***Brief Overview of Taxation of Investors in C Corporations***

Under current law, individuals generally pay a maximum 23.8 percent tax on their dividends and long-term capital gain. I.R.C. §§1(h)(1)(D) and (11), 1411(a)(1). Prior to 2003, individuals generally were taxed on their dividends at ordinary income rates but were taxed preferentially on their long-term capital gains. In that year, Congress conformed the tax rate for both types of income and reduced it to a maximum of 15 percent in an effort to mitigate the effect of the “double tax.” Changes effective beginning in 2013 brought the maximum rate for both types of income up to 23.8 percent.

Different income thresholds determine the exact rate of tax applicable to a given individual under current law. Single taxpayers with taxable income over $425,800 (and joint filers with taxable income over $479,000) must pay a 20 percent tax on their dividends and long-term capital gains. In addition, high-income taxpayers (generally, single individuals with AGI over $200,000 and joint filers with AGI over $250,000) must pay a 3.8 percent tax on their net investment income (which includes dividends and capital gains), but the taxable amount is limited to the excess of the taxpayer’s AGI over those threshold amounts. Taxpayers with lesser amounts of income pay tax at lower rates (all the way down to zero for taxpayers in the bottom two ordinary income tax brackets). Importantly, although the rate fluctuates based on the amount of the taxpayer’s income, the same rate applies to any given taxpayer’s dividends and long-term capital gain.

Despite being taxed at the same rate, dividends and long-term capital gain are not treated identically. Among other differences, the capital gain tax applies only to the “gain” portion of the receipt (i.e., the excess of amount realized over the taxpayer’s basis), whereas the dividend tax generally applies to the full amount of any dividend received. Thus, a sale of shares for $100, including a sale back to the corporation that issued the stock, may not result in the same income tax liability as the receipt of a $100 dividend from that corporation.

The rules described above do not apply to corporate shareholders. Corporations receiving dividends or capital gain must generally pay tax on such income at the regular corporate income tax rate, currently 21% percent. However, corporate shareholders are generally entitled to deduct between 50% and 100% percent of the dividends received from a domestic C corporation, depending upon how large an interest the corporate shareholder owns in the corporation paying the dividend. See I.R.C. §243(a) and (c). The net effect, in general, is to tax corporations on their dividend income at a rate of between zero and 10.5 percent (50% \* 21%) and on their capital gain at a rate of 21% percent. The corporate dividends-received deduction is often explained as a way to reduce and potentially eliminate the imposition of more than one corporate tax on a particular item of income (and more than two taxes total on the same income). The tax treatment of corporate capital gain from investments in corporations is, however, somewhat inconsistent with that policy objective. We consider the dividends-received deduction in [chapter five](https://jigsaw.vitalsource.com/books/9781454860747/epub/OEBPS/xhtml/9781454859000_16_ch05.xhtml).