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Via E-MAIL AND HAND DELIVERY

The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW
Suite 2100
Washington, DC 20220

Re: **Corporate Capital Gains**

Dear Chairman Mack, Vice-Chairman Breaux, and members of the panel:

For the reasons stated below, we believe that any plan for comprehensive tax reform should include a reduction in the tax burden imposed on corporations with respect to a sale of their capital assets. Currently, corporations pay a 35% tax on net capital gains while individuals pay a maximum rate of 15% on such gains.[1] Such a regime:

- Discourages the most economically efficient use of capital and, therefore, acts as a drag on the economy;
- Makes U.S. corporations less competitive in the global economy;
- Is inconsistent with the basic principle that income should be taxed only once;

[1] *Compare* section 1201 *with* section 1(h). As used herein, all references to "section" shall be to sections of the Internal Revenue Code of 1986 (the "Code"), as amended, unless otherwise clear from context.

- Is inconsistent with the neutrality that should be a hallmark of any good tax system; and

- Adds complexity to tax compliance by injecting tax considerations into business decisions that might be made differently were taxes a more neutral factor.

**Summary of Alternatives**

We believe that these issues could be addressed through various modifications to the Code.

Some of these possible modifications include:

- Adopting any one of a number of fundamental modifications to the Code, including replacing the current system with a system that does not tax corporate capital gains at all (such as a consumption tax);

- Adopting certain corporate/shareholder integration proposals;

- Reducing the corporate capital gains rate, either to zero or at least so that it is equal to that imposed on individuals;

- Building on the recently enacted Homeland Investment provision with a provision applicable to gains inherent in foreign corporate stock holdings, whether large holdings or small, as long as those gains were realized pursuant to a qualified domestic reinvestment program; and

- Exempting foreign income, including an exemption for income from and gains on holdings of foreign corporate stock.

## I. BACKGROUND

In 2003, Congress enacted, and President Bush signed, the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTTRA"). JGTTRA contained a number of tax relief measures, including a reduction in the top capital gains rate for individuals from 20% to 15%.[2] Six years before,

[2] *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 301(a)(2)(A).

the Taxpayer Relief Act of 1997 reduced the top individual capital gains rate from 28% to 20%.[3] However, in both 1997 and 2003, the corporate capital gains rate was not reduced. Since 1986, corporations have been subject to tax on their capital gains at rates generally equal to the rate applied to their "ordinary income."[4] Thus, as Congress has gradually restored beneficial capital gains rates for individuals, corporations have continued to pay tax on their capital gains at a substantially higher rate of tax. Accordingly, there is now a significant disparity between the taxation of capital gains at the corporate and individual levels.

## II. <u>DESCRIPTION OF PROPOSAL</u>

We believe that any comprehensive tax reform package should include a provision to reduce or eliminate the tax burden imposed on corporations with respect to their capital assets. As stated above, such an objective can be accomplished through any one of a variety of measures. These include, but are not limited to, the following alternatives.

### A. <u>Consumption Tax</u>

Any of the previously identified shortcomings in the current system related to the taxation of corporate capital gains would, of course, be addressed through any one of a number of fundamental modifications to the Code, including replacing the current system with a system that does not tax gains at all (such as a consumption tax). But other less far-reaching reforms could also accomplish the

[3] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 311(a).

[4] *See* section 1201. Section 1201 currently imposes a tax of 35% on the lesser of a corporation's net capital gains or taxable income.

objective. Some of these are discussed in the following paragraphs.

B. Integration

There is general agreement from the perspective of public finance economics on the desirability of integrating the corporate and individual tax systems. Under a variety of integration approaches, the inefficient and non-neutral taxation of corporate capital gains would be eliminated.

C. Rate Reduction

Reducing the corporate capital gains rate so that it is equal to that imposed on individuals would address each of the above-noted concerns. Reducing the rate to zero would be even more effective at addressing several of them.

D. Building on the Homeland Investment Provision

It has long been recognized that the realization of capital gains in stock holdings can be viewed as the equivalent of realization on a current basis of the current and projected earnings of the corporation whose stock is held. As such, a compelling policy case can be made for a provision similar to the recently enacted Homeland Investment provision which would apply to gains inherent in foreign corporate stock, as long as those gains were realized pursuant to a qualified domestic reinvestment program.[5] Such a proposal would not be as comprehensive as other forms of corporate capital gains

[5] The provision should cover U.S. corporations holding so-called "portfolio investments" in non-U.S. corporations (i.e., small shareholdings), because such shareholders generally exercise little or no control over such non-U.S. corporations. Accordingly, the U.S. corporate shareholders would not have caused the non-U.S. corporations to keep their earnings outside the United States, and could not have caused the non-U.S. corporations to repatriate (as dividends) any portion of the gains in these portfolio investments under the Homeland Investment provision.

relief; however, it would finish the job of stimulating the U.S. economy that was begun by a proposal that had bipartisan support when recently enacted.[6]

E. Exemption for Holdings of Foreign Corporate Stock

An exemption of foreign income, including income from the disposition of foreign corporate stock (to replace our current system in which worldwide income of U.S. residents is taxed, subject to a foreign tax credit) would also alleviate some of the concerns noted above. If such a system contained, as do numerous exemption systems currently in place around the world, an exemption for income from and gains on holdings of foreign corporate stock, it would provide many of the benefits of an expanded Homeland Investment provision.[7]

## III. IMPACT OF PROPOSAL ON CURRENT SYSTEM

Our proposal would cure several flaws in the current system for taxing corporate capital gains.

A. Economic Inefficiency

It is generally accepted that reductions in the tax burden on capital gains improve the efficiency of the economy. Taxation of gains on realization encourages investors to keep their gains "locked in"

[6] Of course, an expanded Homeland Investment provision would not substantially accomplish the objectives described above if it were restricted to apply only to large stock holdings. As such, it would have to apply to portfolio investments as well.

[7] An exemption system would not substantially accomplish the objectives described above if it applied only to large stock holdings. As such, it should apply to portfolio investments as well.

even when better investment opportunities exist.[8] Many theorists and economists believe that lowering the capital gains tax burden removes a constraint on allowing capital to flow to its most economically beneficial use.[9]

Many companies hold appreciated capital assets. However, the current capital gains rate serves as a strong disincentive for selling these assets, because the net returns on such sales do not justify disposing of the assets. If the capital gains tax burden were lower, the net return on these sales would be more attractive and, therefore, these corporations would be more likely to sell their appreciated capital assets to finance new capital spending, hiring, manufacturing, and research and development. In addition, corporations could use the proceeds from the sale of their appreciated capital assets to reduce their debt and thereby increase the corporations' financial stability.

B. Global Economy Competition

A reduction or elimination of the tax on corporate capital gains would help keep U.S.-based companies competitive in an increasingly competitive global economy. For example, Germany, the United Kingdom, and France have all recently taken steps to exempt certain long-term corporate capital

[8] *See, e.g.,* Noel B. Cunningham and Deborah H. Schenk, "The Case for a Capital Gains Preference," 48 Tax Law Review 315, 344 (1993) ("The most serious argument in favor of a capital gains preference is premised on the lock-in effect . . . . This lock-in of accrued gains is said to create inefficiency that impedes the flow of capital to its most productive uses.") (citations omitted).

[9] *Id.* at 350 ("There is general agreement that a preference for capital gains would ameliorate the lock-in problem, and would result in increased realizations.) (citations omitted). *See also* H.Rep. 105-148 at 340-341 (1997) ("All economists that testified before the Committee agreed that reducing the rate of taxation of capital gains would encourage investors to unlock many of these gains. This unlocking will permit more monies to flow to new, highly valued uses in the economy. When monies flow freely, the efficiency of the capital market is improved.")

gains from taxation.[10] Accordingly, companies resident in these jurisdictions have an advantage over their U.S. counterparts that could be eliminated, or at least mitigated, by our proposal.

C. Double Taxation

Any tax on corporate capital gains is a double tax on that income (once at the corporate level and again at the shareholder level), as long as our tax system remains without meaningful corporate-shareholder integration. Therefore, as long as the elimination of double taxation of income remains a policy goal, the reduction or elimination of tax on corporate capital gains is desirable.[11]

D. Lack of Neutrality

A rate reduction would restore neutrality to the Code. It is a fundamental tenet of tax policy that tax consequences ideally should not influence how taxpayers conduct their affairs. However, the 20-point difference between the individual and corporate capital gains rates undoubtedly influences how, and through what kind of entity, taxpayers conduct their affairs. This is true even where non-tax

[10] In Germany, under the Tax Reduction Act of 2001, capital gains recognized by a German-resident corporate shareholder from the sale of stock in another domestic corporation are generally excludable from taxable income. Beginning in April of 2002, the UK began exempting capital gains recognized by certain corporate shareholders from the disposition of certain of their shareholdings. In France, recently proposed rules would exempt capital gains recognized by certain corporate shareholders. *See* Ambroise Bricet, "French Finance Act Contains Major Corporate Tax Changes," 2005 WTD 16-13 (January 13, 2005).

[11] If a U.S. corporation sells a portfolio holding in a non-U.S. corporation, the earnings underlying the gains from the sale of such stock may, in fact, be subject to triple taxation: once in the country where the non-U.S. corporation is resident, once in the U.S. at the corporate shareholder level (in the form of gain from the sale of the non-U.S. corporation stock), and again in the U.S. at the shareholder level (in the form of gain from the sale of stock of the corporate shareholder or dividends from the corporate shareholder).

concerns, such as liability protection, may, in a tax-neutral world, be of greater consequence. Eliminating or at least drastically reducing the disparity would help restore neutrality to the Code and help taxpayers focus on making choices that make sense from a business perspective.

### E. Complexity

Finally, elimination of the capital gains rate differential would simplify the tax system. Without a rate disparity, taxpayers would not be compelled to devote tax planning attention to achieve favorable tax and non-tax objectives.

## IV. TRANSITION, TRADEOFFS AND SPECIAL ISSUES

Revenue effects are important to consider in evaluating any proposed modification to the Code. It is generally accepted that unlocking unrealized capital gains by lowering the tax burden on capital gains can increase Federal revenue, at least in the short-term. Over the long-term, however, as long as the baseline is tax collections under a high capital gains rate system, reducing the tax burden on capital gains can cause revenue loss. Long-term revenue losses could be mitigated by limiting the duration (and/or, possibly, the scope) of any corporate capital gains provision. However, such limits do not promote simplicity and do not address the long-term, more fundamental problems with current law that are noted above. Moreover, the possible long-term revenue loss could well be offset by macroeconomic benefits to the U.S. economy. As such, even if the taxation of corporate capital gains is modified as suggested herein, the benefits of such a modification would appear to outweigh the potential costs.

We would be happy to discuss our proposal with you at your earliest convenience.

Best Regards,

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