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Policy Brief

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Capital Gains Tax is a Not-So-Capital Idea

Briefly

The questionable constitutionality of the tax makes it a risky source of revenue, whether for the schools as previously proposed or property tax relief now. Moreover, should the legislation somehow clear the high constitutional bar, the volatility of the tax would add a substantial degree of instability to property tax bills. It's unlikely any property owner would welcome an unpredictable tax bill. Finally, the legislation is unlikely to make any substantial impact on the alleged and misdiagnosed regressivity of the state tax structure.

A bill to impose a 7 percent capital gains tax has been introduced in Olympia again this year. This is, in itself, not unusual. Such proposals have become nearly routine.

An analyst with the national Tax Foundation took note of this year's bill and, with just slight overstatement, writes, "At a time when nothing feels certain, the reemergence of a capital gains tax proposal (House Bill 2967) in Washington State is almost comforting. Some things never change" (Walczak 2018).

Our previous analyses of the capital gains tax focused heavily on the tax's volatility (WRC 2015, 2017a). That's still a concern, but not the only one. We also will examine the question of whether the tax is an unconstitutional income tax or, as proponents would have it, an excise tax. (It's an income tax.) And we'll briefly consider the potential effect of the tax on economic activity in the state.

We begin, however, by critiquing the bill's intent language. The intent section of proposed legislation has no statutory effect, but rather is often used to signal what problem the sponsors are trying to solve. In this instance, the supposed problem stems from a persistent error in the analysis of the state tax structure.

"Most upside down and regressive"

The bill's introduction describes the Washington's tax system "as the most upside down and regressive in the nation." This characterization is based on a flawed study by the Institute on Taxation and Economic Policy (ITEP). We have critiqued this study in previous reports (WRC 2010). The study has a number of serious problems: It's a point-in-time measure relying on flawed data; it overstates the significance of state taxes by failing to recognize the progressivity of the federal income tax; and, its allocation of the tax burden across income groups overstates the degree to which sales taxes and business taxes are paid by low income households. Together, these errors substantially overstate the regressivity of the Washington tax structure.

We will highlight one problem here: The estimation of sales taxes paid by households at the bottom of the income distribution.

ITEP uses the U.S. Bureau of Labor Statistics' quarterly Consumer Expenditure Survey (CES) to determine how family expenditures vary with income. This survey finds that on average low-income households spend much more than they take in income. For 1992 (the data vin-

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tage ITEP uses) the lowest 20 percent of households reported average expenditures equal to 216 percent of average after-tax income; the second quintile of households reported average annual expenditures equal to 136 percent of average income; and the third quintile of households reported average expenditures equal to 114 percent of average after-tax incomes. Economists call spending in excess of earnings "dissaving."

Researchers at the Urban-Brookings Tax Policy Center have critiqued the CES methodology and find a reason for the apparent substantial discrepancy. They conclude

> *The most credible explanation for the high level of dissaving in the lowest and second-lowest income quintiles . . . is that the income reported in the [consumer expenditure survey] is substantially understated.* (Toder, Nunns and Rosenberg 2011)

This conclusion is also reached by John Sabelhaus and John Groen (2000) and by Sabelhaus et al. (2011).

Because income is understated in the CES for lower income households, ITEP overestimates the purchases of these households, and this leads ITEP to overestimate the amount of sales tax paid by these households.

Additionally, ITEP assumes that much of the taxes paid by businesses is pushed forward onto customers and distributes these taxes across households in proportion to consumption expenditures. The overestimation of consumption expenditures of low income households leads to an overestimation of the amount of business taxes they bear. The effect of this overestimate is not uniform across states. Because Washington state's sales tax rate is higher than that of most other states and because Washington places a higher tax burden on businesses than do most other states, ITEP overestimates the tax burden of lower income households to a greater degree for Washington than for most other states. Consequently, ITEP's state tax burden rankings are unreliable.

While the intent language has no substantive effect, it perpetuates a flawed understanding of Washington's tax system.

House Bill 2967

HB 2967 has three substantive parts: Part I imposes a tax on capital gains. Part II dedicates revenue from the new tax to reducing the state property tax and funding the state portion of the program that reduces property tax relief for low income senior citizens, disabled persons and veterans. Part III indexes the income limits on this program to median household income.

The capital gains tax

HB 2967 would impose upon "natural persons" a tax on the "privilege of selling or exchanging long-term capital assets." The amount of tax would be 7.0 percent of net long-term capital gains reported by individuals for federal income tax purposes, with certain exclusions and exemptions.

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' federal income tax returns.

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. The bill provides an annual exclusion of $25,000 for individuals or $50,000 for couples who file jointly.

Residential dwellings. The bill exempts single family residences, residential condominium units, residential cooperative units, multi-family residential buildings with fewer than four units and floating homes (as defined in RCW 82.45.032) from the tax. The exemption extends to accessory dwelling units subordinate to single family residences.

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, the bill provides a B&O deduction to a business in for any revenue that would otherwise be subject to both the B&O tax and the capital gains tax.

Family-owned small businesses. Sales of substantial interests in certain family-owned small businesses are exempt from the capital gains tax. Among the requirements to qualify for this exemption: the taxpayer must have held the interest for at least eight years; the business must have no more than 50 full-time employees; annual revenues of the business must not exceed $7 million; and the taxpayer or a member of the taxpayer's family must have materially participated in the operations of the business.

These exclusions and exemptions would not automatically sunset after 10 years as would otherwise be required by RCW 82.32.805.

Use of the revenue from the tax

Revenue from the capital gains tax would be deposited in the education legacy trust account.

By December 31st of each year, beginning 2019, the Department of Revenue is to (1) calculate the amount of revenue received from the capital gains tax in the immediately preceding fiscal year (which ended on the preceding June30), (2) estimate the amount required to fund the senior citizen, disabled person and veteran property tax relief program in the next calendar year, and (3) reduce the rate on the state's "McCleary" property tax by the amount necessary to reduce collections by this difference. (The McCleary property tax is a second property tax enacted in 2017 to fund the state's obligations under the McCleary decision. See (WRC 2017b).)

Property Tax Relief Program

The state currently has a program that provides property tax exemptions for residential properties owned by lower income senior citizens, disabled persons and veterans. The amount of relief varies with income according to three thresholds.

- Qualifying taxpayers with income of $40,000 or less are exempt from excess levies (generally these are levies that the state constitution requires to be approved by a vote of the people) and from the McCleary levy. In addition,
- Qualifying taxpayers with income between $30,000 and $35,000 are exempt from regular property taxes on the greater of $50,000 or 35 percent of the property's value, but with a cap of $70,000. And,
- Qualifying taxpayers with incomes of $30,000 or less are exempt from regular property taxes on the greater $60,000 or 60 percent of the property's value.

HB 2967 changes the $40,000 threshold to 65 percent of county median household income, changes the $35,000 threshold to 55 percent of county median household income, and changes the $30,000 threshold to 45 percent of county median household income. This change would first become effective for taxes due in 2020. Thresholds would be adjusted for changes in county median household incomes every five years. In no case would an adjustment reduce a threshold.

Income tax or excise tax?

HB 2967 characterizes the capital gains tax as an excise tax. For all intents and purposes, though, it is an income tax, imposed on a narrow subset of income. In January, we analyzed Superior Court Judge John Ruhl's decision rejecting the City of Seattle's income tax (WRC 2018). Although the ruling did not hinge on his rejection of the city's claim that its income tax is really an excise tax, Ruhl specifically struck down both arguments advanced by the city in support of its unusual definition. As the Tax Foundation writes,

> *Courts frown on such semantic games and prioritize substance over form—and especially over nomenclature. Just last year, when Seattle tried to impose a high earners income tax by calling it an excise tax, a court dispensed with the idea in short order. A tax that falls on income is an income tax, whatever the name.* (Walczak 2018)

If, then, the capital gains tax is an income tax, the 7 percent rate would conflict with the state constitution, which sets a 1 percent cap on the tax rate that can be applied to income.

Even in the unlikely event a court should hold that this capital gains tax is, in fact, an excise tax, HB 2967 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 a standalone excise tax.

Capital gains tax rates

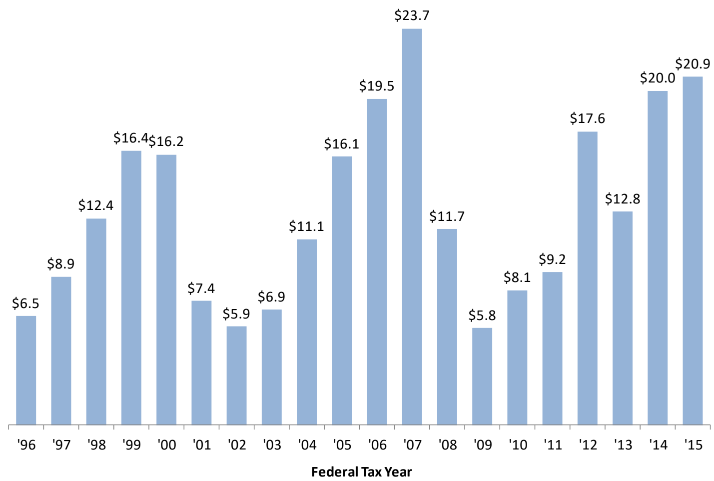
The 7 percent rate on capital gains in the bill would rank 11th highest among the states.

This comparison does not take into account the fact that HB 2967 would not 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.

Volatility of capital gains

Capital gains are highly volatile. Anyone following the stock market over the last few weeks will recognize that the roller coaster is back. Chart 1 shows the dollar amount of net capital gains on federal tax returns filed by Washington residents for the years 1996 through 2015. In 1999,

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



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 $5.8 billion (3.1 percent of AGI). In 2015, the most recent year for which data are available, the net gain was $20.9 billion (8.0 percent of AGI).

In our discussions of previous proposals to add a capital gains tax to Washington's tax system, we noted that this would add significantly to volatility of overall state revenues, as revenues from the capital gains tax would highly correlated with revenues from the existing sales and B&O taxes.

The volatility issue is somewhat different with HB 2967: Overall state revenues would not be more volatile as increases (decreases) in capital gains tax revenue would be offset by decreases (increases) in property tax revenue. Property owners would find that their property tax bills would become more volatile as the state property tax rate moves up and down in response to changes in capital gains revenues. This would likely increase voter dissatisfaction with the property tax. Note that hikes in the state rate are likely to coincide with downturns in the economy.

Deductibility

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. (Motor vehicle excise taxes are deductible because the IRS considers them to be property taxes.) Taxpayers may deduct either income taxes or sales taxes, but not both.

The recent federal tax legislation caps the total amount of state and local taxes that a taxpayer may deduct at $10,000. Most individuals with significant capital gains tax liability under HB 2967 will have paid sufficient property and sales taxes to fully exhaust the allowed state and local tax deduction. Under the old federal law, the effective rate of a state 7 percent capital gains tax on a taxpayer at the top federal income tax rate (39.6 percent) was just 4.228 percent, now the effective rate is the full 7 percent. For this reason, the potential impact on economic activity in the state from this capital gains tax proposal is greater than from previous proposals.

Effect on decision to reside or work in the state

Much of the burden of the proposed capital tax would be concentrated on a small number of persons. Imposition of the tax would 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 would 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 would 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 would likely reduce their capital gains tax burdens by turning over their investments less rapidly. The higher overall tax rate on capital gains (30.8 percent when federal and state tax taxes are combined) would increase the incentive to exploit tax shelters such as trusts to hide capital gains from the individual tax return. These "lock in and lock up effects" could reduce the funding for startups in the state. The state economy would 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

As we concluded in our analysis of capital gains tax proposals last year (WRC 2017a), the questionable constitutionality of the tax makes it a risky source of revenue, whether for the schools as previously proposed or property tax relief now. Moreover, should the legislation somehow clear the high constitutional bar, the volatility of the tax would add a substantial degree of instability to property tax bills. It's unlikely any property owner would welcome an unpredictable tax bill. Finally, the legislation is unlikely to make any substantial impact on the alleged and misdiagnosed regressivity of the state tax structure.

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