Washington Research Council

Special Report

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Proposals For A State Capital Gains Tax

Briefly

- Both Gov. Inslee and the House Democratic Caucus have proposed capital gains taxes.
- Washington residents would have to pay tax on federally-defined gains.
- Nonresidents would pay capital gains on real estate located in the state, or on personal property when the sale takes place in the state.
- A major exemption would be gains from single-family residential real estate, regardless of whether it is owner occupied or a rental, a departure from past proposals.
- Some agricultural, forestry and other activities would also be exempt in both plans.
- Every state that currently taxes capital gains does so through its income tax.
- Framing the proposals as an excise tax may prevent a federal tax deduction.
- The governor's plan calls for a rate of 7.9 percent, the House's for 7 percent.
- Both proposals have exemptions of $25,000 for individuals and $50,000 for couples.
- Revenue projections for the governor's capital gains tax proposal foresee $821 million new funds in 2019 and $1.848 billion in the 2019–21 biennium.
- The House's plan assumes $715 million in revenues in the first year, but a fiscal note has not been issued.
- Tax revenues from capital gains fluctuate significantly with the state of the economy.
- The governor's proposal includes a reserve fund to mitigate revenue volatility; the House Democratic Caucus's proposal does not include a reserve fund.
- Capital gains tax exposure causes large investors to move assets or hold gains, both of which prevent investment in job-creating businesses.
- Investors in some fields will be exempt while others must pay, raising fairness issues.
- Start-up companies which rely on grants of stock or stock options to recruit employees will find the state less attractive.
- Several other tax proposals are on the table, raising the question of what the cumulative impact would be.

Both Gov. Inslee and the House Democratic Caucus have proposed instituting a capital gains tax for Washington state as part of their plans for funding the 2017-19 state budget. Gov. Inslee's proposal is contained in Senate Bill 5111 (and companion House Bill 1730). SB 5111 was referred out of the Senate Ways and Means Committee without recommendation on February 24. The House Democratic Caucus's proposal appears as Part 1 of its omnibus revenue proposal, House Bill 2186. HB 2186 is scheduled for a hearing by the House Finance Committee on April 3.

The fiscal note for SB 5111 estimates that the tax would generate $821 million during the 2017–19 biennium, and $1,848 million during the 2017–19 biennium (OFM 2017). The House Democratic Caucus estimates that the proposal would generate $715 million in 2017–19.

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The bills

The two capital gains proposals are largely identical in wording, although there are several substantive differences.

Both proposals would impose upon "natural persons" a tax on the "privilege of selling or exchanging long-term capital assets." The tax rate would be 7.9 percent under Gov. Inslee's proposal and 7.0 percent under the House Democratic Caucus proposal.

"Unlike the treatment of capital gains under the federal income tax, the proposed Washington capital gains taxes would not allow losses in one year to be carried forward to offset gains in a following year."

Capital gains on property sold or exchanged by C-corporations (corporations that are subject to the federal corporate income tax) would not be subject to the tax. However, capital gains on property sold by partnerships, limited liability companies, S-corporations or trusts would be subject to tax to the extent that those gains are passed through to individuals for federal income tax purposes.

For Washington residents, the tax would apply to (1) capital gains on the sale of real property located in the state, (2) capital gains on the sale of tangible personal property if the sale occurs in the state, or if the sale occurs out of the state and the property has been located in the state at any time during the year of sale, and (3) capital gains from the sale or exchange of intangible personal property (e.g. stocks and bonds).

For nonresidents, Washington's tax would apply to (1) capital gains on the sale of real property located in the state and (2) capital gains on the sale of tangible personal property if the sale occurs in the state.

Unlike the treatment of capital gains under the federal income tax, the proposed Washington capital gains taxes would not allow losses in one year to be carried forward to offset gains in a following year.

Exclusions and exemptions

Annual exclusion. Both proposals provide an annual exclusion of $25,000 for individuals or $50,000 for couples who file jointly.

Residential dwellings. Both proposals exempt single family residences, residential condominium units, residential cooperative units, and floating homes (as defined in RCW 82.45.032) from the tax. The House Democratic Caucus's proposal extends this exemption to accessory dwelling units subordinate to otherwise exempt residential dwellings.

Forced sales. The bill exempts property sold to federal, state or local government under powers of eminent domain.

Retirement accounts. The bill exempts from tax capital gains on assets held in traditional IRAs, Roth IRAs, 401(k)s, 403(b)s and other similar tax-sheltered retirement savings accounts.

Livestock. The bill exempts from tax gains from the sale of cattle, horses and breeding livestock owned for more than 12 months if the owner gets more than 50 percent of his or her income from farming or ranching.

Farmland and timberland. The bill exempts from tax gains from the sale of agricultural land if the owner has continuously and materially participated in the operation of the land during the preceding 10 years.

Timber. The bill exempts from tax transactions that are deemed to be capital gains under sections 631(a) and 631(b) of the internal revenue code.

Property used in a trade or business. The bill exempts from the tax capital gains on property that "is used in the trade or business of the taxpayer" if that property is depreciable under the federal income tax code.

B&O deduction. To avoid double taxation, Gov. Inslee's proposal provides a B&O deduction to a business for any revenue that would otherwise be subject to both the Business & Occupation tax and the capital gains tax.

Sunset after 10 years. Under the House Democratic Caucus's proposal these exclusions and exemptions would be subject to periodic review by the Citizen

Commission for Performance Measurement of Tax Preferences and would automatically sunset after 10 years. Under Gov. Inslee's proposal the exclusions and exemptions would not be reviewed by the Citizen Commission and would be permanent.

Income tax or excise tax?

Both bills describe the capital gains taxes to be excise taxes "on the privilege of selling or exchanging long-term capital assets." For all intents and purposes, these taxes would appear to be income taxes. However, if the capital gains taxes are income taxes, the rates, 7.9 percent for Gov. Inslee and 7 percent for the House Democratic Caucus, would run afoul of the state constitution, which sets a 1 percent cap on the tax rate that can be applied to income.

By describing the taxes as excise taxes, the two proposals are trying to dance a narrow line drawn in two 1933 cases by the Washington Supreme Court. In the first of these cases, Chase v. Cullen, the court ruled that income is property and therefore that an income tax is subject to all the restrictions which the state constitution imposes on property taxes. In the second case, Stiner v. Yelle, the Court ruled the precursor to business and occupation tax to be a constitutionally permitted excise tax on the privilege of doing business rather than an unconstitutional property tax on the business's income. (See the appendix of (WRC 2015) for more on these two Supreme Court decisions.)

Even as an excise tax, either proposal might be challenged as violating Article 1, Section 12 of the state constitution, which states: "No law shall be passed granting to any citizen, class of citizens, or corporation other than municipal, privileges or immunities which upon the same terms shall not equally belong to all citizens, or corporations." It seems problematic that the capital gains of S corporations would be subject to tax, while the capital gains of C corporations would be untaxed.

Every state that currently taxes capital gains does so through its state income tax rather than through an excise tax.

Deductibility

The fact that the bills frame the capital gains tax as an excise tax on the sale or transfer of property rather than an income tax opens the possibility that those who pay the Washington capital gains tax will not be able to deduct their payments when filing their federal income tax returns.

When the federal income tax was first imposed in 1913, taxpayers were allowed to deduct all state and local taxes when calculating the amount of income subject to the federal tax. Over the years, the deductibility provision has been modified. As things now stand, the only state or local taxes that are deductible are income taxes, property taxes and general sales taxes. (Taxpayers may deduct either income taxes or sales taxes, but not both.) Taxes on the transfers of property—such as Washington's real estate transfer tax, for example—are not deductible for federal tax purposes (Maguire and Stupak 2015).

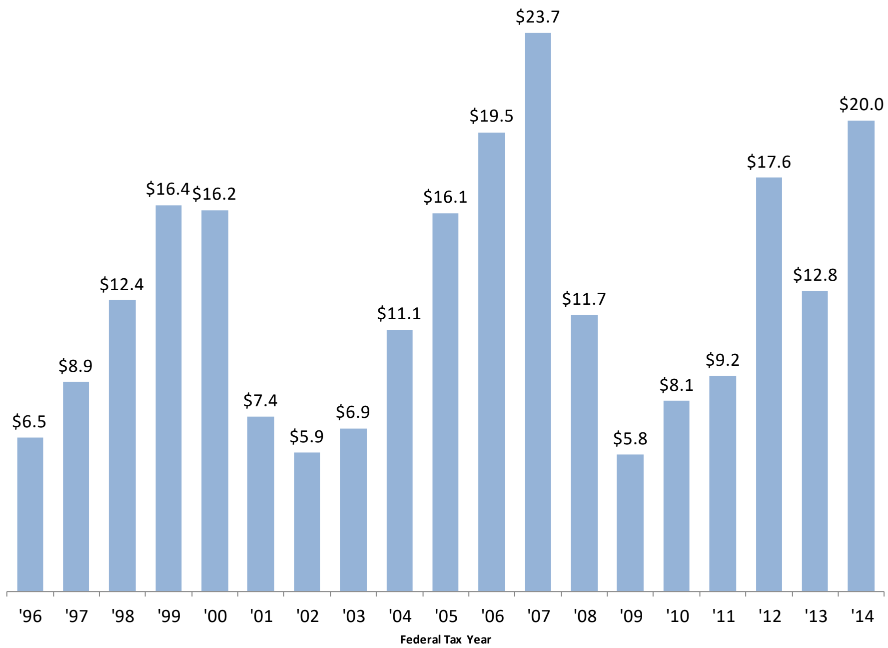
If the IRS holds the Washington capital gains tax to be an excise tax on the transfer of property rather than an income tax, it will not be deductible.

Capital gains tax rates

The 7 percent rate on capital gains in the House Democratic Caucus's proposal would rank 11th highest among the states. At 7.9 percent Gov. Inslee's proposal would rank 9th highest.

This comparison does not take into account the fact that neither proposal would allow unused losses from one year to be rolled forward to offset gains in future years, as the federal government and most states allow. This has the potential to make Washington's capital gains tax more onerous for some taxpayers than that of California, which has the top capital gains tax rate.

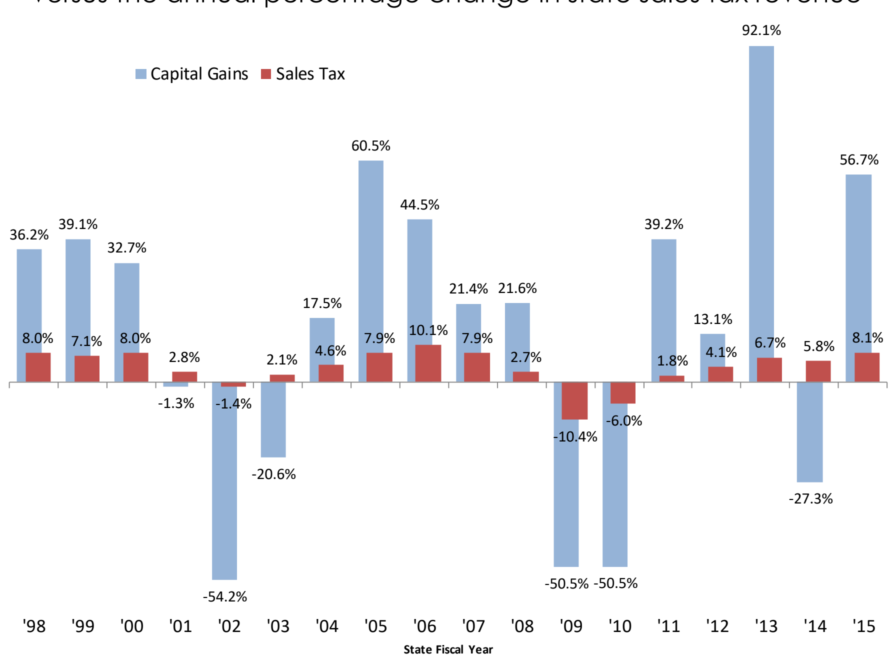
Chart 1: Long-term capital gains reported on Washington residents' federal tax returns (dollars in billions)



Revenue

The fiscal note for SB 5111 estimates that the tax would generate $821 million during its first year, which would be the second year of the 2017–19 biennium, and $1,848 million during the 2017–19 biennium (OFM 2017). The fiscal note estimates that 48,000 taxpayers would owe capital gains tax in 2019.

Chart 2: Annual percentage change in Washington capital gains versus the annual percentage change in state sales tax revenue



As of yet, no fiscal note has been issued for HB 2186. However, a media handout issued by House Democrats estimates that the proposal would generate $715 million during its first year (HDC 2017).

Because capital gains are so volatile, it is hard to have great confidence in these forecasts.

Volatility of capital gains

The imposition of a tax on capital gains would increase the cyclical volatility of the state's tax revenue stream.

Compared to the tax systems of other states, Washington's current system is relatively stable as reflected in the volatility index constructed by the Pew Charitable Trusts. A big reason for this is the lack of an income tax. Pew finds for all but one state which has both a sales tax and an income tax that its income tax is more volatile than its sales tax (Sjoblom 2015). Capital gains contribute greatly to income tax volatility. According to the Federal Reserve Bank of Boston, the cyclical volatility of state income tax has increased greatly since the late 1990s. The reason for this is that capital gains have become much more volatile (Sjoblom 2014).

Charts 1 and 2 illustrate the volatility of capital gains. Chart 1 shows the dollar amount of net capital gains on federal tax returns filed by Washington residents for the years 1996 through 2014. In 1999, the peak year for capital gains before the dot-com collapse of the stock market, Washington residents reported $16.4 billion in net capital gains, which represented 11.5 percent of the total adjusted gross income (AGI) on these returns. By 2002 net gains had fallen to $5.9 billion, which was 4.3 percent of AGI. In 2007, the peak year before the Great Recession, net capital gains totaled $23.7 billion; as in 1999, this was 11.5 percent of AGI. By 2009 net gain had fallen to $5.9 billion (3.1 percent of AGI).

Chart 2 compares annual growth rates for state sales tax revenue to growth rates for net capital gains of Washington

"Taxing these [capital] gains would raise the cost of capital for real estate development, which would ultimately raise rents for office, commercial and manufacturing properties and for apartments."

residents. (A note on timing: the state would receive revenues from a tax on federal tax year 2014 capital gains in April of state tax year 2015.) In percentage terms, the swings in capital gains are much bigger than the swings in state sales tax revenue. Moreover, the two series are highly correlated: In each of the three instances where sales tax revenues were lower than in the preceding year, capital gains decreased by more than 50 percent. (The correlation coefficient between the two series is 0.77.)

In 2011 the Washington Budget and Policy Center (WBPC) recommended that the state adopt a capital gains tax (Nicholas 2011). WBPC acknowledged that "capital gains can decline rapidly at the onset of a recession." For this reason, it recommended that upon enacting the capital gains tax, policymakers and voters should amend the state constitution to dedicate up to 50 percent of the new revenues to the state Budget Stabilization Account, commonly referred to as the "rainy day fund."

In a modest step along these lines, Gov. Inslee's proposal would create a new account called the school investment fund, into which, each year, any capital gains tax revenues in excess of $900 million would be deposited. Money could be withdrawn from this fund only in years when capital gains tax revenues fell short of $900 million. The $900 million threshold is greater than the amount that the tax is projected to yield in its first year and only $1 million less than the amount the tax is projected to yield in its second year (OFM 2017). The House majority proposal includes no mechanism to bank revenues in years when capital gains tax revenues are high.

Impact of the capital gains tax on real estate

It seems likely that the capital gains tax will have some impact on real estate activity in the state. Individual investors in apartments, office buildings and shopping centers often participate through partnerships, LLCs or other sorts of entities which pass through income to the investor's individual income tax return. For tax purposes, most of the income from these investments often comes in the form of capital gains. Taxing these gains would raise the cost of capital for real estate development, which would ultimately raise rents for office, commercial and manufacturing properties and for apartments.

Effect on decision to reside or work in the state

As noted above, much of the burden of this tax will be concentrated on a small number of persons. Imposition of the tax will lead some of those most heavily impacted to rearrange their affairs so that Washington is no longer their home for tax purposes. (This generally means reducing the amount of time they spend in the state each year.) The incentive to move will be greatest for persons for whom most income is in the form of capital gains on intangible property. There will be a modest effect on the state economy through a reduction in these people's consumption spending in the state. The negative impact will be much larger if these people cut back their investments in the state out of fear that such investments might be used as evidence that the state should be considered their tax home.

Wealthy individuals who continue to live and invest in the state will reduce their capital gains tax burdens by turning over their investments less rapidly. This "lock-in effect" may reduce funding for start-ups in the state. The state economy will be less dynamic.

For employees of start-up firms in the technology, biotechnology and other advanced sectors, grants of stock or of stock options can be a significant component of compensation. Capital gains taxes on the sale of stock received through such grants would make this state a less attractive place to work in such firms. This in turn would make the state a less attractive place to locate such firms.

Comment

The legislators are under pressure to find additional revenue to fulfill the state's obligation under the McCleary decision to fully fund education by September 1, 2018 (WRC 2016). Because their constitutionality is questionable, the capital gains taxes proposed by Gov. Inslee and the House Democratic Caucus are not good sources for such revenue, as they would be tied up in court for several years.

Adding a capital gains tax to the mix would make the state's revenue stream more volatile. The additional volatility would surely increase fiscal stress on state government (and schools) in the next economic downturn.

Supporters of the proposed tax like it because they believe it targets the top "one percent" of income earners. However, some of the targeted parties will avoid the tax by moving away from the state. This geographic separation will make them less likely to invest here. Others will stay here but avoid the tax by not cashing in old investments to pursue new opportunities. Start-ups which rely on grants of stock or stock options will find the state less attractive. All of these responses will reduce the dynamism of the state economy.

This capital gains tax proposals must be considered alongside other new revenue proposals coming from the governor and the Legislature to evaluate the potential cumulative effects: The governor would like to institute a carbon tax (projected to add $0.25 to the price of gasoline) and raise the B&O tax rate on service businesses from 1.5 percent to 2.5 percent. The House Democratic Caucus would add a 20 percent surcharge on the B&O tax of many larger businesses and is preparing its own version of a carbon tax. Both the governor and the House Democratic Caucus would end several tax preferences put in place to foster business activity and job creation.

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