TAX FOUNDATION

SPECIAL BRIEF

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Capital Gains Taxation and Small Business
House Small Business Committee Testimony

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The following testimony was presented by Dr. Foster before the House Small Business Committee on February 22, 1995.

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. It is an honor for me to appear before your Committee today on behalf of the Tax Foundation to discuss the federal capital gains tax and its consequences for America's small businesses.

The Tax Foundation is a non-profit, nonpartisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. We have approximately 600 contributors, consisting of large and small corporate and non-corporate businesses, charitable foundations, and individuals. Our contributors cover practically every region of the country and every industry category.

Combined with the estate tax, which also taxes wealth, the capital gains tax is the most important tax a small business must contend with at the start of the business and at the end of the entrepreneur's association with the business.

I would like to emphasize to the Committee that the Tax Foundation is not a "grassroots" organization, a trade association, or a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of the tax principles delineated below, so that you, the policymakers, may make informed decisions.

When it was established in the late 1930s, the Tax Foundation's founding fathers set out certain principles of taxation which the Tax Foundation would promote and which would guide our analysis of tax proposals. According to these principles, a good tax system should:

- Be as simple as possible — complexity makes accurate tax compliance needlessly expensive and diminishes the public's willingness to comply with the law;
- Not be retroactive — taxpayers must have confidence in the law as it exists entering into a transaction;
- Raise revenue, not micromanage the economy with subsidies and penalties;
- Not be continually rewritten — frequent change lessens citizen understanding of the tax code and complicates long-term economic planning; and,
- Be implemented recognizing the competitive nature of the world economy.

I commend the Committee for holding this hearing on capital gains taxation and small businesses. A great deal has been written and said about the effects of the capital gains tax and your efforts to work through this body of work is certainly no small task.

A Short Tax History of a Small Business

To put the capital gains tax into perspective, consider the following short tax history of a small business. Suppose you had an idea for a new product or service, or suppose you saw a market opportunity missed by others. And suppose you decided to start your own business to take advantage of this opportunity, all the while knowing that the vast majority of small businesses fail within the first couple of years.

Your first task is to raise the capital needed to open your doors. As is well known, the traditional capital markets are generally available only to established businesses, so you talk to your local banker only to learn that banks usually make loans to on-going businesses. He will make you the loan, however, if you can collateralize the entire amount. Being a citizen of limited means you turn instead to your own savings, and to your family and friends to raise the seed corn that will give your dream a chance.

At this early stage, the only tax likely to affect your business is the capital gains tax. Anyone lending capital, particularly for such a risky venture as a new business, does so with the expectation of a large return on his or her investment. The capital gains tax diminishes the after-tax value of that return, thereby discouraging the investment.

Suppose you scraped together the capital to rent some space, buy some equipment, pay your workers, and open for business. If you are like most small businesses, your hopes for turning a profit lie somewhere in the future. For now, all you need to worry about is covering your costs, among which are the Social Security tax, the Hospital Insurance tax, and the Unemployment Insurance tax which you must collect based on your payroll whether you are in the black or deep in the red. In frustration, you find these taxes draining the life blood of your fledgling business—your cash flow.

Some time passes and your business turns a profit for the year. Now you get to start worrying about income taxes as your silent partner, the federal government, begins to claim its share.

As it turns out, you were right all along—there is a real opportunity here, but you need more capital. Still too small to turn to the regular equity markets, you contact known venture capitalists in your area or who are known to be interested in your industry. Fortunately, they are interested in making the investment, but the capital gains tax is again an issue. The risks remain high and so the after-tax return must be high. The capital gains tax raises the before-tax return your new investors are demanding and the control they insist on exercising in order to make the capital infusion.

Fortunately, all goes well, the venture capitalists make the investment, your business expands rapidly, and profits continue to climb handsomely. But payroll taxes continue to drain the cash flow you need to meet your investors' demands, the income tax continues to shrink your after-tax resources, and the capital gains tax continues to stunt your business's growth by limiting your ability to attract investors. Moreover, the income tax is starting to really bite, so you find yourself increasingly spending valuable management time in tax planning to keep your effective tax rate under control. Pretty soon, this diversion of your energies is felt in terms of business opportunities lost or decisions made late.

Opportunities abound and you need more capital yet, but now you are large enough to issue shares on one of the stock exchanges. Once again, however, the capital gains tax is hiking up the returns demanded by investors. The shares you issue don't bring as high a price as you might have hoped because the capital gains tax reduces the after-tax return to the investors.

Many years later your business is a success, you've had a good career, and you have just met with a group from another business that has made an offer to buy your shares in the business at a very fair price. What to do? If you sell the shares, then you will owe an enormous amount of capital gains tax. The alternative is to pass the business along to your son and daughter, but then they will be saddled with a large estate tax liability and the bankers aren't sure the business can withstand such a liability.

Epilogue

The moral of this story is that the capital gains tax is a serious brake on business expansion at every stage. Combined with the estate tax, which also taxes wealth, the capital gains tax is the most important tax a small business must contend with at the start of the business and at the end of the entrepreneur's association with the business.

The Capital Gains Tax and Incentives

Capital is the net total of what individuals have saved over their lifetimes. Individuals invest, first, to preserve the value of their capital against inflation and, second, to increase the value of their capital. Investing means purchasing an asset. An asset's price is determined by the after-tax income stream it is expected to generate, discounted to reflect expected inflation, a minimal required rate of return, and the degree of uncertainty perceived to be associated with the investment. In general, the asset price may vary, thereby producing a capital gain or loss to the asset's owner, either through a change in the expected income stream, a change in the tax treatment of the investment, or a change in the perception of the underlying uncertainty associated with either the income or the tax treatment.

At any time individuals have a relatively risk-free investment alternative in the form of federal securities. These securities are risk-free in the sense that both the principal and the stated interest earnings are assured. In a no-tax world, the interest earned on federal securities would be the product of the rate of inflation expected over the holding period of the security and an after-inflation (real) rate of interest which is established by the market as the minimum required to entice investors to hold the securities. Even federal securities, therefore, carry the risk that the inflation rate or the market's required real rate of return will increase and offer the potential of unexpected returns should either of those rates decline.

A capital gain may arise for many reasons. The implications for investors and for tax policy vary case-by-case, so it is important when considering capital gains tax relief to understand which tax disincentives are being abated.

Virtually all other investments carry a degree of risk exceeding that of federal securities. To entice investors to make these other investments, the expected rate of return must exceed that for federal securities. Investors establish the return they will require on a more risky investment by considering the inflation expected over the period, the minimum rate of return, and the degree of uncertainty about the overall investment. These considerations establish a rate of return required by the market on each investment.

When taxes are imposed, the required return on an investment increases sufficiently to allow the investor to receive the after-tax required rate of return. The difference between the pre-tax and the after-tax returns is called the tax wedge. Higher taxes on investment income raise the tax wedge and reduce the range of investments capable of yielding a sufficient rate of return. Therefore, changes in the taxation of capital income alter the capital stock the economy can profitably employ, which, in turn, alters the rate of investment as the actual capital stock is increased or decreased to match the desired capital stock.

The capital gains tax is peculiar in many respects when compared to other taxes on capital income, such as the taxation of corporate income, or of dividends and interest income. The capital gains tax may be deferred in some instances, such as when the taxpayer sells a home and rolls any capital gain into the purchase of a second home. The recognition of a capital gain arising in one tax year may also be deferred until some subsequent year when the underlying asset is actually sold. Despite these and other differences, however, the effect of the capital gains tax on investment has one important feature in common with other taxes on investment income—it raises the tax wedge and reduces the desired stock of capital nationally.

Anatomy of a Capital Gain

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Inflation

Possibly the most dominant source of capital gains is the rise in asset prices, along with all other prices, due to inflation. Unlike all the other sources of capital gain described below, however, to the extent an asset price rises along with the general price level, the asset holder has reaped no real economic gain. The absence of any real gain when assets appreciate due to inflation is the source of the widespread popular appeal for capital gains indexing.

Corporate Retained Earnings

Corporations have long found that internal financing through retained earnings can be very cost-effective. These earnings, which are the residual after all expenses have been paid, dividends are distributed, and previously issued debt or equity is redeemed, are frequently re-invested in the company, thereby sustaining the current price of the company's shares.

Suppose a company had 100,000 shares outstanding that were trading at $100 per share at the beginning of the year. Suppose over the course of the year that the company had after-tax earnings of $12 per share. If the tax rate on dividends and capital gains were 33 percent, then over the course of the year the share prices would tend to rise to about $108 per share. If the company declares a dividend distribution of $12 per share, then on a per share basis the shareholders will receive the $12 distribution, pay tax of $4, and watch their share prices return to $100, for a net 8 percent return. Alternatively, if at the end of the year the company decides to retain these $12 per share earnings for re-investment, then the share prices will rise to $112. Shareholders will have received a 12 percent pre-tax return for the year in the form of unrealized capital gains which, when realized, will yield an 8 percent after-tax return.

Capital Gains and Scarcity

Natural resource commodities such as land, petroleum, gold, etc., also provide capital gains for their owners because of their scarcity. At any point in time, there is a fixed supply of these commodities available to the market. Over time, as natural resources are depleted, unless demand falls due to other forces the prices of these resources naturally rise to reflect this growing scarcity. As these prices rise they produce capital gains for their owners.

Returns to Risk

All investments carry some element of risk, however the nature and degree of risk can vary tremendously from investment to investment. Consider an asset that will either yield nothing or will return exactly $10,000 in ten years, and suppose over the course of time that the investor will be able to gauge with increasing certainty the probability of the $10,000 payoff. Whatever the probabilities of the payoff at the beginning, the asset will begin the year with a price somewhere between one penny and $10,000.

Over time, as more information is acquired about the probability of the payoff, the risk attached to the investment will rise and fall according to the portent of the additional information. Whenever the probability of reaping the return increases, the price of the asset will increase, reflecting the decline in risk. And whenever the return seems less likely, the asset price will decline reflecting the increase in the risk of the investment.

Windfall Gains

Frequently in making an investment an investor is aware of a wide range of possible outcomes, some of which include exceptional capital gains and losses. The investor may also be aware of the possibility of exceptional capital gains and losses from sources that were entirely unexpected. Such a windfall might arise, for example, if a farmer were suddenly to find a large reserve of recoverable oil on his land, while he risks a significant loss if he suddenly finds some rodents listed as endangered species living in his fields. In each case, these windfalls are distinguishable from other sources of capital gains because they are entirely unexpected.

Capital Gains and Small Businesses

Investors in a small business hope for extraordinary returns to compensate for the high degree of risk inherent in their investments. While any of the described sources of capital gains may appear in a small business investment, clearly the only source that offers the necessary and reasonable potential for achieving the desired rate of return is that due to risk. Capital gains tax relief intended to benefit small businesses should be sure to reduce the tax liability from such gains the most.

Reforming the Capital Gains Tax for Small Businesses

While derivatives and fancy, high-risk financial instruments get the headlines, few investments bear as much risk as an investment in a small business. Consequently, these investments must offer a reasonable expectation of extraordinary returns to lure investors' dollars. The capital gains tax raises the pre-tax returns investors will expect.

Capital gains tax relief may take the form of either a reduction in the tax rate, a simple exclusion of taxable gain, indexation of the tax base (generally, the purchase price of the asset), or an increase in the amount of capital loss that can be charged against ordinary income in a given year. Each form of relief would improve a business's ability to raise equity capital.

In considering an investment in a small business, an investor will recognize that capital gains tax liability will probably arise if the investment is successful. On the other hand, in the far more likely event that the business will not succeed and some or all of the initial investment will be lost, the amount of capital loss that may be claimed for the year may be limited. The Internal Revenue Code allows the taxpayer to use capital losses to offset capital gains. However, if the losses exceed the gains for the year, only $3,000 of the excess capital loss may be used to reduce taxable ordinary income. Any excess capital losses over this amount must be carried forward into the future.

Often, and perhaps typically, the friends and family who invest in a small business do not have extensive portfolios that allow the type of asset management that would avoid having to carry capital losses into future tax years. This can significantly reduce the present value of the capital loss and raise the effective tax cost of the investment. Since such a loss is a distinct possibility facing any small business investor, the constraint on the taxpayer's ability to reduce current taxes using capital losses raises the required return on the investment even further. While it is often more popular to reduce the tax rate on capital gains as they represent the returns to successful activity, from the standpoint of the investor, increasing the limit on how much capital loss can be charged in a given year to ordinary income can be every bit as valuable.

Recent Tax Foundation research . . . shows that nearly 20 percent of all taxable capital gains accrue to families with incomes below $50,000 annually, and that over half of all taxable capital gains accrue to families with incomes below $200,000.

Suppose an investor loses $24,000 in principal on an investment and the investor has no capital gains that may be realized to offset the capital losses. With a $3,000 annual limit, eight years would pass before the taxpayer would be able to exhaust the capital losses. In present value terms, therefore, this $24,000 capital loss is worth only about $19,000 at today's interest rates.

Indexing capital gains for inflation is widely recognized as the most fair and most theoretically correct means of providing capital gains relief. It is patently unfair to tax capital gains due solely to inflation, particularly when inflation is, itself, the product of government actions. For small business owners, however, indexing often provides less relief from the capital gains tax than does a simple exclusion. The mechanics of indexing are that the purchase price of the asset is increased by the percentage increase in the price level. This adjusted basis is then subtracted from the sales price to determine the taxable capital gain. Generally, the basis (or original value of the business) is very low, so that the indexing adjustment is applied to a relatively small amount.

For example, suppose a business is worth $25,000 when founded in 1974. In the intervening years, the general price level has risen by a factor of 3, so the inflation-adjusted basis for tax purposes would be $75,000. If the business is sold for $100,000, then indexing has protected the investor from owing capital gains tax on purely inflationary gains and taxes will only be owed on $25,000 in real capital gains [$100,000 - $75,000]. In contrast, however, if the taxpayer were allowed a 50 percent exclusion, then he would have a taxable capital gain of $37,500 [($100,000 - $25,000)x50 percent]. In this case, indexing is clearly preferable to a simple exclusion.

Suppose the final sales price were $250,000, instead of $100,000 as in the previous example. In this case, under indexing the taxpayer would have a taxable capital gain of $175,000 [$250,000 - $75,000 in adjusted basis], whereas a 50 percent exclusion would leave the taxpayer with a $112,500 taxable gain [($250,000 - $25,000 in original basis)x50 percent], which is clearly preferable to indexing. Moreover, as the final sales price increases relative to the purchase price, the tax relief from a simple exclusion becomes progressively more attractive than that from indexing.

In passing, it is important to note that for most taxpayers most of the time, indexing provides more relief than would a simple exclusion. Only in rare cases when the tax basis is very small relative to the final sales price, i.e., as occurs for the investor in a successful small business, is a simple exclusion less preferable. Virtually all other criticisms of indexing, such as those dealing with complexity or with the possibility of tax sheltering, are either incorrect or grossly exaggerated.

Tax Fairness

In recent years the issue of tax fairness has made reasonable debate about the efficacy of capital gains tax relief nearly impossible. For example, indexing capital gains for inflation is widely regarded as fair and at least theoretically correct tax policy even by those who have reservations about indexing on other grounds. Nevertheless, many Members of Congress and some segments of society oppose capital gains tax relief in general, while supporting indexing in particular. It follows that opposition to capital gains relief predominantly relates to real gains.

General opposition to capital gains tax relief derives from a desire to equalize the distribution of wealth through tax policy. Obviously, the wealthy will receive most of the capital gains in society in pure dollar terms. However, the importance of capital gains and capital gains relief may be greater for lower- and middle-income families than it is for upper-income families because these gains, when they arise, may represent a far greater share of the family income than they do for wealthy families. Recent Tax Foundation research supports this supposition. This research shows that nearly 20 percent of all taxable capital gains accrue to families with incomes below $50,000 annually, and that over half of all taxable capital gains accrue to families with incomes below $200,000.

Finally, while it is appropriate to consider whether a specific tax policy or change in policy is fair, it is important to place these matters within the context of the overall tax policy and even within the overall economic policy of the government. Capital gains relief is proposed for two solid economic policy reasons—to increase the rate of saving and investment in the United States, and to increase wages and employment.

The capital gains tax represents an explicit choice in economic policy favoring a high degree of income redistributionism at the expense of a stronger economy and a more prosperous people. The net result may or may not be a more "equitable" distribution of the fruits of our economy, but it is a peculiar sense of fairness that would choose such a distribution when the cost of such a policy is that all members of society have less income and less wealth.

Other Policies for Encouraging Small Business

A basic principle of Tax Foundation analysis is that the tax code should not be used to micro-manage the economy. While such an operating rule would disqualify certain tax proposals, there are more than enough instances in the federal tax code where disincentives have been created whose removal would both help small businesses and reduce the government's interference in the marketplace.

The short history of a small business described above should indicate some ways in which a change in tax policy would foster small business success. For example, capital gains relief would make it easier for small businesses to expand. Payroll tax relief, however, would be most beneficial for businesses when they are first starting out or whenever they are in financial distress because the payroll tax creates a serious drain on vital cash flow. Many forms of income tax relief would help small businesses, including raising the amount of capital expenditures that may be expensed in a given year; making the Research and Experimentation Tax Credit permanent; and giving all taxpayers the ability to deduct their health insurance premiums whenever they do not enjoy employer-provided insurance.

Tax Complexity

Among the many burdens a small businessman must face is compliance with the federal, state, and local tax codes. Too small to hire professional help the small businessman must proceed as best he can through the tax forms and regulations, all under threat of severe penalty. Tax Foundation research indicates that the average business with sales of $1 million or less (which represents over 80 percent of the corporations in America) must spend over $5,000 annually complying with the federal tax system alone. Tax reform efforts that would simplify the tax code, thereby freeing both time and financial resources for more productive activities, would be equivalent to explicit tax relief from the small businessman's perspective, and yet could be achieved with no loss in federal tax receipts.

Conclusion

While small businesses have much in common with their larger brethren in terms of tax concerns, one matter which distinguishes them is their ability under normal circumstances to access the nation's capital markets to acquire the seed corn necessary to develop and expand. Another aspect which tends to distinguish small businesses is the prospect of very great returns if the business flourishes, and the possibility of losing much or all of one's investment if the business does not succeed. In each case, properly crafted capital gains tax relief would ease these burdens on small businesses tremendously.

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