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OP-ED CONTRIBUTOR

Two Americas, Two Tax Codes

By DOROTHY BROWN

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WARREN BUFFETT knows there's something very unfair about the American tax system. He's often complained that while his 2006 tax rate (for federal income taxes and Social Security withholding) on $46 million of income was 17.7 percent, his secretary's combined tax rate was 30 percent.

There are effectively two tax systems in America: one for the very rich and one for the rest of us. Income from stock dividends and capital gains, which makes up a disproportionate amount of the earnings of the very rich, is taxed at 15 percent. But the bulk of what the rest of us earn — wages and interest from savings accounts — is taxed at up to 35 percent. Though President Obama's recent tax proposals are progressive and comprehensive, his reforms don't do nearly enough to address this significant disparity.

Yes, President Obama's plan would eliminate the loophole that has allowed hedge fund titans, whose income comes in no small part from management fees, to be taxed at just 15 percent instead of the ordinary income tax rate.

Families earning more than $250,000 and singles earning more than $200,000 would likewise see taxes on their wages and interest increased to a top rate of 39.6 percent from 35 percent. And the rate on both capital gains and dividends on the sale of stock would increase, but only to 20 percent from 15 percent. These changes lessen the unfairness in our tax system; they don't eliminate it.

The gap between the tax rates for the rich and the rest of us is relatively recent. Until 1921, capital gains were taxed at the same rate as ordinary income. Then Congress enacted a law that taxed capital gains at 12.5 percent while ordinary income was taxed at as much as 58 percent.

In the decades since, the tax rate on capital gains varied — sometimes it increased, sometimes it decreased. But with the exception of a brief period in the late 1980s, it was always lower than the tax on ordinary income. That was not the case for stock dividends, which were taxed like wage income and savings account interest — that is, until President George W. Bush and Congress in 2003 gave dividends the same preferential treatment as capital gains. The Bush tax cuts moved our tax system too far in the wrong direction.

There is a flip side to raising the tax rates for dividends and capital gains. In this market, there won't be too much capital gain to worry about. So how should we treat capital losses?

Under current law, capital losses that exceed capital gains can be deducted up to $3,000 (losses above that limit can be carried forward indefinitely into future tax years). If we increase the tax rate on capital gains, then a more generous limit on capital losses should almost certainly be allowed. During the presidential campaign, Senator John McCain proposed increasing the $3,000 offset against ordinary income to $15,000. It's an idea worth dusting off.

The question of how to tax capital gains and dividends is one of fundamental fairness. Why should tax law treat income from savings accounts differently from income from a diversified stock portfolio? Either we push up the rates on corporate dividends and capital gains or we lower the rates on wages and interest: it's all income and it should all be taxed at the same rate.

Dorothy Brown is a professor of tax law at Emory University.