Comments for the Record

Joint Hearing on Tax Reform and the Tax Treatment of Debt and Equity

House Committee on Ways and Means
Senate Committee on Finance

Wednesday, July 13, 2011

by Michael Bindner

The Center for Fiscal Equity

Chairmen Camp and Baucus and Ranking Members Levin and Sessions, thank you for the opportunity to submit my comments on this topic. We will leave the technical analysis of current law to the Joint Tax Committee Staff and focus our comments on how these issues relate to the Tax Reform options proposed by the Center for Fiscal Equity.

Those who have previously read our comments know that the Center has a four pronged tax reform proposal:

- Value Added Taxes (VAT) to fund domestic military and civil discretionary spending (in addition to other excises, such as the gasoline tax);

- VAT-like Net Business Receipts Taxes (NBRT) on labor and capital to fund non-pension entitlement spending which replace some payroll and most income taxation at both the individual and corporate levels;

- Old Age and Survivors Insurance (OASI) payroll taxes on employers and employees to fund old age and survivors insurance (retirees only) – with survivors insurance to non-retirees and disability insurance funded by the NBRT (and decoupled from income); and

- Income surtaxes on cash disbursements from all sources, including inheritance to fund overseas military and naval deployments, retirement of debt to the Social Security system and other trust funds, and net interest on the debt and any additional debt retirement.

We preface our analysis by noting that debt and equity are not taxed, per se. Instead, the interest on debt is taxed as income to the lender and their depositors or investors and is considered an expense to those who incur it for the purchase of capital or for home financing while dividends are taxed rather than equity. Indeed, equity cannot be federally taxed – only the dividend income earned as a result of holding such equity. State governments can, of course, tax equity under personal property tax provisions and it could potentially be taxed under a state level Equity Value Tax, which would operate on the same principal as a Land Value Tax on economic rent.

Two perspectives on taxing interest and dividends are important to note – the perspective of the producer/business owner and the perspective of the consumer. Identifying both points of view is essential to any analysis of the economic and equity impacts of tax reform on interest and dividend taxation

Under the VAT and NBRT elements of our proposal, interest paid would continue to be an expense while increases to equity would be considered a result of adding value and therefore subject to tax, whether paid out in dividends or not. The equity itself, however, is not taxed – rather the income which grows income is.

Under VAT and NBRT regimes, labor is also taxed while interest paid is not, however the return on equity and labor would ideally be taxed at the same rate – rather than taxing dividends at either a higher or lower rate than income, depending on the tax bracket of the taxpayer and their primary source of income.

An advantage to both VAT and NBRT is that they are potentially much simpler with regard to the tax treatment of interest expenses than the current personal and corporate income tax systems, although that simplicity is as much a function of how the tax laws are written as the inherent nature of these taxes.

Under our proposals, wages, interest income and dividend income for most households would not be taxed directly. In order to facilitate the payment of VAT, net income would increase by the same percentage as the VAT plus any adjustment due to receipt of refundable Child Tax Credits through NBRT, while gross income would decline to Net Income plus OASI taxes and for high income individuals and families, continued income surtax withholding.

For most families, taxation would occur through consumption rather than through wages. The loss of gross income would be for wages which were never paid anyway, as the responsibility for being an object of taxation shifts from the employee to the employer. Of course, economically, the consumer is the already the ultimate funder of all income taxes currently paid by both labor and capital under the current system.

There is extensive literature already in existence on the tax treatment of interest income to financial services firms. We will leave review and comment of this highly technical literature to those who are expert in it, as we believe it is beyond the purposes of this hearing. Such issues are important to consider when implementing legislation and regulation are in the drafting stage – and we surmise that this debate is no where near that point.

OASI contributions have no impact on the question of interest and dividends unless personal accounts are included as a feature. Whether such accounts are on the Cato Institute model, with diversified investment, or our model with insured investment in the employing company, equity would largely replace debt and value added to equity would be taxed as income under VAT and NBRT rather than as interest income to the financial institution making the loan.

High income individuals are more likely to be taxed both as consumers and as producers, however, their greater propensity to consume less of a percentage of income in any current period requires a separate surtax, especially if dividends are reinvested rather than spent and capital gains remain unrealized. In the short term, reinvestment or holding investments leaves this potential income outside the reach of taxation, creating real vertical equity issues that can only be resolved with the adoption of surtaxes on all income above a certain level.

Under our proposal, there would be no separate rate for interest, dividends, disbursements from inheritance or sale of inherited assets (unless the sale is to a qualified Employee Stock Ownership Plan), capital gains or wages. All income would be taxed at the same rate. For high income tax payers, all income is fungible. It matters not whether it comes from dividends or from interest on deposits loaned out to firms who pursue debt finance rather than equity finance.

We propose graduated rates from the $100,000 per year income level to the $550,000 per year level, as it is no more complicated to look up tax due on a tax table for graduated rates than for a single rate, so tax simplification concerns provide no justification for abandoning graduated tax rates. Indeed, such rates are necessary to compensate for the fact that at higher levels, families are more likely to defer spending for decades, if not generations, and may attempt to avoid taxation permanently. While in the long term, all income must eventually be spent to have any value, in the short term there are serious equity concerns from not taxing high income individuals at a higher rate because they are less likely to consume within a given period.

Without high income surtaxes, the pool of potential investment becomes more and more concentrated until the vast majority of the population is reduced to wage slavery alone. Indeed, the lowering of tax rates in the last three decades has produced such a result, with productivity gains going to an ever shrinking high income population at the top of the income distribution, while most workers see income levels rise only by the rate of inflation, even when they are the source of the increased productivity that is growing the economy.

Drawing this distinction is much more important than the impact of tax reform on debt finance versus equity finance.

Thank you for this opportunity to share these ideas with the subcommittee.

Contact Information

Michael Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, VA 22304

571-334-8771
202-314-3444 (fax)
iowafiscalequity@verizon.net

Clients:

The Center for Fiscal Equity has received no outside funding of any kind to support this testimony. It is not compensated for representing the interests of any clients.