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The Right Capital Gains Tax Rate Is Zero

By Dan Mitchell **April 14, 2012**

The silly debate about the "Buffett Rule" is really an argument about the extent to which there should be more double taxation of income that is saved and invested.

Politicians conveniently forget that dividends and capital gains get hit by the corporate income tax. And since America now has the developed world's highest corporate income tax rate, it's adding insult to injury to tax the income again. Actually, it's adding injury to injury!

No wonder Ernst and Young found that the United States has a very anti-competitive system for taxing dividends and capital gains. (perhaps it's time to copy the clever British campaign against punitive double taxation)

If you believe in fairness, the right capital gains tax rate is zero. John Goodman of the National Center for Policy Analysis has a good explanation.

Income tax time is an appropriate moment to go to the heart of President Obama's complaint about the taxes Warren Buffett and other rich people pay, or don't pay. What the president is really complaining about is that the tax rate on capital gains is too low. But there is a more basic question to be asked: why tax capital gains at all?

That's a very good question, because a capital gain isn't income. It's an asset that has increased in value. But the tax only applies on the gain if you sell the asset.

But why does an asset, such as shares of stock, rise in value? According to finance research, asset prices rise in value when there's an expectation that there will be a greater after-tax stream of future income. But that income will be taxed (at least once!) when it materializes, so why tax it before it even happens? John hits the nail on the head.

The companies will realize their actual income and they will pay taxes on it. If the firms return some of this income to investors (stockholders), the investors will pay a tax on their dividend income. If the firms pay interest to bondholders, they will be able to deduct the interest payments from their corporate taxable income, but the bondholders will pay taxes on their interest income. Here is the bottom line: There is no need for the IRS to tax the bets that people make along the way — as stock prices gyrate up and down. Eventually all the income that is actually earned will be taxed when it is realized and those taxes will be paid by the people who actually earned the income.

Amen. John is exactly right. He's making the same arguments I put forward in my video on capital gains taxation.

By the way, the capital gains tax isn't indexed for inflation. So if you bought an asset 30 years ago and it's doubled in value, you've actually lost money after adjusting for inflation. Yet the IRS will tax you. Sort of adding injury to injury to injury.

Finally, I like how John closes his column.

…why not avoid all these problems by reforming the entire tax system along the lines of a flat tax? The idea behind a flat tax can be summarized in one sentence: In an ideal system, (a) all income is taxed, (b) only once, (c) when (and only when) it is realized, (d) at one low rate.

In this awful period leading up to tax day, isn't it nice to at least dream of a tax system that is simple, fair, and non-corrupt?