the incomes of such prominent public figures known as Warren Buffett, John Kerry, and Mitt Romney.

In this context, it is important to note that, even absent congressional action in response to its budget proposals, the administration may effectively prevail. The proposed rates are scheduled to take effect by default on January 1, 2013 if Congress takes no action, due to the confluence of three factors.[1]

- The expiry of the 2001 and 2003 tax cuts will drive the capital gains tax rate up to 20 percent.

- The limitation on itemized deductions, known as Pease after Rep. Donald Pease (D-OH), will add 1.2 percentage points to the tax rate on investment income and capital gains for upper income earners, depending on the structure of the phase-out.

- Under the Patient Protection and Affordable Care Act, the investment income of taxpayers earning more than $250,000 in modified adjusted gross income ($200,000 for singles) will be subject to an additional tax of 3.8 percent.

The capital gains tax rate for high earners will rise to 25 percent for capital gains and 44.6 percent for dividends in the absence of congressional action. So it is that this portion of the administration's proposed budget cannot be declared "dead on arrival" unless Congress passes a new tax bill before the end of the year, or passes a retroactive tax bill in 2013.

There are additional reasons to believe that higher rates on investment income may be likely to take effect. This involves an additional form of income that has heretofore been treated as investment income, what is known as "carried interest."

Carried interest is a profit share, often in the range of 20 percent, received by general partners on the sale of a capital asset, whether it is a shopping center or a company. The remainder of net profit is distributed among limited partners, generally public and corporate pension funds, charitable foundations, endowments, individuals, and other equity funds. Carried interest on real estate, private equity, or venture capital investments is treated as a capital gain because it represents the profit earned from a capital asset whose acquisition and sale involves some risk. It is not guaranteed income and thus has historically been distinguished from "ordinary," or wage and salary income.

Representative Sander Levin, a Michigan Democrat and the ranking member on the House Ways and Means Committee, is, according to the Committee staff, planning to reintroduce a version of his bill from the 111th Congress to raise taxes on "carried interest" profits from private equity firms and investment partnerships. These profits have been taxed at long-term capital gains rates for decades. Mr. Levin's bill in the 111th Congress, H.R. 1935, passed the House of Representatives in December 2009, as part of H.R. 4213, a tax extender bill. Under that legislation, 75 percent of carried interest would have been taxed as ordinary income beginning in 2013, at the top rate of 39.6 percent. The management fees, usually in the range of 2 percent of funds invested, received by partners, would have also been taxed at 39.6 percent. The remaining 25 percent of carried interest would be taxed as capital gains. The bill was projected to have raised $19 billion over 10 years.

Table 2: Distribution of Average Tax Rates in 2011

Adjusted Gross Income	Combined Income, Social Insurance, and Excise Taxes	Individual Income Taxes
Less than $10,000	5.30 %	-10.40 %
$10,000 to $20,000	0.60 %	-9.3 %
$20,000 to $30,000	5.20 %	-2.9 %
$30,000 to $40,000	8.60 %	0.10 %
$40,000 to $50,000	10.50 %	2.20 %
$50,000 to $75,000	12.80 %	4.50 %
$75,000 to $100,000	14.90 %	6.30 %
$100,000 to $200,000	19.30 %	9.50 %
$200,000 to $500,000	24.10 %	16.60 %
$500,000 to $1,000,000	26.80 %	22.60 %
$1,000,000 and over	23.60 %	22.20 %
Total, All Taxpayers	**16.80 %**	**8.80 %**

Source: Staff of the Joint Committee on Taxation, Federal Tax Treatment of Individuals, JCX-43-11, September 12, 2011.

That static revenue estimate does not account for changes in investment behavior caused by the higher rates. If taxes on carried interest rise, some part of private equity investment will not take place, or will move offshore.

Many politicians say that carried interest bears greater resemblance to wage and salary income than to capital gains, so should be taxed at ordinary rates. But they miss the point: capital gains treatment is afforded to owners to encourage investment. If you own the asset and make a profit from its sale, that qualifies your profit for capital gains treatment.

Managing partners generally contribute personally between 1 percent and 4 percent of a partnership's investment in a business to be turned around, or in a start-up venture in a new technology. If the investment is unsuccessful, they receive no carried interest and lose their investment. Some investments produce no carried interest at all, and "clawback" provisions can require partners to give back to the business some of the early profits if later profit targets are not met. Like the administration's proposals to increase rates on capital gain and dividend income, it suffers from a fallacy: that higher rates will not reduce investment at a time when the economy is so much in need of such risk-taking and the employment to which it can lead.

By citing the tax rates now paid by upper-income individuals, such as Warren Buffett, proposals to "soak the rich" have a potent, anti-elitist ring. But capital is mobile in a global economy, and can easily move to lower-tax environments. It is especially important to ensure that America's environment is hospitable to investment, so that jobs are created here rather than in London or Shanghai. Populist rhetoric might make Americans feel fiscally responsible, but tax hikes on capital gains, dividends, and carried interest would harm America's economy and those who want to get back to work.

ENDNOTE

[1] See Donald B. Marron, "Health Reform's Tax on Investment Income: Facts and Myths," *Tax Notes*, January 30, 2012, page 599.