



## Key To Reforming The Tax Code: Properly Defining Capital, Income

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Congress has before it the opportunity to take a major step toward tax reform, while also achieving several of its most pressing real-time legislative priorities in the tax area.

It can repeal the pernicious alternative minimum tax (AMT) that is devastating the middle class. Instead of scrambling to keep the temporary 15% tax rates on dividends and capital gains from going back up to their previous high levels in the near future, it can permanently reduce the rate to zero for most financial assets. It can provide permanent first-year expensing for capital equipment.

And it can enact a Universal Savings and Investment Account (USIA) that will allow all Americans the freedom to save in a way that dovetails with the idea of allowing private accounts to supplement Social Security.

Moreover, it can do all of this without raising taxes or increasing the deficit.

The key to accomplishing these results is found in the basic tenet of tax reform - which is to define income correctly. The present definition is overly broad. It taxes both the income used to purchase a share of stock and the dividends received.

But, in real terms, the purchase price of the stock today and the amount of dividends received in the future are the same thing.

When we buy a share of stock, what we are really purchasing and paying for in advance is the stream of dividends the market predicts the stock will produce. The price of the stock is the discounted present value of the dividends.

Since we paid for the dividends with after-tax income (i.e., capital) when we bought the stock, the dividends should not again be taxed when actually received in the future. Nor should there be any tax if the stock is sold in the meantime at a gain in anticipation of the dividends.

The Supreme Court and others have sought to illustrate the distinction between taxing income and capital by analogy to a tree (stock) and the fruit (dividends) it will produce. Taxing the fruit is the same as taxing the tree - and if the tree has already been taxed once, based on the value of the fruit the market anticipates it will produce next season, the fruit should not again be taxed when it arrives in the spring.

A practical way of distinguishing between capital and income - and avoiding double taxation - is exemplified by the Universal Savings and Investment Account that was recently put before the Tax Reform Advisory Panel for consideration.

Taxpayers who desire to save a portion of current-year income would first pay tax on that income, thereby converting it to "capital." They would then put the after-tax capital in a USIA, which would function like a brokerage account.

When they use this capital to purchase a stock, the dividends and gains received in the future would be correctly identified as returns of capital and would not be taxed again as additional income.

Similarly, the interest received on bonds purchased in a USIA account with after-tax income would be excluded from additional tax.

This same simple USIA device can also be used to remove the double tax on \$22 trillion of existing investments in market-traded stocks, securities and other cash equivalents - and also to generate revenues sufficient to pay for the rest of tax reform.

The owners of existing investment portfolios would be allowed to pay a voluntary toll charge for putting stock and securities in a USIA - as if they had sold them, paid the tax on the sale, put the after-tax cash in a USIA, and purchased financial assets inside that exempt account.

A reasonable toll charge would be 10% of the current market-value of the stock and securities (i.e., 10% of the present value of the future stream of dividends, gains and interest). The tax having been prepaid, all future dividends, gains and interest received in the account would be returns of capital taxed at a zero rate.

If investors act rationally, as they are notorious for doing, nearly all of them would see the wisdom of paying the toll charge. Because of the current 15% tax rate on dividends, a stock that is expected to produce a future stream of pretax dividends worth \$117 is actually worth only \$100 after tax.

### **Cash Flow**

But if the owner were to pay a \$10 toll charge, bringing the cost of the stock up to \$110 - and then put the stock in a USIA, which exempts all future dividends from tax - the present value of that future stream of dividends (and the stock) would go up to the pretax level of \$117. In effect, the owner would have paid \$10 in order to get \$17.

Given that advantage - and the prospect that the present 15% maximum tax rate on dividends and stock gains outside USIAs will soon increase - the transfer of eligible financial assets into USIAs could be close to 100%.

But even if only 75% were immediately moved into these accounts, the 10% toll charge

would produce a one-time revenue pickup of \$1.6 trillion.

That cash infusion into the Treasury's coffers is sufficient, on a present value basis, to pay for the projected future-year revenue cost of many important reforms - including the USIAs themselves, first-year expensing, repeal of the AMT and effectively reducing to zero the tax rate on nearly all dividends, capital gains and interest.

There is no mystery about the likely consequences of enacting these changes in the tax code. Common sense as well as econometric models say that productivity and GDP growth rates would accelerate.

### **If The Price Is Right**

What is new to some people (but not necessarily to the Tax Reform Advisory Panel or to the most knowledgeable members of Congress) is the ability to make these salutary changes in a self-financing way that provides sufficient offsetting revenues to eliminate the need for an actual tax increase.

Before Congress can take advantage of this opportunity, the amount of revenue gain from the toll charge must pass muster with the staff experts who "estimate" the revenues for the Treasury and the Congress - often 10 years out.

These technicians function in an area of inherent uncertainty by relying on common sense and reasonable probabilities. Despite its "voluntary" nature, the revenue gain from the one-time toll charge can be estimated using the same assumptions these experts are accustomed to working with in projecting the revenue effects of other changes in the current tax code.

For example, in estimating the revenue effect of tax-reducing credits or deductions, these experts assume that taxpayers will act rationally and take advantage of the opportunity offered to them to pay less tax.

Even when the option is to pay more tax - as in the case of the ubiquitous "user fees" that were so famous a few years ago - the experts assume people will pay more money to the government to get what they want in exchange, provided that the price is right.

From the perspective of those standard assumptions, the logic behind a large and realistic revenue pickup from the toll charge is compelling. If savers and investors are informed about the opportunity and if too many bureaucratic obstacles are not put in their way, nearly every one of them will pay the toll charge just as surely as anyone would choose to pay \$10 to get \$17.

In short, the need for a reliable revenue estimate should not be a barrier to paying for real-world tax reform with a voluntary onetime toll charge.

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