Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

May 31, 2011 Joint Committee on Finance Paper #310

Policy Implications of Deferral for Capital Gain Reinvested in Qualified Wisconsin Businesses and Capital Gain Exclusion for Wisconsin Capital Assets (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2011-13 Budget Summary: Page 182, #1 and Page 183, #2]

CURRENT LAW

Under current law, an individual income tax exclusion is provided for 30% of the capital gain from the sale of assets held for more than one year, except for farm assets where the exclusion percentage is 60%. A 100% exclusion is provided for gains realized on the sale of business assets to a family member and for gains resulting from the sale of small business stock. Gains from assets held one year or less are fully taxed. Beginning in tax year 2011, a new deferral is provided for certain capital gains that are reinvested in certain new business ventures.

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. The state's top marginal income tax rate is 7.75%. Therefore, with the 30% exclusion, long-term capital gains are generally taxed at a maximum rate of 5.425%. The maximum effective tax rate is slightly higher for taxpayers who have income within the phase-out range for the sliding scale standard deduction. The maximum effective rate is lower for taxpayers in lower tax brackets.

GOVERNOR

Create two new income tax provisions for capital gains income.

Deferral of Capital Gains Reinvested in Wisconsin Businesses. Authorize state taxpayers to defer the taxation of any amount of a long-term capital gain if the taxpayer claiming the deferral: (a) deposits the gain into a segregated account in a financial institution; (b) invests all of the proceeds in the account in a qualified Wisconsin business within 180 days of the sale of the asset generating the gain; and (c) notifies the Department of Revenue (DOR) that the capital gain has been reinvested and, therefore, will not be declared on the claimant's income tax return. Tax on the deferred gain would be paid when the new investment is sold. This provision would first apply for tax years beginning after December 31, 2010, and would decrease revenues by an estimated $16.1 million in 2011-12 and $20.2 million in 2012-13. In order to be a "qualified Wisconsin business" for purposes of the deferral, a business would have to be certified by the Wisconsin Economic Development Corporation (WEDC), and would have to have at least 50% of its payroll and property in Wisconsin.

100% Exclusion for Gains on Investments in "Wisconsin Capital Assets." Create a 100% income tax exclusion for the taxpayer's qualifying gain from the sale of a Wisconsin capital asset that is purchased after December 31, 2010, and held for at least five years. With the required five-year holding period, this provision would first apply for taxable years beginning after December 31, 2015. Therefore, no fiscal effect is estimated for the 2011-13 biennium. DOR estimates that (in 2012-13 dollars) the exclusion would reduce individual income tax collections by $6 million in the first year of the phase-in (2016-17) and by approximately $79 million annually when fully phased in. Due to fluctuations in capital asset markets and the proposal's delayed effective date, these estimates are subject to substantial variation. "Wisconsin capital asset" would mean property that is located in this state and used in a Wisconsin business, or stock or other ownership interest in a Wisconsin business. A "Wisconsin business" would have to be certified by the WEDC and have at least 50% of its payroll and property in Wisconsin.

Additional detail about the proposed deferral and exclusion is provided in LFB Paper #311.

DISCUSSION POINTS

1. SB 27/AB 40 would create two new provisions regarding capital gains income. Another paper (#311) provides information about how the treatments could be structured. This paper provides information regarding the policy implications of the proposals. Approving the Governor's recommendations is presented as Alternatives 1a. and 1b., while removing the Governor's recommendations from the bill is offered as Alternatives 2a. and 2b.

Rationale for the Proposals

2. According to the Department of Administration (DOA), the proposed tax deferral for capital gains that are reinvested in a qualified Wisconsin business would have the effect of "providing a modest discount on the purchase price of Wisconsin-based assets that are purchased with capital gains realizations. All other conditions being held constant, Wisconsin-based businesses will be more attractive to an investor seeking to reinvest realized gains than businesses in other states. Even though the investor will eventually pay the deferred state taxes upon the sale of the subsequent investment, the present value of those taxes to the investor will be less due to the time value of money."

3. DOA indicates that the proposed exclusion for capital gains on Wisconsin assets is intended to increase "the attractiveness of Wisconsin-based investments by increasing the after-tax

return on those assets. All else being held constant, including the prospective returns from each investment, an investor would choose to invest in a state offering a complete exclusion from capital gains taxation over one that does not. Even in the case where the nominal rate of return of an investment in Wisconsin would be marginally lower than in another state, the exclusion may push the after-tax rate of return higher for the Wisconsin investment."

4. While such present value calculations are appropriate, other conditions cannot be held constant because each investment opportunity carries a different element of risk. After the stock market's contraction associated with the "dot.com" bubble, the S&P 500 rose 74%, from 860.0 in the first quarter of 2003 to 1,494.1 in the fourth quarter of 2007, but then decreased by 46% to 809.3 in the first quarter of 2009 as the market contracted due, in part, to the housing bubble. Since then, the S&P 500 has risen 61% to 1,302.7 in the first quarter of 2011. Such wide fluctuations in investment opportunities may eclipse the effect that the proposed state tax deferral or exclusion would have on investor decisions. Other asset markets and business ventures are also characterized by wide variations in risk and returns.

5. On the other hand, when investors make investment decisions, they often have an expected after-tax rate of return relative to the perceived risk associated with the investment. By effectively reducing the up-front cost of an investment, the proposed tax deferral would result in marginally higher rates of return, and make qualified Wisconsin investments more attractive relative to other investments viewed as having similar levels of risk. The proposed exclusion for gains on Wisconsin capital assets could also improve an investor's after-tax rate of return, compared to other investments. Consequently, the Governor's proposals could encourage investors to make investments in Wisconsin firms that they might not otherwise make.

6. The proposed modifications would only benefit investors who are required to pay Wisconsin income taxes on their capital gains income. Nonresidents who have capital gains on sales of real property in Wisconsin are subject to the Wisconsin income tax on such gains. However, investors in other states or countries who purchase stock in publicly-traded Wisconsin corporations are not subject to the Wisconsin income tax on gains realized from the sale of such stock. Likewise, individuals who reside in other states and realize a capital gain on the sale of an ownership interest in a Wisconsin partnership, limited liability company, or tax-option corporation are not subject to the Wisconsin income tax on such gains. Therefore, the impact of the proposed deferral and exclusion in attracting investment capital from outside of Wisconsin would be limited.

Federal Taxes on Capital Gains

7. For federal income tax purposes, 60% of the gain from the sale of long-term assets was excluded from taxation prior to 1987, but since then, capital gains have been fully included in income. However, capital gains are taxed under a federal tax rate schedule that differs from the tax rate schedule for ordinary income, and the rates applied to long-term capital gains are lower than the rates applied to ordinary income. For taxpayers whose ordinary income falls within the brackets corresponding to the 10% or 15% tax rates, dividends and long-term capital gains are not subject to tax in 2011 and 2012. For taxpayers in other brackets, dividends and long-term capital gains, other than collectibles, are taxed at a rate of 15%. After 2012, dividends are scheduled to be taxed like ordinary income, and long-term capital gains are scheduled to be taxed at a rate of 10% for

taxpayers subject to the bottom tax rate and 20% for taxpayers in other tax brackets. However, gains on assets held for more than five years will be taxed at 8% and 18%, respectively, depending on the tax bracket.

Capital Gains Tax Provisions in Other States

8. Among the 43 states and the District of Columbia that imposed a state individual income tax in 2009, 11 states followed federal practice and taxed all capital gains, and the treatment in ten other states was substantially similar to the federal treatment. The taxes in New Hampshire and Tennessee are imposed only on interest and dividend income. New Hampshire does not tax capital gains, and Tennessee taxes only certain capital gains from the sale of mutual funds. Five other states provide partial exclusions that are similar to Wisconsin's treatment, and the exclusions range from 30% to 50%. New Mexico offers the highest exclusion rate (50%), but the exclusion cannot exceed $1,000. Finally, Montana offers a nonrefundable tax credit equal to 2% of net capital gains. For a taxpayer subject to Montana's top marginal tax rate (6.9% for income over $15,400), the credit is equivalent to a 29% exclusion.

9. When capital assets held for more than one year are sold or exchanged, Wisconsin generally excludes 30% of the gain and taxes the remaining 70% as ordinary income, unless the asset has been used in farming where the exclusion rate is 60%. This treatment was adopted in 2009 Wisconsin Act 28, but prior to tax year 2009, the exclusion rate for all long-term capital gains was 60%. As noted above, the 30% exclusion reduces the effective tax rate on long-term capital gains from 7.75% to 5.425% for taxpayers in Wisconsin's top tax bracket. Among the 43 states and the District of Columbia imposing a state income tax in 2011, the top tax rate in 13 states is below 5.425% (see Table 1). As noted in the preceding and following points, some of these states also offer preferential treatment for long-term capital gains, but eight of the states either fully tax capital gains, follow the federal treatment, or employ a treatment similar to the federal treatment.

TABLE 1

States with a Top Individual Income Tax Rate Below 5.425%, 2011

State	Top Tax Rate	Capital Gain Treatment	State	Top Tax Rate	Capital Gain Treatment
Alabama	5.0%	taxable	Mississippi	5.0%	federal
Arizona	4.54	federal	New Hampshire	5.0	exempt
Colorado	4.63	targeted exclusion	New Mexico	4.9	general exclusion
Illinois	5.0	federal	North Dakota	4.86	general exclusion
Indiana	3.4	federal	Pennsylvania	3.07	similar to federal
Massachusetts	5.3	taxable	Utah	5.0	targeted exclusion
Michigan	4.35	similar to federal			

10. In tax year 2009, 13 states, including Wisconsin offered some type of preferential capital gain treatment for gains related to businesses or property located in that state. For example, Colorado excludes gains from the sale of real or tangible personal located there or from the sale of stock or an ownership interest in a Colorado company, provided the asset has been owned

continuously for five years prior to the transaction date. Montana exempts capital gains from small business investment companies that are organized for the purpose of diversifying and strengthening employment opportunities of Montana companies. The investment companies must make 75% of their investments in manufacturing and timber businesses located in Montana, and those manufacturing and timber companies must have at least 50% of their employees working in Montana.

Other Capital Gains Exclusions in Wisconsin

11. In addition to Wisconsin's capital gain exclusion for 60% of the capital gain from the sale of farm assets and 30% of the capital gain from the sale of other assets, Wisconsin offers preferential treatment for three specific types of long-term gains. First, a complete exclusion is provided for net long-term capital gains realized on the sale of business assets and assets used in farming to an eligible family member. Second, a 100% exclusion for long-term capital gains resulting from the sale of qualifying small business stock is also provided under state law. Finally, 2009 Wisconsin Act 28 created a deferral for up to $10 million for a long-term capital gain provided the claimant: (a) deposits the gain into a segregated account in a financial institution; (b) invests all of the proceeds in the account in a qualified new business venture within 180 days of the sale of the asset generating the gain; and (c) notifies DOR that the capital gain has been reinvested and, therefore, will not be declared on the claimant's income tax return. The deferred gain is subject to tax when the subsequent investment is sold. The Department of Commerce (WEDC under the budget bill) is required to certify qualified new business ventures, provided the businesses are engaged in: (a) developing a new product or business process; or (b) manufacturing, agriculture, or processing or assembling products and conducting research and development. Businesses desiring certification must submit an application in each taxable year for which certification is desired. The Act 28 deferral first applies in tax year 2011.

12. SB 27/AB 40 would add two new capital gains treatments to the special treatments described above. The proposed treatments would increase the complexity of state income tax filings. As the number of special tax treatments increases, the periodic evaluation of those treatments might be warranted. One way to achieve such an evaluation would be to sunset the proposed deferral and exclusion five years from their effective dates. Alternative 3 would sunset the proposed deferral for capital gains reinvested in qualified Wisconsin businesses effective for tax year 2016. Alternative 4 would sunset the proposed exclusion for capital gains from the sale of Wisconsin capital assets effective for tax year 2021. However, a sunset provision would create additional uncertainty for investors, which could mitigate the impact of the Governor's proposals.

Other Considerations

13. Historically, the preferential treatment of long-term capital gains is based on the recognition that gains accrue over a multi-year period and that fully taxing those gains when realized could move taxpayers into higher tax brackets. In response, investors would lock into longer investment holding periods, thereby postponing the "tax penalty." This behavior was thought to be harmful to capital markets. However, those arguments were made when the top federal tax bracket was 70% or higher. In 1982, the top rate was reduced to 50%, and when the federal Tax Reform Act of 1986 repealed the 60% federal capital gains exclusion, the top rate was reduced to

38.5%. Lowering the top federal tax rate was thought to reduce or offset the "lock in" effect. Another reason for the preferential treatment of capital gains income is that, in many cases, some portion of the gain reflects overall price inflation rather than real growth in the asset's value. It is argued that the portion of gain attributable to inflation is "illusory" and should not be subject to tax. However, inflation also affects wages, business income, and other types of income that are fully taxed, and the income tax code includes indexing provisions to address this issue.

14. As noted above, the federal tax rates on long-term capital gains are lower than the rates for wages, interest, and other types of income. This treatment, as well as Wisconsin's current capital gain treatment and the treatments proposed in the bills, runs counter to other proposals that are designed to simplify the tax code and broaden the tax base. Both the National Commission of Fiscal Responsibility and Reform (the Bowles-Simpson Commission) and the Debt Reduction Task Force of the Bipartisan Policy Center (the Domenici-Rivlin Report) propose to "tax capital gains and dividends as ordinary income, subjecting them to the same rates that apply to earned income." (Federal Funds Information for the States, "Deficit Commissions Recommend Changes that Carry Risks, Opportunities for States," Special Analysis 11-101, February 2, 2011.) Both proposals would eliminate a variety of exclusions, deductions, and credits, thereby broadening the tax base and permitting fewer tax brackets and lower tax rates.

15. Tax equity is defined both in terms of horizontal equity and vertical equity. Horizontal equity is achieved when taxpayers with similar economic circumstances bear similar tax burdens. If one taxpayer's income is from a source that is fully taxed while another taxpayer's income is from a source that is taxed at a lower rate or is exempted from taxation, then the first taxpayer might perceive that he or she is being treated unfairly. 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.

16. Preferential tax treatment of capital gain income decreases progressivity because capital gain income is concentrated among high income taxpayers. This is displayed in Table 2, which reports the distribution of the capital gains exclusions among Wisconsin taxpayers by income class for tax year 2009. This is the latest data available, but it may understate the current significance of the exclusion since the data reflects the effects of the recent economic recession. Between 2007 and 2009, the number of taxpayers claiming the exclusions decreased from 483,337 to 180,767. Nonetheless, the table displays how the exclusions are distributed by income class. Although taxpayers with adjusted gross income in excess of $150,000 represented only 10% of 2009 tax filers, they claimed 52% of the capital gains exclusions. In addition, the average exclusion and the percentage of filers claiming exclusions increases with each income class, after adjusted gross income exceeds $5,000.

TABLE 2

Distribution of Taxpayers with Capital Gains Exclusions by Income Class
Tax Year 2009

Wisconsin Adjusted Gross Income	Count	Percent of Count	Amount of Exclusions	Percent of Amount	Average Exclusion	Count of All Returns	% of All Returns in AGI Class
	Taxpayers With a Capital Gains Exclusion						
Under $5,000	16,588	9.2%	$73,024,655	8.3%	$4,402	487,407	3.4%
5,000 to 10,000	10,014	5.5	13,813,021	1.6	1,379	261,270	3.8
10,000 to 15,000	9,046	5.0	14,987,473	1.7	1,657	203,534	4.4
15,000 to 20,000	8,800	4.9	17,091,962	1.9	1,942	185,755	4.7
20,000 to 25,000	8,112	4.5	15,538,121	1.8	1,915	171,672	4.7
25,000 to 30,000	8,672	4.8	17,086,003	1.9	1,970	164,216	5.3
30,000 to 40,000	15,796	8.7	31,118,292	3.5	1,970	276,668	5.7
40,000 to 50,000	13,995	7.7	31,058,943	3.5	2,219	210,829	6.6
50,000 to 60,000	12,706	7.0	28,486,240	3.2	2,242	172,168	7.4
60,000 to 70,000	11,628	6.4	27,690,886	3.1	2,381	143,766	8.1
70,000 to 80,000	10,162	5.6	26,048,929	3.0	2,563	119,173	8.5
80,000 to 90,000	8,885	5.0	25,403,266	2.9	2,859	94,425	9.4
90,000 to 100,000	7,272	4.0	21,343,652	2.4	2,935	73,541	9.9
100,000 to 150,000	21,067	11.7	80,856,064	9.2	3,838	173,476	12.1
150,000 to 200,000	7,523	4.2	51,901,325	5.9	6,899	45,232	16.6
200,000 to 500,000	8,075	4.5	138,911,518	15.8	17,203	38,654	20.9
500,000 to 1,000,000	1,663	0.9	79,446,687	9.0	47,773	6,738	24.7
Over 1,000,000	763	0.4	187,899,590	21.3	246,264	2,949	25.9
Totals	180,767	100.0%	$881,706,627	100.0%	$4,878	2,831,473	6.4%

Source: Department of Revenue, 2009 Aggregate Statistics.

17. The data in Table 2 indicates that the proposed capital gain deferral and exclusion would likely reduce the progressivity of the state's individual income tax system because they are targeted to individuals with higher incomes. Having preferential tax treatment of capital gains also detracts from horizontal equity because taxpayers with similar amounts of income pay different amounts of tax, based on the source of income.

18. As noted, the proposed exclusion for gains on Wisconsin capital assets requires a five-year holding period and, therefore, could not be claimed until tax year 2016. The Department of Revenue estimates that the proposed exclusion would reduce individual income tax collections by $6 million in the first year of the phase-in (2016-17) and by $79 million annually when fully phased in. Therefore, the proposed exclusion represents an advance commitment and it would contribute to any structural deficit that may be projected for those years.

ALTERNATIVES

1. Subject to any modifications approved in Legislative Fiscal Bureau Paper #311, approve the Governor's recommendation to create:

a. A deferral for capital gains reinvested in qualified Wisconsin businesses; and/or

b. A 100% exclusion for capital gains on Wisconsin capital assets that have been held for at least five years.

2. Delete the Governor's recommendation to create:

a. A deferral for capital gains reinvested in qualified Wisconsin businesses; and/or

ALT 2a	**Change to Bill** Revenue
GPR	$36,300,000

b. A 100% exclusion for capital gains on Wisconsin capital assets that have been held for at least five years.

3. Sunset the proposed deferral for capital gains reinvested in qualified Wisconsin businesses effective for tax years beginning after December 31, 2015.

4. Sunset the proposed exclusion for capital gains from the sale of a Wisconsin capital asset effective for tax years beginning after December 31, 2021.

Prepared by: Rick Olin