Submission to the

President's Advisory Panel on
Federal Tax Reform

Submitted by:

Edgar D. McClellan, Esq.
and
Jasper L. Cummings, Esq.

Alston & Bird LLP
601 Pennsylvania Ave., NW
North Building, 10th Floor
Washington, D.C. 2000

October 14, 2005

ALSTON&BIRD LLP
601 Pennsylvania Avenue, N.W.
North Building, 10th Floor
Washington, DC 20004-2601

202-756-3300
Fax: 202-756-3333
www.alston.com

Edgar McClellan **Direct Dial: 202-756-3462** **E-mail: ed.mcclellan@alston.com**

October 14, 2005

The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW
Suite 1200
Washington, DC 20220

Re: Corporate Capital Gains

Dear Chairman Mack, Vice-Chairman Breaux, and Members of the Advisory Panel:

We are writing to respectfully request that you include a reduction of the corporate capital gains tax rate in your comprehensive proposal for tax reform. Our reason for submitting this request is to align the current rate on corporate capital gains with the President's criteria for overall tax reform.

The current corporate capital gains rate is 35-percent. With the exception of the years 1940 and 1941, the 35-percent rate surpasses any capital gains rates imposed on corporations in the history of the Internal Revenue Code.[1]

The 35-percent corporate capital gains tax rate has resulted in a "lock-in" of corporate investment capital. The principal economic rationale for reducing the corporate capital gains tax rate is the need to foster greater economic productivity of U.S.

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[1] The 35% rate matches the very highest rate at which capital gains could be taxed to individuals at any time since 1921 (the 35% rate applied from 1972-1977). See, Summary of Tax Treatment of Long-Term Capital Gains 1913-1991, in The Capital Gains Controversy: A Tax Analysts Reader, p. 3 (Tax Analysts 1992). The 35% rate surpasses any rate at which capital gains could have been taxed to corporations other than during 1940 and 1941. See, H. Comm. on Ways and Means, Overview of the Federal Tax System, (WMCP:103-17 June 14, 1993), at 83.

corporations, including the ability to convert one form of capital to a more productive form, without incurring unduly harsh tax consequences. The 35-percent capital gains rate induces a "lock-in" effect, under which corporate taxpayers may be reluctant to sell appreciated assets because the tax cost severely reduces the after-tax proceeds of that asset's sale. Recent economic analysis shows that corporate capital gains tax rates do create this lock-in effect and affect corporate capital gain recognitions: "...the corporate capital gains tax regime appears to significantly influence the decisions of firms to dispose of assets and realize gains and losses."[2]

The economic consequences of the lock-in effect are particularly undesirable because the impetus for a sale of assets by a corporation is often a desire to convert those assets to other assets or businesses that will be more economically productive for the corporation, consequently creating more jobs and economic growth. Another owner, in turn, might put the divested business or assets to their highest and best use, better managing them and creating yet more jobs and economic growth. Faced with the prospect of a large "tax wedge" in the form of a 35-percent "toll charge" for redeploying capital, corporate managements either refrain from selling or are tempted to borrow on existing appreciated assets instead of selling them, thus increasing the corporation's debt obligations and reducing its economic stability and flexibility. The cost of losing 35-percent of an asset's appreciated value often exceeds the cost and risk of incurring additional debt. As a consequence, these unsold, newly leveraged assets may not realize their greatest economic value.

The impact of the capital gains tax on the international competitiveness of U.S. companies is equally troubling. As noted in a prior submission to the Advisory Panel,

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[2] Desai and Gentry, The Character and Determinants of Corporate Capital Gains, NBER Working Paper No. 10153, p. 26 (Dec. 2003). The Working Paper supports many other points made in this submission, including: if reallocation of assets among firms raises their productivity, then corporate capital gains realizations can have a positive effect on productivity that individual capital gains realizations do not have; the logic of the corporate dividends received deductions also supports some tax relief for corporate capital gains; the "lock-in" effect can result in social costs from a mismatch of assets with a more productive owner; the "lock-in" effect also can prevent the corporate owner of an asset from redeploying its value to a more productive use.

several European countries have, in certain circumstances, substantially reduced corporate capital gains or eliminated them altogether.[3] In general, other major economies tend to subject corporations to materially lower effective long-term capital gains rates, permitting – if not encouraging – corporations in these countries to redeploy capital to a more productive use. Accordingly, the international competitiveness of U.S. businesses will be enhanced if the capital gains lock-in effect is reduced.

We are not asking the Advisory Panel to take an action that is without historical precedent. The 1986 Tax Code eliminated the reduced rate for corporate capital gains in order to raise sufficient funds to make the 1986 tax reforms revenue neutral. From 1942 to 1986, however, corporate capital gains had always been given a preferential rate. The rationale Congress relied on for reducing individual capital gains rates in 1997 and again in 2003 is equally applicable to reducing the rate for corporations, namely, eliminating the lock-in effect promotes long-run economic growth and job creation, and better encourages work effort, savings and investment, which also happen to be the President's third criterion for tax reform. What makes this rationale even more compelling in the

[3] For example, there are varying degrees of capital gains relief for corporations on certain asset sales in these countries:

Germany. In general all capital gains are included in ordinary income and taxed at ordinary rates. However, special rules apply for gains realized on the sale of stock. Beginning in 2002, generally speaking, gains realized on the sale of stock in a domestic or foreign corporation are exempt from tax (losses realized in such sales are also not taken into account). Anti-abuse rules deny the exemption to gains realized on shares received in tax-free transactions in exchange for business assets.

France. While the French regime is quite complex, generally speaking, 95% of long term capital gains realized in accounting years beginning after December 31, 2004, are exempt from tax. The benefit is not limited to gains from stock sales. Short term capital gains (2 years or less holding period) are generally taxed as ordinary income.

United Kingdom. Capital gains are generally taxed except to the extent attributable to the sale of "substantial shareholdings" in another company, in which case gains are exempt.

The Netherlands. Corporations are generally taxed on capital gains. However, gains realized on the sale of stock of an affiliate are exempt from tax under the participation exemption.

Switzerland. Corporations are generally taxed on capital gains. However, gains realized on the sale of stock of an affiliate are exempt from tax under the participation exemption.

corporate context is the fact that corporate capital investment substantially outstrips individual investment in new corporate equity, and corporate investment generally involves direct purchases of business assets, equity interests, and active business operations. If there is ever a circumstance in which reducing capital gains tax will yield an immediate up-tick in investment reallocation and federal tax revenues, it is in the corporate arena.[4]

We would add one final point. Some commentary has suggested that integration of the corporate and individual tax systems would eliminate the investment reallocation problems created by the current 35-percent corporate capital gains rate. We respectfully disagree. Corporations base their investment decisions and rate-of-return calculations on the effect to the corporation itself, not on whether a shareholder pays the current 15-percent tax on dividends or whether, under an integrated system, the shareholder would pay no tax on a dividend. The variety of shareholder tax rates and their possible tax-indifferent status (such as mutual funds and pension plans) make it impossible for a corporation to consider shareholder tax effects in its investment decisions. What they do consider, however, is that one of the highest capital gains tax rate in the history of the United States creates a tax wedge that forces them to keep investment capital locked in place and borrow to the hilt to finance the future of their company, thereby depriving the economy of the highest and best use of those leveraged assets. This cannot, under anyone's measure, be considered sound tax policy.

We now turn to a more detailed explanation of our position, beginning with a detailed history of the corporate capital gains tax rate.

[4] Stimulating corporate investment through reducing the corporate capital gains tax can also buoy the economy as a whole. The recession during the 2001 to 2003 timeframe was caused largely by a lack of business-to-business investment, rather than a downturn in consumer spending and investment.

History of the Corporate Capital Gains Tax Rate

A. 1921 to 1942

In 1921, Congress adopted the first individual capital gains tax preference in the form of a 12.5-percent maximum rate.[5] At that time, the maximum corporate income tax rate also was 12.5-percent.[6] No corporate capital gains preference was enacted in 1921, most likely because the same rates were applicable to both individual capital gains and corporate income. The Revenue Act of 1942, adopted the first capital gains preference for corporate taxpayers in the form of a 25-percent maximum rate.[7] Against the backdrop of World War II, the 1942 Act also increased the combined corporate normal and surtax rates from 31-percent to 40-percent, and the corporate excess profits tax rate was increased substantially to 90-percent.

B. 1942 to 1986

The 1942 Act's 25-percent corporate capital gains tax rate changed very little between the years 1942 to 1986. The maximum rate on a corporation's net capital gains was increased to 26-percent for a very short time in the early 1950's.[8] By 1954, the rate was returned to its historical 25-percent rate.[9] It was increased to 30% in 1969,[10] but was again reduced in 1978 to 28-percent.[11] The corporate capital gains tax rate remained at 28-percent until 1986.[12]

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[5] Revenue Act, ch. 136 § 230, 42 Stat. 227 (1921).
[6] Id.
[7] Revenue Act, ch. 619 § 150(c)(1), 50 Stat. 798 (1942).
[8] Revenue Act, ch. 521, § 123, 65 Stat. 452 (1951).
[9] I.R.C. § 1201(a)(2) (1954).
[10] Tax Reform Act of 1969, Pub. L. No. 91-172, § 511(b), 83 Stat. 487 (1969).
[11] Revenue Act of 1978, Pub. L. No. 95-600 § 403(a), 92 Stat. 2763 (1978).
[12] See generally, Joint Comm. on Tax'n, Report on Capital Gains Tax Proposals, (JCS-4-97 Mar. 12, 1997).

C. The Tax Reform Act of 1986

The Tax Reform Act of 1986 effectively eliminated the 28-percent rate for corporate capital gains by subjecting capital gains to the same rate of tax as ordinary income. It set the rate for both capital and regular corporate income at 34-percent. Specifically, the Tax Reform Act of 1986 retained the section 1201(a) "alternate tax for corporations" that applies to a corporation's net capital gains, but it increased the maximum rate to 34%, while simultaneously reducing the then-current corporate regular income tax rate from 46-percent to 34-percent.[13] The Tax Reform Act of 1986 also eliminated the preferential capital gains tax rate for individuals. As enacted, the capital gains tax rates for individuals and corporations would not exceed 28% and 34%, respectively.[14]

The 1986 elimination of the capital gains preference for individuals and corporations appears to have been part of an overall simplification measure, and was not motivated by any specific intent to disfavor corporate capital gains. There is no evidence that Congress intended to disfavor corporate capital tax rates.

D. Capital Gains Legislation After 1986.

The Omnibus Budget Reconciliation Act of 1990 increased the maximum individual regular income tax rate from 28-percent to 33-percent. It made no change to the individual capital gains rate, which remained capped at 28-percent, if the individual ordinary income rate was higher than 28-percent.[15] The Code contained a provision similarly capping the rate on corporate capital gains at 34-percent,[16] but because the corporate regular income tax rate was not increased in the Omnibus Budget

[13] Tax Reform Act of 1986, P.L. 99-509, § 311(a).
[14] I.R.C. §§ 1(j) and 1201(a), respectively.
[15] I.R.C § 1(h).
[16] I.R.C. § 1201(a).

Reconciliation Act of 1990, no disparity between corporate regular and capital gains rates was created in 1990. Thus, the rate differential between individual regular and capital gains rates that developed in 1990 was not the result of a new choice to prefer individual capital gains over corporate capital gains, but rather, reflected a decision not to increase the rate of tax on capital gains above the rates enacted in the Tax Reform Act of 1986.

In the Omnibus Budget Reconciliation Act of 1993, the maximum corporate regular tax rate was increased from 34-percent to 35-percent, and the corporate capital gains tax also was increased from 34-percent to 35-percent. As a result of the 1993 tax increase, which was the largest tax increase in the history of the United States, U.S. corporations were now subjected to the highest capital gains rate in the history of the Internal Revenue Code.[17]

The House passed the Contract with America Tax Relief Act of 1995, which sought to reverse the 1993 tax increases on capital gains.[18] That bill contained a maximum 25-percent corporate capital gains tax rate. Eventually, both houses passed H.R. 2491, The Balanced Budget Reconciliation Act of 1995, section 11025 of which reduced the maximum corporate capital gains tax rate to 28-percent. The President vetoed that bill, however, and objected to the retroactive effective date of the capital gains cut. The President did not comment on the corporate capital gains rate cut.[19]

The Taxpayer Relief Act of 1997[20] enacted the first capital gain tax reduction after the Tax Reform Act of 1986. The Taxpayer Relief Act of 1997 reduced the

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[17] We would note, however, that the mechanism for setting a different rate for net capital gains remains in the Internal Revenue Code – only the rates need to be changed. See I.R.C. §§ 1201(a)(2) and 11(b)(1)(D). Also fn.1, supra, noted that in 1940 and 1941 corporate capital gains could be taxed at ordinary corporate tax rates above 35%.

[18] H.R. 1215, 104th Cong. § 6311 (1995).

[19] 141 Cong. Rec. H14136-37 (Dec. 6, 1995).

[20] Pub. L. No. 105-34, 111 Stat. 788 (1997).

maximum rate on individual net capital gains to 20-percent.[21] The House Report for that bill, in its "Reasons for Change," stated that reduced taxation of capital gains promotes economic growth for three principal reasons:[22]

- Reduced capital gains taxes would increase the return to individual savings and cause an increase in the savings by individuals, which in turn, would help increase business investment in equipment and research
- Reduced capital gains taxes would reward risk taking and the pursuit of new technologies
- Reduced capital gains taxes would encourage investors to dispose of assets and allow the proceeds to flow to the segments of the economy where they would be most productive, thus offsetting the "lock-in" effect that high taxes on capital income are thought to have on the willingness of the owner to divest
- Such an "unlocking" effect would increase government revenue in the short and long run, both due to current reduced taxes collected on sales and to improved economic consequences generally resulting from the freer flow of capital.

The most recent Congressional action on capital gains occurred in 2003, with the passage of the Jobs and Growth Tax Relief Reconciliation Act of 2003. This bill reduced the individual capital gains tax rate from 20-percent to 15-percent. This reduction expires in the year 2008, when the individual capital gains rate will revert back to 20-percent. The Administration has supported extending the 2008 expiration to the year 2010, as part of the current year's budget reconciliation bill. Because the Jobs and Growth Tax Relief Reconciliation Act of 2003 was primarily a bill for individuals and small businesses, there was no consideration of reducing the corporate capital gains tax rate.

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[21] The House Bill (H.R. 1215 § 3221) would have reduced the corporate capital gains tax rate to 30% for property held for more than 8 years. The Senate Bill did not contain this provision, and accordingly, it was not agreed to by the House-Senate conference for the Taxpayer Relief Act of 1997.

[22] H. R. No. 105-148, 105th Cong., 1st Sess., sec. 111.B.1.

The Economic Rationale for Reducing Individual Capital Gains Tax Rates Are Even More Compelling for a Corporation.

Historically, support for reducing the individual capital gains tax rate rests in part on the theory that lower rates make individuals more willing to invest in capital assets generally and particularly in stocks. This theory is widely accepted by economists and policymakers. This theory, however, is even more compelling in the corporate context because of the greater magnitude of corporate capital investment activity and the more direct relationship between corporate capital spending and economic productivity.

Corporations raise huge amounts of capital from both stock issuances and debt sources, and redeploy it into business and investment ventures. In terms of new investment, corporations raise far more capital from borrowing than from new equity investment. This is evidenced by the fact that debt, rather than equity from public stock offerings, is a far more significant source of investment capital for corporations. For example, in 2004 the ratio of global debt to stock underwriting was 10 to 1.[23] This means that for every dollar invested by individuals and others in new stock issuances, another 10 dollars were created by the corporation's own borrowing. When this new capital is used for new investment in productive assets, the result is a more immediate economic up-tick and increase in federal tax revenues than from individual investments in stocks. The magnitude of these benefits could dwarf the economic investment stimulus created by reducing the individual capital gains tax.

Corporations' investments in assets that would produce capital gains occur in many ways, but three are most prominent: (1) controlling ownership interests in active business entities, (2) equity investments in business entities, and (3) acquisition of the corporation's own plant, equipment or intellectual property.

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[23] Diya Gullapalli, Underwriting Volume Rises to a Record, Wall St. J., Jan. 3, 2005, at R17.

The 35-percent capital gains tax was referred to by Congress in 1997 and 2003 as the "lock-in" effect,[24] so the term we use in this submission is not unknown to Washington's tax policymakers. Again, the principal rationale for reducing the corporate capital gains tax rate is to foster greater economic productivity for U.S. corporations by allowing companies to convert one form of capital investment to a more productive form, without incurring a 35-percent "toll charge" for doing so. Economic growth and job creation are impeded when the unwanted businesses or assets are not put to their highest and best use.

Unique Aspects of Corporate Tax Policy Compel Capital Gains Relief.

A feature of corporate income taxation that distinguishes it from individual taxation is that corporate assets are indirectly owned by the corporation's shareholders. This can result in the so-called "double taxation" of corporate income: once to the corporation and again to the shareholder, either when the shareholder receives a dividend or when the shareholder sells their stock in the corporation. Such double taxation applies to the corporation's sale of capital assets followed by a distribution of the sale proceeds (net of tax) to shareholders.

Double taxation of corporate capital gains has been exacerbated since 1986, during the same time period when the corporate capital gains also reached its highest level. From 1913 to 1986, the gains that a corporation accrued on its capital assets would not be subject to double taxation if the corporation distributed the assets to its shareholders or sold the assets and liquidated the corporation. The Internal Revenue Code allowed this result under the holdings of a tax case called *General Utilities*. As a

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[24] H.R. Rep. No. 108-93, 108th Cong., 1st Sess. III.A. The lock-in effect is further exacerbated by Code provisions that are hostile to redeployment of capital asset investment. For example, under section 1245 certain gains on sale of depreciable property used in a trade or business are "recaptured" as ordinary income. Similarly, restrictions on capital losses increase the tax cost of capital redeployment. Section 1212 of the Code provides that corporate capital losses can be carried back 3 years and forward 5 years. The ability of a corporation filing consolidated returns to deduct a loss on the stock of a group member is heavily restricted by various consolidated return regulations, including Regs. §1.1502-19(c) and -35T, and §1.337(d)-2.

practical matter, corporations frequently used these rules to dispose of capital assets tax-free. The Tax Reform Act of 1986, however, repealed the provisions that followed the court's decision in *General Utilities*, thus setting the stage for widespread double-taxation of gain on corporate capital assets. It may not have been generally recognized in 1986 that the repeal of the *General Utilities* doctrine would be combined with the repeal of the corporate capital gains tax rate to produce a doubly unfriendly treatment of corporate capital gains.[25]

Moreover, under current law, it is not uncommon for corporate capital gains to be subject to triple taxation. In the situation where one corporation owns stock in a second corporation, the income from a disposition of that stock can result in triple taxation of the of the second corporation's income: once to the second corporation; once on the capital gain of the "owner" corporation when it sells its second corporation stock; and once to the individual shareholder of the "owner" corporation.

Because of the pervasive levels of double and triple taxation within a corporation, a lower corporate capital gains rate serves to mitigate, but not eliminate, the damaging effects of multiple taxation of the same income. What is even more troubling, however, is that much of the double and triple taxed income may not represent economic income at all. As explained below, corporate capital gains often represent an inflationary increase in asset value, which does not represent an economic enhancement of the corporation's financial condition.

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[25] However some appreciation of the difficulties looming may be reflected in the 1986 recommendations of the Staff of the Senate Finance Committee. The staff recommended that the effect of *General Utilities* repeal be softened by a phasing in repeal of the corporate capital gains tax rate. Staff of Senate Committee on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Taxation of Corporations 65-66, 94 (Comm. Print 1983).

Traditional Grounds for Capital Gains Relief also Apply

Long before the benefits to the economy of reduced taxes on capital income achieved a high profile, the Code's capital gains preference served as a rough tool to ameliorate the taxation of gains that reflect inflation. An ideal income tax base would not tax inflationary gains, but the theoretical remedy of indexing basis has generally been judged too difficult to attempt, and so reduced tax rates on capital gains is a rough attempt at justice.[26] Policymakers should never overlook the dubious nature of capital gain "income" and the extent to which capital gains are attributable to inflation. In this respect, they represent no increase in the corporation's spending power and, hence, should not be viewed as "income." Historically, the dubious nature of capital gain income has justified a lower capital gains rate.

Another principle of tax policy that has long been recognized but infrequently honored is the principle that a large divergence in tax rates between different taxpayers can produce unhealthy distortions. Currently, individuals can sell their stock and pay a 15% tax on the gain but if the corporation sells its business to the same buyer, the corporation will pay a 35% tax on the gain. Obviously, this state of affairs will make it even less palatable for a C corporation's business to be acquired in an asset sale. This reverses the closer alignment of individual and corporate rates that occurred in the Tax Reform Act of 1986, which was thought to be a significant advancement in terms of reducing tax planning based on widely divergent rates between individuals and corporations. Since 1986 the individual and corporate regular income tax rates have shifted, but have always remained within one to seven base points of each other. In contrast, the wildly divergent capital gains rates once again unsettle that balance.

[26] See U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform, p. 42 (Tax Analysts, 2d ed.).

Corporate Capital Gains Relief Is Not Provided by Corporate-Shareholder Integration

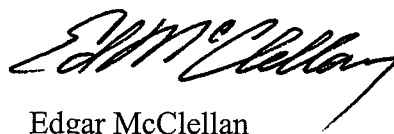
Proposals to integrate the corporate and individual income taxes will not address the major reasons for corporate capital gains relief. Integration generally means eliminating or reducing the possibility that corporate income will be taxed a second time when it is distributed to the shareholders of the corporation as a dividend. The 15-percent rate for dividend income enacted in the Jobs and Growth Tax Relief Reconciliation Act of 2003 is a mitigating step toward integration. However, so long as the corporate capital gains tax is imposed, some level of the lock-in effect will continue. The question is what level of rate reduction is necessary to remove taxes as a material investment consideration. As noted above, corporations base their investment decisions and rate-of-return calculations on the effect to the corporation itself, not on whether a shareholder pays the current 15-percent tax on dividends or whether, under an integrated system, the shareholder would pay no tax on a dividend. What they do consider, however, is that the highest corporate capital gains rate in the history of the United States will appropriate 35-percent of their asset values if they redeploy assets to potentially more productive investments, forcing them to lock that investment in place.

Conclusion

For the reasons discussed above, we urge that the Advisory Panel consider a reduction of tax imposed on corporate capital gains as a component of its proposal for tax reforms to the President.

Respectfully submitted,

ALSTON & BIRD LLP



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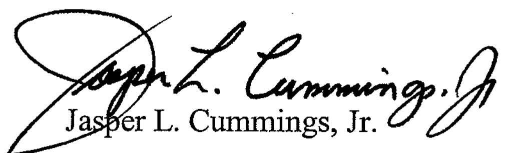

Jasper L. Cummings, Jr.

EM:sas