

SPECIAL REPORT

May 2001

Double Whammy for U.S. Investors: Federal and State Capital Gains Tax Rates High

INTRODUCTION

During the last 50 years, the U.S. Congress has acted several times to increase or decrease individual and corporate capital gains tax rates and to raise or lower the holding period requirement for capital gains treatment. The top marginal federal statutory rate on long-term individual capital gains has ranged from as high as 35 percent to the current low of 20 percent. Corporate capital gains tax rates have ranged from 25 percent to the current-law 35 percent. Holding period requirements have varied from six months to as long as 18 months; currently the holding period is one year. (In 2001, the top individual capital gains federal rate drops from 20 percent to 18 percent for assets held five years or more.¹) However, even with the individual capital gains tax reductions included in the 1997 Taxpayer Relief Act, the tax burden remains high on individual and corporate capital gains, especially when the burden of state taxes is included.

STATE CAPITAL GAINS TAXES

As a new report by Arthur Andersen LLP commissioned by the ACCF Center for Policy Research shows, investors (both individual and corporate) also face state capital gains taxes in most states (see Table 1 for the states with the highest rates on individual capital gains and Table 2 for details on all states for households with an annual income of \$60,000 and capital gains of \$10,000). When combined with the already-heavy federal capital gains tax rate, these state capital gains tax rates considerably increase the “tax wedge” (the tax wedge measures the difference between what an investment yields and an individual or corporate investor receives). The higher the tax wedge, the fewer investments will be able to meet the “hurdle rate” and be

undertaken. In the United States, the average middle-income individual investor faces a combined state and federal capital gains tax burden of 25 percent on long-term gains (see Table 2). U.S. corporations face even steeper rates which average 39 percent on capital gains (see Table 4 for the states with the highest rates on corporate capital gains and Table 3 for details on all states).

INTERNATIONAL COMPARISON OF CAPITAL GAINS TAX RATES

■ Individual Capital Gains

Even with the individual federal tax rate reductions in 1997, U.S. capital gains tax rates, which affect the cost of capital and therefore investment and economic growth, are still high compared to those of other countries. In fact, most industrial and developing

Table 1 States With HIGHEST Rates for Individual Capital Gains*

Montana	30.00%
District of Columbia	29.50%
Oregon	29.00%
Iowa	28.98%
Maine	28.50%
Idaho	28.10%
California	28.00%
Hawaii	27.25%
Minnesota	27.05%

*Married, filing jointly with \$60,000 in annual income and capital gains of \$10,000. Includes top federal marginal capital gains rate of 20 percent.

The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, trade, and environmental policies. For further information, contact the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2302; telephone: 202/293-5811; fax: 202/785-8165; e-mail: info@accf.org; Web site: www.accf.org.

Table 2 Combined Federal/State Marginal Individual Capital Gains Tax Rate
Family With \$60,000 in Annual Income

Category*	State	State Capital Gains Tax Rate†	Comb. Federal and State Tax Rate
1	Alabama	5.00%	25.00%
5	Alaska	0.00%	20.00%
1	Arizona	3.74%	23.74%
3	Arkansas	7.00%	24.90%
1	California	8.00%	28.00%
1	Colorado	4.63%	24.63%
1	Connecticut	4.50%	24.50%
1	Delaware	5.95%	25.95%
1	Dist. of Columbia	9.50%	29.50%
5	Florida	0.00%	20.00%
1	Georgia	6.00%	26.00%
2	Hawaii	7.25%	27.25%
1	Idaho	8.10%	28.10%
1	Illinois	3.00%	23.00%
1	Indiana	3.40%	23.40%
1	Iowa	8.98%	28.98%
1	Kansas	6.45%	26.45%
1	Kentucky	6.00%	26.00%
1	Louisiana	4.00%	24.00%
1	Maine	8.50%	28.50%
1	Maryland	4.85%	24.85%
2	Massachusetts	5.00%	25.00%
1	Michigan	4.20%	24.20%
1	Minnesota	7.05%	27.05%
1	Mississippi	5.00%	25.00%
1	Missouri	6.00%	23.00%
1	Montana	10.00%	30.00%
1	Nebraska	6.68%	26.68%
5	Nevada	0.00%	20.00%
3	New Hampshire	0.00%	20.00%
1	New Jersey	2.45%	22.45%
1	New Mexico	0.00%	20.00%
1	New York	6.85%	26.85%
1	North Carolina	7.00%	27.00%
1	Ohio	4.84%	24.84%
1	Oklahoma	6.75%	26.75%
1	Oregon	9.00%	29.00%
1	Pennsylvania	2.80%	22.80%
1	South Carolina	7.00%	27.00%
5	South Dakota	0.00%	20.00%
3	Tennessee	0.00%	20.00%
5	Texas	0.00%	20.00%
1	Utah	7.00%	27.00%
1	Virginia	5.75%	25.75%
5	Washington	0.00%	20.00%
1	West Virginia	6.50%	26.50%
3	Wisconsin	6.55%	22.62%
5	Wyoming	0.00%	20.00%

States With Income Tax as % of Federal Liability:

4	North Dakota	14%	22.80%
4	Rhode Island	26%	25.20%
4	Vermont	24%	24.80%

Average 24.60%

*With capital gains of \$10,000; see Notes on Tables, p. 5.

†Married, filing jointly.

Table 3 Combined Federal/State Marginal Corporate Capital Gains Rate

Category*	State	Combined Rate, Corporations
1	Alabama	36.59%
5	Alaska	37.93%
1	Arizona	40.18%
3	Arkansas	39.23%
1	California	40.75%
1	Colorado	38.09%
1	Connecticut	39.88%
1	Delaware	40.66%
1	Dist. of Columbia	41.48%
5	Florida	38.58%
1	Georgia	38.90%
2	Hawaii	37.60%
1	Idaho	40.20%
1	Illinois	39.75%
1	Indiana	40.04%
1	Iowa	39.10%
1	Kansas	39.78%
1	Kentucky	40.36%
1	Louisiana	37.62%
1	Maine	40.80%
1	Maryland	39.55%
2	Massachusetts	41.18%
1	Michigan	36.37%
1	Minnesota	41.37%
1	Mississippi	38.25%
1	Missouri	39.06%
1	Montana	39.39%
1	Nebraska	40.08%
5	Nevada	35.00%
3	New Hampshire	40.20%
1	New Jersey	40.85%
1	New Mexico	39.94%
1	New York	40.20%
1	North Carolina	39.49%
4	North Dakota	38.54%
1	Ohio	40.53%
1	Oklahoma	38.90%
1	Oregon	39.29%
1	Pennsylvania	41.49%
4	Rhode Island	40.85%
1	South Carolina	38.25%
5	South Dakota	35.00%
3	Tennessee	38.90%
5	Texas	37.93%
1	Utah	38.25%
4	Vermont	41.34%
1	Virginia	38.90%
5	Washington	35.00%
1	West Virginia	40.85%
3	Wisconsin	40.14%
5	Wyoming	35.00%

Average, All States 39.17%

Average, States With Capital Gains Tax 39.52%

*See Notes on Tables, p. 5.

countries tax individual and corporate capital gains more lightly than does the United States, according to a 24-country survey the ACCF Center for Policy Research commissioned from Arthur Andersen LLP. Figures 1 and 2 highlight the results of the 24-country survey with a “snapshot” of specific countries’ top tax rates on individual and corporate capital gains (see testimony before the Canadian Parliament at www.accf.org/December99test.htm for a complete listing of countries surveyed).

Both short- and long-term individual capital gains on equities are taxed at higher rates in the United States than in most of the other 23 countries surveyed. Short-term gains are taxed at 39.6 percent in the United States compared to an average of 18 percent for the sample as a whole. Long-term individual gains face a tax rate of 20 percent in the United States versus an average of 14.5 percent for all the countries in the survey (see Figure 1). Thus, U.S. taxpayers face tax rates on long-term gains that are 38 percent higher than those paid by the average investor in other countries. In addition, the United States is one of only five countries surveyed with a holding period requirement in order for the investment to qualify as a capital asset.

■ Corporate Capital Gains

Similarly, short- and long-term corporate capital gains tax rates are higher in the United States than in most other industrial and developing countries surveyed. Both short- and long-term gains are taxed at a maximum rate of 35 percent in the United States, compared to an average of 22.5 percent for short-term gains and 19.3 percent for long-term gains for the sample as a whole (see Figure 2). In other words, U.S. corporations face long-term capital gains tax rates almost 80 percent higher than those of all but one of the other countries surveyed (Germany is currently at 45 percent but its rate is scheduled to drop to zero in 2002), and only four of the 24 countries surveyed impose a holding period in order to be eligible for preferential corporate capital gains tax rates.

The failure to reduce corporate capital gains tax rates in conjunction with the 1997 individual rate cuts heightens the inequities already inherent in the double taxation of corporate profits

Table 4 States With HIGHEST Rates for Corporate Capital Gains*

Pennsylvania	41.49%
District of Columbia	41.48%
Minnesota	41.37%
Vermont	41.34%
Massachusetts	41.18%
New Jersey	40.85%
Rhode Island	40.85%
West Virginia	40.85%
Maine	40.80%

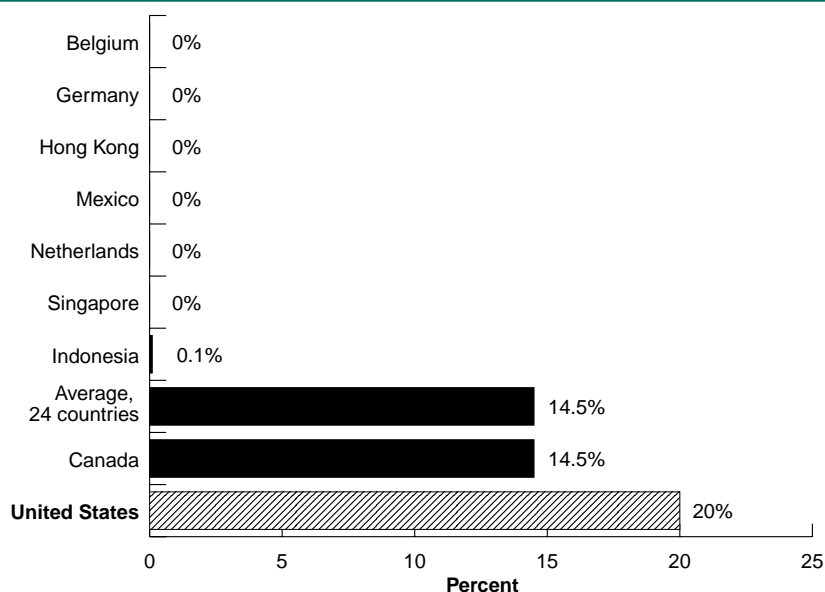
*Includes federal corporate capital gains tax rate of 35 percent.

under current law, leading to excessive tax planning, and may accentuate the trend away from the traditional corporate form of organization.

ECONOMIC IMPACT OF FURTHER CAPITAL GAINS TAX REDUCTIONS

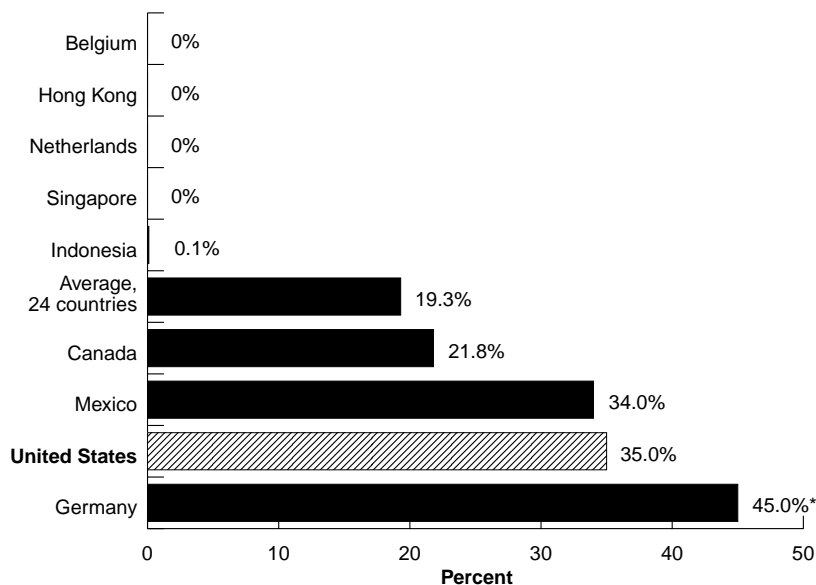
Many tax policy experts in the U.S. Congress, academic institutions, and think tanks conclude that fur-

Figure 1 International Comparison of Select Individual Capital Gains Tax Rates on Equities



Source: Testimony of Margo Thorning, Ph.D., before the Standing Committee on Banking, Trade, and Commerce of the Senate of Canada, “Capital Gains Taxation and U.S. Economic Growth,” December, 1999. The complete survey of 24 industrialized and developing countries is available at www.accf.org/December99test.htm.

Figure 2 International Comparison of Select Corporate Capital Gains Tax Rates on Equities



*Scheduled to drop to zero in 2002.

Source: Testimony of Margo Thorning, Ph.D., before the Standing Committee on Banking, Trade, and Commerce of the Senate of Canada, "Capital Gains Taxation and U.S. Economic Growth," December, 1999. The complete survey of 24 industrialized and developing countries is available at www.accf.org/December99test.htm.

Table 5 Cumulative Impact of Capital Gains Tax Reductions in H.R. 2488, the "Taxpayer Refund and Relief Act of 1999" Compared to baseline forecast

	FY 2000–2004
Real GDP	
(billions of 92\$)	\$64.6
(average change per year in GDP growth rate)	0.1%
Employment	
(average change per year)	112,000
Real business capital spending	
Total (billions of 92\$)	\$18.2
Equipment	\$17.2
Structures	\$2.0
New Business Incorporations	200,000
Cost of capital	
Pretax return required by an investor	-0.13%
(average change per year)	
S&P Stock Index	0.8%
(average change per year)	
National Saving	\$84.2
(billions of dollars)	

H.R. 2488 included a capital gains tax reduction from 20/10 percent to 18/8 percent.

Source: Data from Dr. Allen Sinai, president and chief global economist, Decision Economics, Inc., December, 1999.

ther reductions in federal taxes on individual as well as corporate capital gains will enhance U.S. saving, investment, and GDP growth and boost equity values. For example, an analysis of the capital gains tax reductions included in the "Taxpayer Refund and Relief Act of 1999" (H.R. 2488) by Dr. Allen Sinai, president and chief global economist, Decision Economics, Inc., shows that reducing the individual long-term rates from 20/10 percent to 18/8 percent (for all assets, no matter when acquired) would have a significant positive impact. (H.R. 2488 was vetoed by President Clinton in September, 1999. See Note 1 for current law.)

Dr. Sinai's analysis indicates that if the rate reductions in H.R. 2488 had been enacted, real GDP would be \$64.6 billion higher, and employment, investment, new business formations, and national saving would be greater over the 2000–2004 period compared to the baseline forecast (see Table 5). In addition, U.S. capital costs would be slightly lower. He concludes that the capital gains tax cut would have produced a "significant bang for the buck."

CONCLUSION

Recent (1997 and 1998) individual capital gains tax reductions and shortening of the holding period have boosted U.S. economic growth. While the U.S. long-term tax policy goal should be fundamental tax reform and more reliance on consumption taxes, the ACCF believes that the short-run policy agenda in the United States should include additional capital gains tax cuts.

A soundly structured, broad-based cut in individual and corporate tax rates on capital gains would significantly benefit all taxpayers. By reducing the cost of capital, it would promote the type of productive business investment that fosters growth in output and high-paying

jobs. By increasing the mobility of capital, it would help assure that scarce saving is used in the most productive manner. By raising the value of equities, it would help support values in capital asset markets in general and the stock market in particular. By increasing the availability and lowering the cost of capital, it would aid entrepreneurs in their vital efforts to promote technological advances in products and services that people need and want. By reducing taxes on their savings, it would treat fairly those thrifty taxpayers who must bear a heavier tax burden than the profligate. And, because of the combined impacts of unlocking and macroeconomic feedback, a broad-based capital gains tax cut is likely to increase government revenues. ❖

SOURCES

See the ACCF Center for Policy Research's Web site at www.accf.org for more details on capital gains taxes including testimony and special reports.

NOTE

1. The federal capital gains tax rates on assets held five years or more will drop in 2001 from 20 percent to 18 percent for assets acquired after December 31, 2000. For investors in tax brackets above 15 percent, the 18 percent tax rate cannot be used until 2006. An investor can, however, make a special election to make pre-January 1, 2001, property eligible for the 18 percent tax rate sooner than 2006 by paying tax on the fair market value of the asset on January 1, 2001. For investors in the 15 percent bracket, the capital gains tax rate drops from 10 percent to 8 percent after December 31, 2000, and the asset does not have to have been acquired after December 31, 2000, to qualify for the 8 percent tax rate as long as it has been held for five years or more.

NOTES ON TABLES 1 AND 2

Category 1 = No preferential capital gains rate.

Category 2 = State law provides a maximum rate for capital gains.

Category 3 = State law provides a deduction or exclusion for all or a portion of capital gains.

Category 4 = Income tax is percentage of federal liability.

Category 5 = No state income tax.

Federal marginal rate: The rate shown is the maximum rate on portfolio long-term capital gains for the particular taxpayer situation, taking into account the effect of any phaseouts of individual itemized deductions or personal exemptions attributable to having the additional capital gains.

State marginal rate: The rate shown is the nominal state rate adjusted to take into account the fact that a resident of the particular state may receive a benefit from deducting state income taxes on capital gains on the federal return. In addition, this rate reflects the fact

where applicable that the state reduces or phases out allowable itemized deductions as income increases. Also, this rate reflects the effect of deducting additional federal taxes attributable to the capital gain for the few states that allow this deduction.