Effect on Asset Price

Favorable tax status raises the price of an asset and thus lowers the expected pre-tax return.

Taxation of Nominal Income

For investment gains, what is taxed is *nominal* gains, not *real* gains.

For example, suppose that the interest rate equals the rate of inflation. One pays full income tax on the nominal interest, even though the real interest rate is zero. The after-tax, real rate of return is negative.

In contrast, for salary nominal and real income are the same.

Taxation of Interest

	Federal Income Tax	State Income Tax
Bank interest	Yes	Yes
Corporate bonds	Yes	Yes
U. S. Treasury bonds	Yes	No
Municipal Bonds	No	No

Treasury Bills

Treasury bills are bought at a discount below the maturity value. The increase in value is taxed as ordinary income, not as capital gains.

Taxation of Returns on Investment

	Federal Income Tax
Capital Gains	15% Maximum
Dividends	15% Maximum

One pays the capital gains tax only on "realized capital gains." One pays the tax only when the asset is sold, not when the asset rises in price. For example, Bill Gates has presumably paid only a small tax relative to his wealth, because he has sold only a small portion of his stock.

In contrast, a worker pays a much higher income tax rate on wages and salary. Furthermore, his social security/medicare tax ("contribution") is 15 $1/4\%$ of gross income (employee and employer tax combined).

New York State Tax Law

Overall, New York State income taxes are tied to federal taxes, but not exactly. In particular, the income tax on capital gains is the same as on other income.

Timing

It is advantageous to declare income later rather than sooner, so the present value of the tax is less.

Pensions

Pension funds owned by an individual accumulate tax-free until received as income in retirement. At that point the individual pays *full* income tax, even if much of the income stems from capital gains. Delaying the tax to retirement is a great saving, as one gains the benefit of the compounding of returns. If tax were paid as interest, dividends, and capital gains were earned, the loss of the compounding would make the pension much smaller.

An individual saving for retirement in a pension fund *loses* from a direct tax cut on the return on an asset. The asset is then worth more and has a lower expected return. Consequently additions to the pension fund accumulate value more slowly.

Income of Money Managers

A key reason why money managers have gained so much income during recent decades is that more and more wealth is invested in pension funds. If their management fee is one-half *per cent* of assets managed and the real rate of return is two *per cent*, they receive 25 *per cent* of the income from pension assets. Consequently their income is huge, a significant fraction of national income.

Here the tax situation is crucial. An individual receives the tax benefit from a pension only if he pays someone to manage his pension assets; one cannot manage one's own pension and receive the tax benefit. The huge income of money managers derives from the tax break on pension funds. Despite the high management fee, the compounding of returns via the tax break is even more valuable.

A puzzle is why competition among money managers does not force down the typical management fee. In an efficient market, the contribution of a money manager is minimal, so why is the fee so high?

Differential Tax Rates

If the law establishes two different tax rates, then a potential loophole is created: there is a strong incentive to claim that one is subject only to the lower rate.

Clever accountants are creative and bold, so the potential for abuse is enormous. The greatest abuse involves capital gains.

National Football League

An example from the past is the taxation of the profit of a National Football League team. Naively, one might think that a team owner would pay full income tax on the profit.

Clever accountants devised the following scheme. Instead of recognizing that the team profit comes from the ownership of the franchise to field a team in the league, the fiction was that the valuable asset of the team owner was instead the contracts of the players. As the players age, they depreciate, so a contract is worth less. The enormous depreciation declared as an expense each year meant that the team had no taxable income, and thus paid no tax.

After the passage of time, the depreciated team value was zero, so no more depreciation could be charged. The team owner would then sell the team to another investor, who would repeat the scheme.

The seller reduces his tax in two ways. The price received by the seller is a capital gain, subject to a lower tax rate. Furthermore, by delaying the tax for some years to the date of the sale, the present value of the tax is much less.

Office “Ranch” in Texas

In Texas, the property tax rate on a farm/ranch is negligible, far lower than the substantial tax rate on residential or commercial property.

Imagine a large complex of office buildings surrounded by big parking lots. In the far corner, twenty cows graze on a patch of grass. The owner pretends that the property is a ranch, not a commercial building, and escapes the property tax.

A typical homeowner cannot copy this ploy, because his lot size is too small to qualify as a ranch.

Toys R Us

For many years, Toys R Us paid no state income tax, despite having successful stores all over the country.

Because Delaware has no corporate income tax, the company pretended that all income was earned in there. It maintained that each store paid to the corporate headquarters in Delaware a franchise fee equal to the excess of its revenue over expenses, so that the store profit was zero.

Management Fee to Hedge-Fund Managers

Hedge-fund managers show remarkable hutzpah in their tax filings. Whereas mutual-fund managers pay full income tax on their management fees, hedge-fund managers pay only capital-gains tax, a much smaller tax. They argue the following: their fee is performance-based, a percentage of profits, and the profit is mostly capital gains, so they should only pay the capital-gains tax.

The flaw of their argument is that the capital gain is not a capital gain on their own assets. In other businesses, recipients of a portion of profit pay full income tax. Yet the government has not pursued them for full income tax. Why not?

One interpretation is that the government sees some tax revenue as better than none. If it were to demand full-income tax, the hedge-fund managers would pretend that all their income is earned in the Cayman Islands! (Most expensive yachts moored in harbors in the U. S. fly the Cayman Islands flag.)