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Decrease Capital Gains Exclusion
(General Fund Taxes -- Income and Franchise Taxes)

[LFB 2009-11 Budget Summary: Page 254, #2]

CURRENT LAW

The initial step in calculating the state individual income tax is to make modifications to federal adjusted gross income (AGI) to reflect differences between federal and state law as to what sources of income are taxable. At the federal level, capital gains are generally taxed at a maximum rate of 15%, although the rate is reduced to zero for taxpayers in the two lowest tax brackets (10% and 15%). In Wisconsin, a capital gains exclusion is provided for 60% of the capital gain from the sale of assets held more than one year, unless the gain is realized on the sale of an asset to a family member or the gain results from the sale of qualifying small business stock, and the reduced amount is taxed at the same rate as the taxpayer's other income. The amount of capital losses that may be used to offset ordinary income is limited to $500 annually, with the remainder carried over to future years. At both the federal and state levels, gains from assets held one year or less are fully taxed.

GOVERNOR

Decrease from 60% to 40% the percentage of capital gains that is subtracted from federal adjusted gross income for purposes of calculating income subject to the individual income tax. Extend this treatment to taxable years beginning on January 1 of the year the budget bill takes effect, but delay the treatment to the succeeding year if the effective date of the bill is after August 31. At the time the budget bill was introduced, the administration estimated that this proposal would increase individual income tax collections by $85,100,000 in 2009-10 and $95,500,000 in 2010-11, assuming the modification would first apply to tax year 2009. The capital gains exclusion applies to income from the sale or disposition of assets held more than one year or acquired from a decedent.

DISCUSSION POINTS

1. Since the Governor introduced AB 75, the condition of the nation's economy has deteriorated, and the state is expected to collect less individual income taxes in the 2009-11 biennium than previously estimated. Consequently, the additional revenues likely to be realized by reducing the capital gains subtraction from 60% to 40% are also lower and are estimated at $75,400,000 in 2009-10 and $83,400,000 in 2010-11. Table 1 reports the estimated effect of the Governor's proposal and of proposals to reduce the subtraction to 50% and 30%, compared to current law and compared to the Governor's original estimates. The percentage could be changed to other levels to yield different revenue impacts.

TABLE 1

Effect of Reducing the 60% Capital Gains Exclusion Under Three Alternatives

Subtraction	Change to Current Law		Change to AB 75	
Rate	2009-10	2010-11	2009-10	2010-11
Original AB 75 Estimate	$85,100,000	$95,500,000		
40% (Alternative 1)	75,400,000	83,400,000	-$9,700,000	-$12,100,000
50% (Alternative 2a)	37,700,000	41,700,000	-47,400,000	-53,800,000
30% (Alternative 2b)	113,100,000	125,100,000	28,000,000	29,600,000

2. "Capital assets" include almost everything taxpayers own and use for personal or investment purposes. A capital gain or loss results when the capital asset is sold and equals the difference between the amount of the sale and the taxpayer's basis, which is typically the asset's purchase price. A gain occurs when the sale price exceeds the basis, and a loss results when the basis exceeds the sale price. The gain or loss is "long-term" if the asset has been held more than one year and "short-term" if the asset has been held for a year or less.

3. Prior to 1987, Wisconsin generally followed the federal treatment of capital gains. At that time, state and federal law provided an exclusion from AGI of 60% of all long-term capital gains. Short-term capital gains were taxed as ordinary income. Under the federal Tax Reform Act of 1986, the 60% capital gains exclusion for individuals was repealed, and all of a taxpayer's income, including any net capital gain, became taxable as ordinary income under the federal income tax. The 1987-89 biennial budget act (1987 Wisconsin Act 27) retained the 60% exclusion for long-term capital gains, but lengthened the holding period from six months to one year for Wisconsin tax purposes. As noted under "Current Law," long-term capital gains are now taxed at a lower rate than ordinary income for federal income tax purposes.

4. Among the 43 states and the District of Columbia that imposed a state individual income tax in 2007, 14 states followed federal practice and taxed all capital gains and provided a $3,000 limit on losses. New Hampshire completely exempted capital gains from taxation and Tennessee taxed only the gains from selling mutual funds. Alabama and Pennsylvania taxed capital gains, but specified that all losses were deductible in the year incurred. In addition, Pennsylvania

applied a separate state tax benefit rule with respect to unused losses, depreciation, and reduction of basis. Hawaii had a special alternative tax for capital gains. New Jersey did not permit any capital losses to be deducted from ordinary income. The remaining 24 states provided a variety of exclusions and deductions, such as Wisconsin's 60% exclusion for long-term gains and exemption of 100% of gains from the sale of a business to a family member and from the sale of qualifying small business stock.

5. A recent analysis in State Tax Notes of state tax treatment of capital gains characterized Wisconsin as one of nine states that "offer substantial tax breaks from income derived from capital gains." Table 2 summarizes these treatments, which consist of deductions or exclusions in six states, preferential tax rates in two states, and a tax credit in one state.

TABLE 2

Treatment of Long-Term Capital Gains in Nine States

State	Treatment
Arkansas	Exclude up to 30% of net long-term capital gains
Hawaii	Alternative tax on capital gains
Montana	Tax credit for 10% of net capital gains
New Mexico	Deduct the greater of 50% or $1,000 of federally taxable gains
North Dakota	Exclude 30% of long-term gains
Rhode Island	Taxed at lower rates than ordinary income
South Carolina	Exclude 44% of long-term gains
Vermont	Exclude 40% of net long-term capital gains
Wisconsin	Exclude 60% of net long-term capital gains

6. Over the years, the taxation of capital gains has been a controversial issue. Numerous changes at the federal level have occurred with respect to the percentage of the gain that is taxable, the tax rate on the gain, and the holding period for the gain. Since the Federal Tax Reform Act of 1986, cited above, the federal taxation of capital gains has changed nine times. The following material summarizes the arguments for and against preferential treatment that have accompanied those changes.

7. *Savings and Growth.* Excluding a portion of capital gains from taxation has the effect of decreasing the effective tax rate on the gain. Proponents of preferential treatment argue that a lower rate encourages savings and promotes economic growth. Opponents dispute these conclusions and indicate that economic theory is uncertain about the relationship between tax rates and saving. Further, by lowering the effective tax rate on capital gains, preference is conferred on one type of capital at the expense of other types of capital. One of the policy objectives of the Federal Tax Reform Act of 1986 was to promote tax neutrality across investments by narrowing the differences in tax burdens on different types of capital.

8. *Lock-In Effect.* One criticism of capital gains taxation is that investors may postpone realizing a gain to avoid additional taxes. In this way, investors are "locked-in" to their current investments. Theoretically, this behavior increases stock prices and impairs the efficiency of the capital market. Advocates of reduced tax rates on capital gains argue that lowering capital gains taxes unlocks substantial amounts of gains thereby increasing tax revenues. Some studies suggest that the "lock-in" effect may be exaggerated. First, gains may be realized by purchasing a new asset, which outweigh the "cost" of selling an existing asset. Second, the "lock-in" effect is not likely to distort stock prices because institutional investors control a large segment of the capital market. Nonetheless, the capital gains tax is acknowledged to impose an impediment to sales of assets by taxpayers with very high incomes.

9. *Tax Equity.* Tax equity can be defined as ensuring that taxpayers with similar economic circumstances have similar tax burdens. Taxing one source of income at a lower rate than another source of income would seemingly violate this principle since two taxpayers with identical incomes would bear different tax burdens if their sources of income differ. Opponents of preferential treatment argue that from an economic perspective, a dollar is a dollar, regardless of how it is earned, so income from capital gains should be treated like income from any other source. However, these criticisms may be too simplistic because they fail to consider other factors, such as inflation. Because capital gains must be held for more than one year to receive preferential treatment, the value of an asset's purchasing power is somewhat diminished over time due to the impact of inflation. A lower rate or an exclusion for a portion of the gain help offset the impact of inflation.

10. *Progressivity.* Tax equity is evaluated both in terms of horizontal equity, as described in the preceding point, and vertical equity. Vertical equity refers to the distribution of tax burdens among taxpayers with different economic circumstances. In a progressive tax system, the share of income paid in taxes increases as income rises, while the share of income paid in taxes falls as income rises in a regressive tax system. In its 2004 Wisconsin Tax Incidence Study, the Department of Revenue (DOR) found that in Wisconsin "total state and local taxes appear to be proportional to slightly progressive" and that "the individual income tax was the most progressive tax in the Wisconsin tax system." On one hand, the taxation of capital gain income contributes to progressivity because capital gain income is concentrated among high income taxpayers. On the other hand, the progressivity of the individual income tax is reduced due to the preferential treatment that is extended to income from capital gains. In 2006, only 22% of all Wisconsin filers reported capital gains income on their federal tax returns, but that percentage increased to 49% for filers with AGI between $100,000 and $200,000 and to 79% for filers with AGI of $200,000 or more.

11. Table 3 reports the distribution of capital gains income for Wisconsin taxpayers with incomes above and below $200,000 for federal income tax years 2002 through 2006. Between those years, capital gains as a percent of income was approximately ten times greater for taxpayers with incomes above $200,000, than for taxpayers with incomes below $200,000. Over the same period, 65% to 70% of all capital gains income accrued to taxpayers with incomes above $200,000. Finally, almost 80% of all taxpayers with incomes over $200,000 reported some capital gains income, while

only about 20% of all taxpayers with incomes below $200,000 reported any capital gains.

TABLE 3

Capital Gains Distribution by Income Class Based on Federal Individual Income Tax Returns Filed by Wisconsin Taxpayers, Tax Years 2002 - 2006

	Capital Gains as a Percent of Federal AGI for Income Class		Capital Gains for Income Class as a Percent of Statewide Capital Gains		Percent of Returns in Income Class with Capital Gains Income	
Tax Year	Under $200,000	Over $200,000	Under $200,000	Over $200,000	Under $200,000	Over $200,000
2002	1.4%	14.8%	34.3%	65.7%	19.8%	77.8%
2003	1.6	15.4	35.4	64.6	18.6	76.8
2004	2.0	18.5	33.9	66.1	20.8	79.6
2005	2.4	19.4	33.3	66.7	21.5	79.6
2006	2.7	22.5	30.2	69.8	21.2	79.4

Source: Internal Revenue Service, Statistics of Income Bulletin, Spring 2005 through 2008 and IRS website.

12. Table 4 reports the estimated distributional effects of the proposal on taxpayers by income class. Although based on information from tax year 2007, DOR has adjusted the data by reducing the number of affected taxpayers reporting gains, as well as the amount of those gains, to reflect current economic conditions. While taxpayers with Wisconsin adjusted gross income (WAGI) over $300,000 represent only 4.3% of the taxpayers reporting capital gains income, those taxpayers are projected to bear 41.8% of the estimated tax increase. Taxpayers with WAGI over $200,000 would bear 50.9% of the increase, but represent only 8.7% of the taxpayers with capital gains income, and taxpayers with WAGI over $70,000 would bear an estimated 76.3% of the increase, but represent only 44.8% of the affected taxpayers. While the average tax increase resulting from the proposal is estimated at $325, taxpayers with WAGI of $300,000 or more would experience increases averaging over $3,000. Finally, the table indicates how the percentage of taxpayers reporting capital gains income changes relative to income level. The percentage of taxpayers with capital gains income increases from 5.4% of all taxpayers with WAGI below $50,000, to 11.4% of all taxpayers with WAGI between $50,000 and $100,000, to 23.7% of all taxpayers with WAGI between $100,000 and $200,000, to 41.3% of all taxpayers with WAGI of $200,000 or more.

TABLE 4

Distribution of Taxpayers with a Tax Increase Under AB 75 Proposal to Decrease the Capital Gains Exclusion

Wisconsin Adjusted Gross Income	Taxpayers With a Tax Increase: Count	Percent of Count	Amount of Tax Increase	Percent of Amount	Average Increase	Count of All Returns	% of All Returns in AGI Class
Under $5,000	9,663	3.9%	$207,756	0.3%	$22	345,665	2.8%
5,000 to 10,000	6,927	2.8	312,865	0.4	45	263,941	2.6
10,000 to 15,000	5,347	2.2	192,269	0.2	36	212,780	2.5
15,000 to 20,000	9,047	3.6	804,011	1.0	89	191,541	4.7
20,000 to 25,000	8,429	3.4	804,677	1.0	95	179,699	4.7
25,000 to 30,000	12,016	4.8	2,831,918	3.5	236	166,691	7.2
30,000 to 40,000	26,729	10.8	3,508,572	4.3	131	283,322	9.4
40,000 to 50,000	22,412	9.0	3,492,565	4.3	156	224,322	10.0
50,000 to 60,000	19,940	8.0	4,365,550	5.4	219	186,831	10.7
60,000 to 70,000	16,622	6.7	2,620,894	3.2	158	159,464	10.4
70,000 to 80,000	13,365	5.4	2,376,637	2.9	178	130,073	10.3
80,000 to 90,000	13,071	5.3	2,012,593	2.5	154	102,086	12.8
90,000 to 100,000	11,570	4.7	1,983,913	2.5	171	77,801	14.9
100,000 to 150,000	37,594	15.1	8,652,477	10.7	230	173,287	21.7
150,000 to 200,000	13,943	5.6	5,413,583	6.7	388	44,189	31.6
200,000 to 250,000	6,847	2.8	3,567,633	4.4	521	17,412	39.3
250,000 to 300,000	4,146	1.7	3,792,586	4.7	915	9,306	44.6
300,000 and over	10,676	4.3	33,746,141	41.8	3,161	25,709	41.5
Totals	248,344	100.0%	$80,686,640	100.0%	$325	2,794,119	8.9%

SOURCE: Wisconsin Department of Revenue, 2007 Individual Income Tax Statistics.

13. The preceding items discuss arguments for and against the preferential treatment of capital gains at the "macro" level. The applicability of these arguments to the current proposal is diminished due to the lower rate of taxation at the state versus federal level. Also, the Governor's proposal would reduce, but not eliminate, the state's preferential treatment of capital gains. The examples in Table 5 seek to quantify the proposal's effect on taxpayers. Each year, DOR compiles aggregate statistics from state individual income tax returns filed for that year. For the 2007 tax year, almost 470,000 Form 1 filers claimed capital gains subtractions totaling over $5 billion. This equates to an average capital gain of $18,000 for all taxpayers, and the average gain for taxpayers with incomes over $1 million equaled about $900,000. For illustrative purposes, these amounts are rounded up to $20,000 for Taxpayer A and $1 million for Taxpayer B, and each taxpayer's state capital gains tax liability under current law and under AB 75 is displayed in Table 5. Both calculations assume the taxpayer is in the top income tax bracket, and the AB 75 impact uses the 7.75% tax rate proposed in the bill. For each taxpayer, AB 75 would increase the capital gains tax liability by 1.95%.

TABLE 5

Effect on the Tax Liability of Two Hypothetical Taxpayers of Reducing the Capital Gains Exclusion from 60% to 40%

	Taxpayer A		Taxpayer B	
	Current Law	AB 75	Current Law	AB 75
Capital Gain	$20,000	$20,000	$1,000,000	$1,000,000
Excluded	12,000	8,000	600,000	400,000
Taxable	8,000	12,000	400,000	600,000
Tax Rate	6.75%	7.75%	6.75%	7.75%
Tax Rate After Exclusion	2.70%	4.65%	2.70%	4.65%
Tax	540	930	27,000	46,500
- Change in Tax		390		19,500
- Percent Change in Tax		72.2%		72.2%
Change in Effective Tax Rate		1.95%		1.95%

14. Because the administration constructed AB 75 by individual decision item, it failed to consider the interactive effect of its capital gains and additional income tax bracket proposals. Based on the reestimated fiscal effects of the two proposals, their interaction would generate an additional $11.4 million ($5.3 million in 2009-10 and $6.1 million in 2010-11) in the biennium. If the exclusion was lowered to 50%, an additional $5.8 million would result ($2.7 million in 2009-10 and $3.1 million in 2010-11), and if the exclusion was lowered to 30%, an additional $17.2 million would result ($8.0 million in 2009-10 and $9.2 million in 2010-11).

ALTERNATIVES

1. Approve the Governor's recommendation and:

a. Decrease the estimated increase in individual income tax collections by $21,800,000 ($9,700,000 in 2009-10 and $12,100,000 in 2010-11) to reflect changes in economic conditions since the introduction of AB 75; or

ALT 1a	Change to Bill Revenue
GPR	- $21,800,000

b. Decrease the estimated increase by $10,400,000 (-$9,700,000 in 2009-10 and -$12,100,000 in 2010-11 to reflect changes in economic conditions since the introduction of AB 75 and +$5,300,000 in 2009-10 and +$6,100,000 in 2010-11 to reflect the interaction between the proposed change in the capital gains exclusion and the proposed additional income tax bracket).

ALT 1b	Change to Bill Revenue
GPR	- $10,400,000

2. Modify the Governor's recommendation by setting the percentage of capital gains excluded from taxation at 50% and:

a. Decrease the estimated increase in individual income tax collections by $101,200,000 ($47,400,000 in 2009-10 and $53,800,000 in 2010-11) to reflect a higher exclusion rate and changes in economic conditions since the introduction of AB 75; or

ALT 2a	Change to Bill Revenue
GPR	- $101,200,000

b. Decrease the estimated increase by $95,400,000 (-$47,400,000 in 2009-10 and -$53,800,000 in 2010-11 to reflect a higher exclusion rate and changes in economic conditions since the introduction of AB 75 and +$2,700,000 in 2009-10 and +$3,100,000 in 2010-11 to reflect the interaction between the proposed change in the capital gains exclusion and the proposed additional income tax bracket).

ALT 2b	Change to Bill Revenue
GPR	- $95,400,000

3. Modify the Governor's recommendation by setting the percentage of capital gains excluded from taxation at 30% and:

a. Increase the estimated increase in individual income tax collections by $57,600,000 ($28,000,000 in 2009-10 and $29,600,000 in 2010-11) to reflect a higher exclusion rate and changes in economic conditions since the introduction of AB 75; or

ALT 3a	Change to Bill Revenue
GPR	$57,600,000

b. Increase the estimated increase by $74,800,000 ($28,000,000 in 2009-10 and $29,600,000 in 2010-11 to reflect a lower exclusion rate and changes in economic conditions since the introduction of AB 75 and $8,000,000 in 2009-10 and $9,200,000 in 2010-11 to reflect the interaction between the proposed change in the capital gains exclusion and the proposed additional income tax bracket).

ALT 3b	**Change to Bill** Revenue
GPR	$74,800,000

4. Delete provision.

ALT 4	**Change to Bill** Revenue
GPR	- $180,600,000

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