Washington Research Council

Policy Brief

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A Capital Gains Tax Would Not Improve Budget Sustainability

Briefly

Although the March revenue forecast increased estimated state revenues for the 2017–19 and 2019–21 biennia, the House Appropriations Committee Chair proposed a new capital gains tax along with his 2019–21 operating budget. The Senate is also considering a capital gains tax, although in this case the proceeds would be used to reduce other taxes rather than to increase the operating budget.

A capital gains tax would be highly volatile. Taxpayers can arrange their affairs to avoid them, and the value of capital gains realized by Washington taxpayers varies significantly year to year. Also, swings in capital gains are much bigger in percentage terms than swings in state sales tax revenue. Volatile taxes require stronger reserves to manage downturns, but the House bill would avoid constitutionally-required transfers to the rainy day fund by directing revenues from the tax to the education legacy trust account.

Additionally, a capital gains tax would certainly be challenged as an unconstitutional income tax. Even if it were eventually found to be constitutional, a court case would likely mean that any revenues would be suspended until after 2019–21. Building the budget around such a tax would be risky at best.

Both the House and the Senate are actively considering capital gains taxes. The House version, which is part of the House Appropriations Committee Chair's operating budget plan, is contained in House Bill 2156. HB 2156 would establish an annual 9.9 percent tax on capital gains in excess of $100,000 for an individual and $200,000 for a couple that files a joint federal income tax return. This bill would also replace the state's current flat 1.28 percent rate real estate excise tax with a progressive tax that starts at 0.9 percent on the first $500,000 of value and increases in steps to 3 percent on increments of value in excess of $7 million.

The Senate version is contained in a proposed striking amendment to an existing bill—Senate Bill 5961. The proposed substitute bill, PSSB 5961, would establish an annual 8.9 percent tax on capital gains in excess of $250,000 for either an individual or for a couple that files a joint federal return. Revenue from the tax would offset various new tax preferences: sales tax rebates for low income households, business and occupation tax reductions for businesses with less than $2.5 million in revenue, property tax reductions for low income seniors, and sales tax exemptions for diapers, feminine hygiene products, over-the-counter medications and certain medical equipment.

In this brief we will discuss the details of both plans and some of the drawbacks of a capital gains tax in Washington generally.

An "Excise" Tax on Capital Gains

HB 2156 and PSSB 5961 would both impose an excise tax for the "privilege of selling or exchanging long-term capital assets." HB 2156's 9.9 percent rate would tie Oregon for the third highest top marginal rate on capital gains in the nation. PSSB 5961's 8.9 percent would rank sixth highest. In both cases, the tax would apply to asset sales occurring on or after January 1, 2020.

Under both bills, 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 under either bill 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 (e.g. art and automobiles) 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, the tax under either bill would apply to (1) capital gains on the sale of real property located in Washington state and (2) capital gains on the sale of tangible personal property if the sale occurs in Washington state.

Unlike the treatment of capital gains under the federal income tax, neither bill would allow losses in one year to be carried forward to offset gains in a following year.

Exclusions, Exemptions and Credits

Annual exclusion. HB 2156 would provide an annual exclusion of $100,000 for individuals or $200,000 for couples who file jointly. PSSB 5961 would provide the same $250,000 exclusion to individual filers and to couples who file jointly. Both bills would require couples who file a joint federal income tax return to file a joint state capital gains tax return. Similarly, both bills would require couples who file separate federal returns to file separate state returns.

Residential dwellings. Both bills would exempt gains on single family residences, residential condominium units, residential cooperative units, and floating homes (as defined in RCW 82.45.032). The exemption would extend to accessory dwelling units (such as "mother-in-law" apartments) subordinate to otherwise exempt residential dwellings.

Forced sales. Both bills would exempt gains on property sold to federal, state or local government under powers of eminent domain.

Retirement accounts. Both bills would exempt gains on assets held in traditional IRAs, Roth IRAs, 401(k)s, 403(b)s and other similar tax-sheltered retirement savings accounts.

Livestock. Both bills would exempt gains on 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. Both bills would exempt from tax gains on agricultural land if the owner has continuously and materially participated in the operation of the land during the preceding 10 years.

Both bills would also exempt timber transactions that the federal government taxes as long-term capital gains according to sections 631(a) and 631(b) of the internal revenue code.

Property used in a trade or business. Both bills would exempt 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 (e.g. buildings and machinery).

B&O deduction. To avoid double taxation, both bills would provide a business and occupation (B&O) tax deduction for any revenue that would otherwise be subject to both the B&O tax and the capital gains tax.

Family-owned small businesses. Both bills would exempt sales of substantial interests in certain family-owned small businesses. Among the requirements under both bills 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; and the taxpayer or a member of the taxpayer's family must have materially participated in the operations of the business. Under HB 2156 annual revenues of the business must not exceed $7 million to qualify; under PSSB 5961 annual revenues must not exceed $5 million.

Credit for out-of-state taxes. Both bills would allow a credit against the taxpayer's Washington liability with respect to a specific capital gain for taxes paid on that gain to another taxing jurisdiction.

Estimated Revenue

Payment of the capital gains tax, accompanied by a state tax return and copies of the taxpayer's federal income tax returns, would be due on April 15 of the year following the year of the sale (which, despite the constitutional arguments by proponents covered below, would feel a lot like an income tax to the filer). The first payments would be due in 2021.

The preliminary fiscal note for HB 2156 provided to the House Finance Committee estimates that capital gains tax revenue, net of the B&O credit, would be about $780.7 million during FY 2021 (the second year of the 2019–21 biennium) and $1,906.7 million during the ensuing 2021–23 biennium.

There is as yet no fiscal note for PSSB 5961. A March 29 blog post from the Senate Democratic Caucus estimates that the Senate's capital gains tax would raise $780 million in FY 2021. This seems too high given the FY 2021 revenue estimate for HB 2156, which has a higher rate and lower exclusion levels than PSSB 5961.

Revenue from a capital gains tax is difficult to forecast because (as we show below) capital gains are extremely volatile and because the initiation of a new tax would have significant impacts on taxpayer behavior. For these reasons, it is hard to have great confidence in estimates of future revenue from the tax.

It is well documented that increases in state tax rates on capital gains reduce the amount of gains reported by state residents (Dowd, et al. 2015; Bakija and Gentry 2014). Washington's fiscal notes do not account for this. Much of the burden of the HB 2156 and PSSB 5961 taxes 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.) Wealthy individuals who continue to live in the state would likely reduce their capital gains tax burdens by turning over their investments less rapidly and increasing their use of tax shelters, such as trusts that hide capital gains from the individual tax return.

Based on Dowd et al.'s statistical analysis, HB 2156's capital gains tax would reduce Washington taxpayers' annual capital gains by 22 percent in the long run. The reduction in the first year would be even bigger, 34 percent, because some taxpayers planning sales subject to the new tax would rush to complete the transactions before the tax goes into effect. For PSSB 5961's tax, the reductions would be 21 percent in the long run and 32 percent in the first year.

A tax minimization strategy unique to standalone capital gains taxes could further reduce revenue from the tax. Every state that currently taxes capital gains does so through a state income tax under which dividends are taxed at a rate equal to or greater than the rate on capital gains. A standalone capital gains tax, like those proposed in HB 2156 and PSSB 5961, would allow some investors to avoid the tax by structuring transfers of assets so that some of the profit comes as untaxed dividends rather than taxed capital gains. In income tax states converting capital gains into dividends does not provide tax savings.

Any revenue estimate for FY 2021 is specifically questionable because the bill, if enacted, is sure to be challenged as unconstitutional for reasons we discuss below. The tax would most likely be suspended until the challenge is decided, which could take several years.

Use of the Revenue from the Tax

HB 2156 would direct revenue from its capital gains tax to the education legacy trust account (ELTA). In contrast, PSSB 5961 would direct revenues from its capital gains tax to the general fund.

The ELTA currently receives all the proceeds of the estate tax and portions of the real estate excise tax, the solid waste collection tax, the public utilities tax and (for FY 2019) the property tax. It effectively functions as an appendage to the state's general fund. Unlike the general fund, revenue dedicated to ELTA is not considered to be "general state revenue" and therefore does not figure into the calculation of the 1 percent of general state revenues that is required by the state constitution to be transferred to the budget stabilization account (BSA, or rainy day fund). (See the box to the left.) Nor do ELTA funds figure into the calculation as to whether there has been extraordinary revenue growth requiring additional funds be transferred to the BSA.

As we will show below, revenue from a capital gains tax would be very volatile. Because of this volatility, it would be much better to direct revenue from a capital gains tax to the general fund than to ELTA. As part of the general fund, capital gains revenue would help increase reserves during good economic times.

Washington State Constitution
Article VII, Section 2

(a) A budget stabilization account shall be established and maintained in the state treasury. ...

(b) (1) By June 30th of each fiscal year, an amount equal to one percent of the general state revenues for that fiscal year shall be transferred to the budget stabilization account.

(2) By June 30th of the second year of each fiscal biennium, three-quarters of any extraordinary revenue growth shall be transferred to the budget stabilization account. However, no transfer of extraordinary revenue growth under this subsection (b)(2) shall occur in a fiscal biennium following a fiscal biennium in which annual average state employment growth averaged less than one percent per fiscal year. "Extraordinary revenue growth" means the amount by which the growth in general state revenues for that fiscal biennium exceeds by one-third the average biennial percentage growth in general state revenues over the prior five fiscal biennia. ...

Volatility of Capital Gains

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

Washington's current system is relatively stable compared to the tax systems of other states. According to the volatility index constructed by the Pew Charitable Trusts, Washington ranked 14th most stable from 1998 to 2017 (Pew 2018). A big reason for the relative stability is the lack of an income tax. Pew finds that the income tax is more volatile than the sales tax in most states that have both (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 (Kodrzycki 2014).

Charts 1 and 2 on page 5 illustrate the extreme volatility of capital gains.

Chart 1: Capital Gains Realized By Washington Taxpayers
(Dollars in Billions)

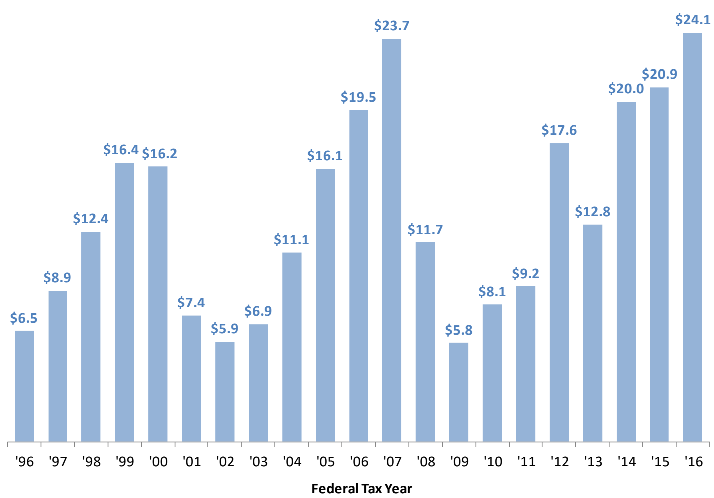

Chart 2: Capital Gains Are More Volatile than the Sales Tax

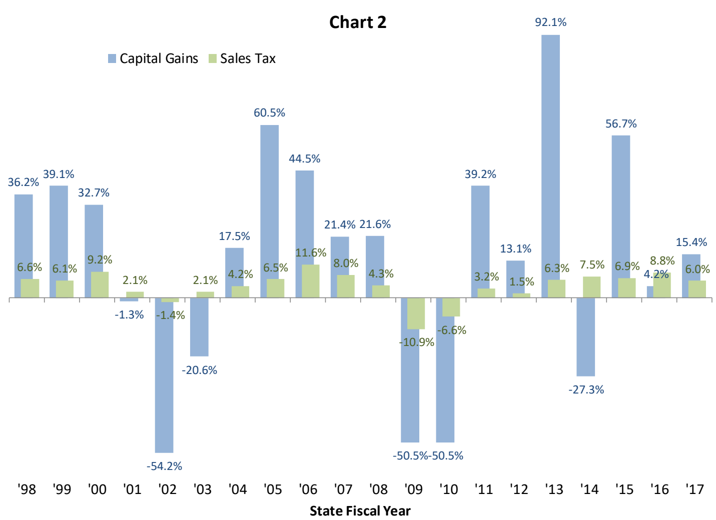

Chart 3: Capital Gains Tax Would Make Revenues More Volatile

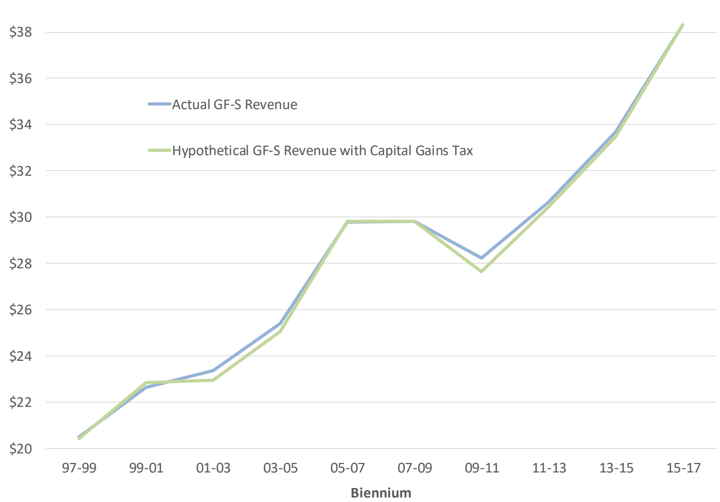

Chart 1 shows the dollar amount of capital gains on federal tax returns filed by Washington residents for the years 1996 through 2016. In 1999, the peak year for capital gains before the dot-com collapse of the stock market, capital gains were 11.5 percent of the total adjusted gross income (AGI). By 2002 gains were just 4.3 percent of AGI. In 2007, capital gains were again 11.5 percent of AGI. By 2009 they were just 3.1 percent of AGI.

Chart 2 compares annual growth rates for Washington state sales tax revenue to growth rates for net capital gains of Washington residents. (On this chart, capital gains are dated according to the state fiscal year in which they would be taxed.) In percentage terms, the swings in capital gains are much bigger than the swings in state sales tax revenue. Moreover, the two 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 is 0.72.)

Chart 3 compares actual Washington general fund–state revenue to a hypothetical where the state sales tax rate is reduced from 6.5 percent to 6.0 percent and a capital gains tax with 3.166 percent rate is added. (This rate has been chosen so that in the 2015–17 biennium the revenue gained from adding the capital gains tax exactly equals the revenue lost by reducing the state sales tax by 0.5 percent.) Not surprisingly, the hypothetical system with a modest capital gains tax is more volatile than the historical system. The hypothetical system performs better than the historical during economic expansions and worse than the historical system during economic contractions. From the 1999–01 biennium to the 2001–03 biennium (the dot-com bust) actual revenue rose by $725 million while revenue for the hypothetical system grew by just $108 million. From the 2007–09 biennium to the 2009–11 biennium (the Great Recession) actual revenues fell by $1,598 million while hypothetical revenues fell by $2,162 million. We calculate that the hypothetical system would have placed 21st in Pew's volatility rankings, compared to the historical system's 14th place ranking.

Constitutional Issues

Both bills frame their capital gains taxes as excise taxes. A number of legal experts believe that a capital gains tax is inherently an income tax rather than an excise tax. The fact that the value taxed on the state return is taken from the taxpayer's federal income tax return would lend common sense support to such a claim.

If the capital gains tax is an income tax, the 9.9 percent rate in HB 2156 and the 8.9 percent rate in PSSB 5961 would conflict with the state constitution, which sets a 1 percent cap on the tax rate that can be applied to property: In 1933 the state Supreme Court ruled that the Washington state constitution's very broad definition of property encompasses income and, therefore, that all constitutional restrictions on property taxes apply also to income taxes (WRC 2015).

Comment

A capital gains tax would be a highly volatile source of revenue for Washington. First, it would likely be tied up in the courts for years, so even if it were certain that a capital gains tax would eventually be found to be constitutional, the Legislature should not build the 2019–21 budget around it. Second, since capital gains taxes are highly volatile, the state would need to accumulate substantial reserves in good times in order to sustain programs during economic downturns. By directing capital gains tax revenues to the ELTA (thereby avoiding automatic payments to the state's rainy day account), HB 2156 specifically would make accumulation of such reserves less likely.

With a potential downturn on the horizon, adopting a new, volatile tax with dubious revenue estimates is not sustainable budgeting.

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