Washington Research Council

Policy Brief

February 9, 2015 PB 15-03

Gov. Inslee's Capital Gains Tax Proposal

Briefly

Imposition of a capital gains tax would increase the cyclical volatility of the state's tax revenue stream. Supporters of the proposed tax like it because it targets the "one percent." 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. Both of these responses will reduce the dynamism of the state economy.

As we noted in a brief published last month, Governor Inslee's proposed budget for the 2015–17 biennium would spend $2 billion more than existing state revenue sources can cover (WRC 2015). Among the new sources of revenue that the governor proposes to fill this gap is a tax on long-term capital gains. In this brief we provide the details of this tax.

Gov. Inslee's bill

Governor Inslee's proposed capital gains tax is contained in House Bill 1484 and its companion Senate Bill 5699. The bill would impose upon "natural persons" a tax on the "privilege of selling or exchanging long-term capital assets." The tax rate would be 7 percent.

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 tax would not allow losses in one year to be carried forward to offset gains in a following year.

Exemptions

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

Principle residences. The bill exempts from state tax any gains from the sale of a principle residence that are exempted from tax under the federal income tax. The federal rules provide an exemption for the first $250,000 of gains on the sale of a home if a single homeowner has lived in a home for two of the past five years. (The exempt amount is $500,000 for a couple.) In addition HB 1484 completely exempts gains on homes that have been owned for 20 years or longer, so long as it had been used as the taxpayer's principle residence for at least 10 of those years.

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. 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.

Income tax or excise tax?

The bill describes the capital gains tax as an excise tax, while for all intents and purposes the tax would appear to be an income tax. However, if the capital gains tax is an income tax, its 7 percent rate would run afoul of the state constitution, which sets a 1 percent cap on the tax rate applied to income.

By describing the tax as an excise tax, the governor is 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 occupations tax to be constitutional as a tax on the privilege of doing business rather than a tax on the business's income. (The Appendix provide more on these two Supreme Court decisions.)

Deductibility

The fact that the bill frames 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 will be deductible for 2015 and subsequent tax years are income taxes and property taxes. (In recent years taxpayers who chose not to deduct income taxes have been allowed to deduct sales taxes. This provision is not a permanent part of the tax code, although Congress may well continue to extend it year by year.) Taxes on the transfers of property—such as Washington's real estate transfer tax, for example—are not deductible for federal tax purposes (Maguire Stupak 2014).

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

Table 1 shows the maximum effective state capital gains tax rates for each of the 50 states as of July 1, 2014, compared to the 7 percent rate proposed for Washington. At 7 percent, Washington's capital gains tax rate would rank 11th highest among the states.

This comparison does not take into account the fact that the governor's proposal would not allow unused losses

Table 1: Proposed Washington capital gains tax compared to the maximum rates in other states

California	13.30%	1
Oregon	9.90%	2
Minnesota	9.85%	3
Iowa	8.98%	4
New Jersey	8.97%	5
Vermont	8.95%	6
New York	8.82%	7
Maine	7.95%	8
Idaho	7.40%	9
Hawaii	7.25%	10
Washington	7.00%	11
Nebraska	6.84%	12
Connecticut	6.70%	13
Delaware	6.60%	14
West Virginia	6.50%	15
Georgia	6.00%	16
Kentucky	6.00%	16
Louisiana	6.00%	16
Missouri	6.00%	16
Rhode Island	5.99%	20
North Carolina	5.80%	21
Maryland	5.75%	22
Virginia	5.75%	22
Wisconsin	5.36%	24
Ohio	5.33%	25
Oklahoma	5.25%	26
Massachusetts	5.20%	27
Alabama	5.00%	28
Illinois	5.00%	28
Mississippi	5.00%	28
Utah	5.00%	28
Arkansas	4.90%	32
Montana	4.90%	32
Kansas	4.80%	34
Colorado	4.63%	35
Arizona	4.54%	36
Michigan	4.25%	37
South Carolina	3.92%	38
Indiana	3.40%	39
Pennsylvania	3.07%	40
New Mexico	2.45%	41
North Dakota	1.93%	42
Alaska	0.00%	43
Florida	0.00%	43
Nevada	0.00%	43
New Hampshire	0.00%	43
South Dakota	0.00%	43
Tennessee	0.00%	43
Texas	0.00%	43
Wyoming	0.00%	43
Washington, DC	8.95%	

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 than California's for some taxpayers.

Revenue

The fiscal note for HB 1484 estimates that the tax would generate $798 million during its first year, which would be the last year of the 2015–17 biennium, and $1,778 million during the 2017–19 biennium (OFM 2015). It is estimated that 32,000 taxpayers would owe capital gains tax, and that one-half of the revenues would come from just 1,000 of them (Shirk 2015).

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).

State Treasurer Jim McIntire said this about the governor's proposal: "Capital gains is probably the most volatile revenue source for most state governments" (Brunner 2015).

Charts 1 and 2 illustrate the volatility of capital gains. Chart 1 shows the dollar amount of net capital gains on federal

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

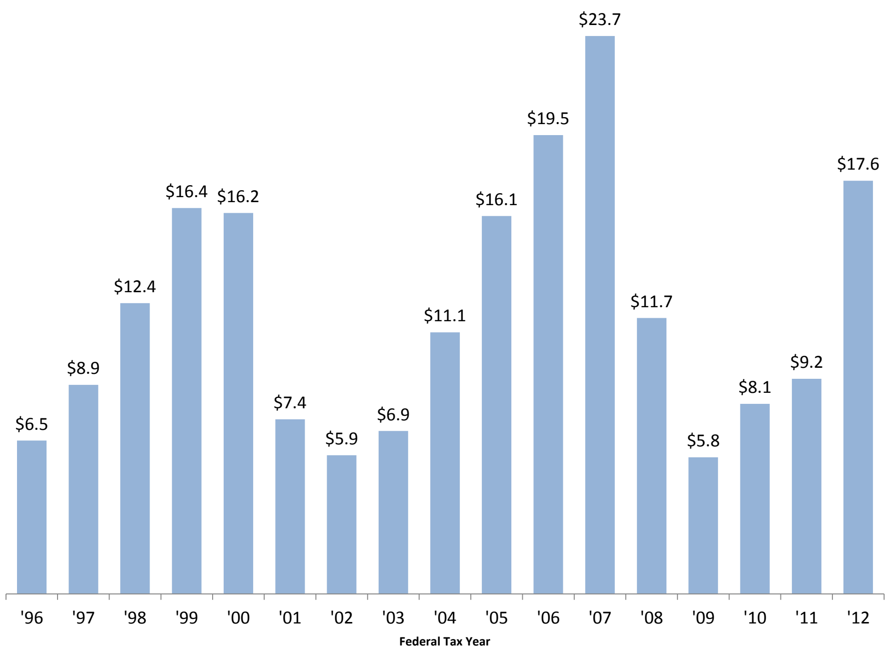
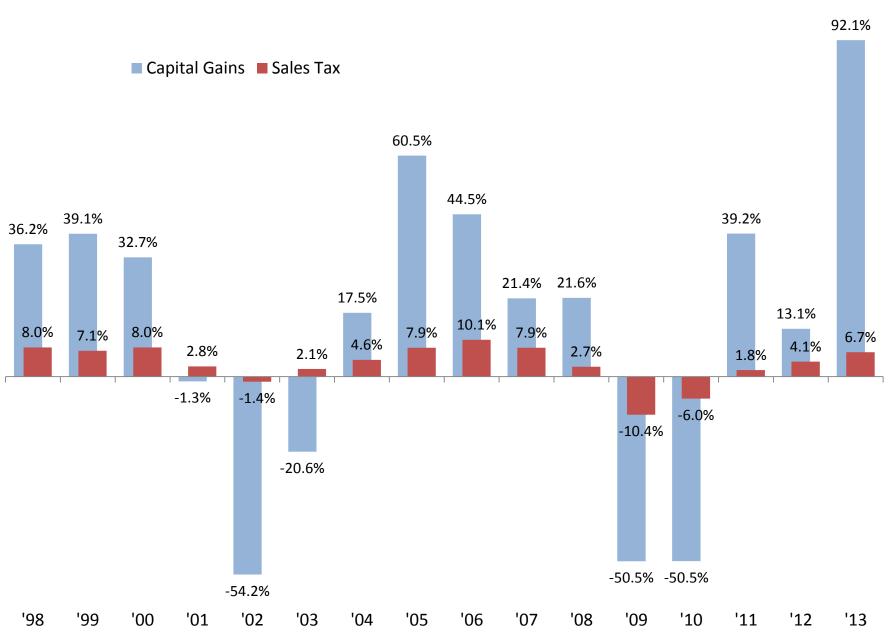


Chart 2: Annual percentage change in Washington capital gains versus the annual percentage change in state sales tax revenue



tax returns filed by Washington residents for the years 1996 through 2012. 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 residents. (A note on timing: the state would receive revenues from a tax on federal tax year 2012 capital gains in April of state tax year 2013.) 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 0.82.)

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." The governor does not propose dedicating any of the revenue from his capital gains tax to the rainy day fund. In fact his proposed 2015–17 budget would withdraw $450 million from the rainy day fund.

Impact of the capital gains tax on real estate

It seems likely that the capital gains tax will have a significant 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.

In some instances, the exemption for depreciable property used in a business or trade may apply to such investments. However, in many cases, the IRS regulations hold that a person who owns an interest in income-producing real estate is not engaged in a "trade or business." If the department of revenue follows these precedents, the gains will be taxed. This 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 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 move from Washington to a state with a much lower capital gains tax rate. 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. The negative impact will be much larger if moving away from the state makes these people less likely to invest in the state.

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" will reduce the funding for startups in the state. The state economy will be less dynamic.

Comment

Revenue from the governor's capital gains tax would be extremely volatile.

Supporters of the proposed tax like it because it targets the "one percent." 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. Both of these responses will reduce the dynamism of the state economy.

It is unlikely that the Legislature will enact the governor's capital gains tax proposal—or any other capital gains tax proposal—this session. However some sort of capital gains tax may well make it to ballot as an initiative in November 2016.

Appendix: A bit of history

In November 1932, Washington voters approved two initiatives. The first initiative (I-64) limited regular property taxes to 40 mills (four cents for each dollar of assessed value). I-64 also specified that property be assessed at 50 percent of market value.

The second initiative (I-69) established personal and corporate graduated income taxes. The constitutionality of the income taxes was immediately challenged, however, and the superior court ordered the state tax commission not to collect the taxes. As a result, the 1933 Legislature sought an alternate tax to replace the lost property tax revenue; it passed a temporary tax on business gross receipts that was to expire July 31, 1935. While the legislation (SHB 92) named this tax the occupation tax, today it is commonly called the business activities tax, to avoid confusion with the current business and occupation tax. The 1933 Legislature also voted to send a constitutional amendment allowing a graduated income tax to the November 1934 statewide ballot. (Voters rejected this amendment.)

As passed by the Legislature, the business activities tax featured 11 different rates, ranging from 0.1 percent (agricultural production) to 5.0 percent (license fees paid to societies of authors, composers and publishers). Governor Clarence Martin vetoed a paragraph imposing the 0.1 percent tax on agricultural production and a paragraph imposing a 0.6 percent tax on services and any type of business not explicitly covered by the act. (Without the second veto, the first veto would have increased the tax on agricultural production to 0.6 percent.) In 1934 the Legislature passed and Governor Martin approved HB 196, extending the business activities tax at a 0.5 percent rate to services and businesses not explicitly covered. This bill also explicitly exempted agricultural products and insurance premiums (which were already subject to the insurance premiums tax) from the business activities tax.

In September 1933, the state Supreme Court struck down the (I-69) income taxes; Culliton v. Chase, 174 Wash. 363, 25 P.2d 81 (1933). Citing the "peculiarly forceful constitutional definition" of property introduced by the 14th amendment, the Court (by a five to four majority) ruled income to be property and all income to fall into a single class of property that must therefore be taxed uniformly. Since the tax imposed by I-69 was not uniform, it was unconstitutional.

On the very same day (again by a five to four majority), the Court ruled the business activities tax to be constitutional as a tax on the privilege of doing business rather than a tax on the business's income; Stiner v. Yelle, 174 Wash. 402, 25 P.2d 91 (1933). Two of the four dissenting justices agreed with the majority that the business activities tax was not a tax on property. However, they believed, because agriculture and services were exempt, that the tax violates Article I, Section 12 of the state constitution: "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."

By framing the capital gains tax as a tax on either the privilege of selling or exchanging long-term assets, the governor's proposal attempts to deflect court challenge to the 7 percent rate as unconstitutionally high.

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