To: Senate Finance Committee

Attention: Subcommittee on Savings & Investment

Subject: Clipping Capital Gains

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About Bill Parks

- Founder and President, NRS, Inc. 1972 to present. Started with $2,000, and now 100% employee owned, NRS has grown to over $40,000,000 in sales and is the world's largest paddlesports accessory provider.
- Finance Faculty Univ. of Oregon, Colorado State Univ. and Univ. of Idaho 1965-94.
- PhD. in Finance and Economics, Michigan State University
- Accountant, Cadillac Division, General Motors Corporation, 1958-60.

Clipping Capital Gains

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Warren Buffett suggests there are persuasive reasons why he shouldn't pay taxes at a lower rate than his administrative assistant and if you include payroll taxes, than the person that empties his wastebasket. And the logic is inescapable – even the President's Debt Commission proposal agrees. Proponents of special capital gains rates cite the need for investment in risky small business and that incentives are necessary to raise or invest needed capital. These can be separated from the traditional arguments that special tax rates for capital gains spur economic growth and investment. Prescribing special treatment for capital gains as a way to foster growth may be commonly accepted, but it is far from proven.

Capital Gains

While helping small business owners and investors are the most cited reasons for special rates for capital gains, the beneficiaries are more likely to be hedge fund managers and top business executives with stock options. We propose that special capital gains rates be limited to levels usually associated with small business and that gains above that threshold be taxed at ordinary income rates. Account would be taken of assets held for a number of years in determining the threshold. Fervent supporters of special rates for capital gains usually cite small business owners or farmers that have owned assets for many years as a justification for the low rates. Indexing for inflation is another high priority item for those looking to reduce taxes by using the small business person as their example. Indexing for inflation doesn't do much for the small business owner that bootstrapped an initial $10,000 investment into a million dollar enterprise. Thus the extremely rich invoke plight of small business to justify special treatment for the multimillionaires and passive investors most likely to benefit from inflation indexing. An upper limit to the capital gains qualifying for a preferential rate in each year should be such that it helps small business and family farms, but does not unnecessarily reward those that do not grow the economy nor work to increase the value of the enterprise. Gains for small businesses are often limited and most small businesses do not have substantial gains, nor contribute substantial employment. For those that do, a limit of $100,000 times the number of years the owner has held the asset would do much to reward the small business entrepreneur while not rewarding those multimillionaires that benefit most from capital gains and hide behind the legitimate needs of the small business owners and farmers that depend of selling their business and assets to provide for their retirement.

Despite some liberal opposition, there are legitimate reasons to offer special rates for some capital gains. Think of the business person above that grew a small initial investment into as much as a million or even multimillion dollar investment. That person is more likely than not to have invested every spare dollar into the business rather than putting the money aside in a tax deferred investment account or even a Roth IRA. Now, after many years, it is time to sell the business and retire. The result?—a single year of very high income. To avoid this problem, convoluted multiyear agreements would be required to spread the income out over a number of years. Clearly, a legitimate reason for having a special rate for capital gains. However, to separate our entrepreneur from the many other beneficiaries of special capital gains rates this paper proposes a modification of the present system that benefits long term business owners and others with medium and long term investments.

We suggest that most business owners and supporters would find it reasonable that $100,000 a year should qualify for capital gains treatment at a lower 15% maximum rate. Allow this special rate on all investments held at least one year. Then multiply that $100,000 times the number of years the asset was held. Suppose that our small business owner above has owned the business for ten years. The owner would be eligible for capital gains rates on $1,000, 000 in gains. If the business is sold for $500,000, the $490,000 gain would all be eligible for the capital gains rate. A wealthy investor, corporate executive or even hedge fund manager would be eligible for the same $100,000 times the number of years the asset was held. Having a $20 million profit on an asset held 2 years would give the person $200,000 of capital gains and ordinary income treatment on the rest.

The same year could not be used to shelter more than $100,000 of investment income. Should the business be sold for $1,500,000 then the owner would receive special capital gains treatment on $1,000,000 of the proceeds and ordinary income rates on the remainder. By making this change we limit capital gains special treatment primarily to those on which its rationality is based. The argument that special capital gains rates are necessary to encourage investment really misses the point of how investments are made. Giving a special rate for those selling investment has the same rationale as offering freed divorces as a way to encourage marriage!

The choice of $100,000 is reasonable and could be adjusted if needed. Separating long-term holders from traders by giving a tax break for the first dollars of gain times the number of years the asset was owned could benefit both the economy and investors by encouraging long-term investment instead of short term trading.

Making these changes to tax policy would energize the economy by encouraging and rewarding long-term investments while aiding both small business owners and middle-income investors by continuing the capital gains rate. The outrage that most people would feel if they understood how much of high-income returns is structured to create capital gains assures us that this proposal would only be fought by representatives of the wealthiest Americans. The vast majority of Americans would support this change in capital gains treatment because they are the people who do the work, including emptying Mr. Buffett’s wastebasket!