

# Issues Raised by Income Tax Treatment of Capital Gains

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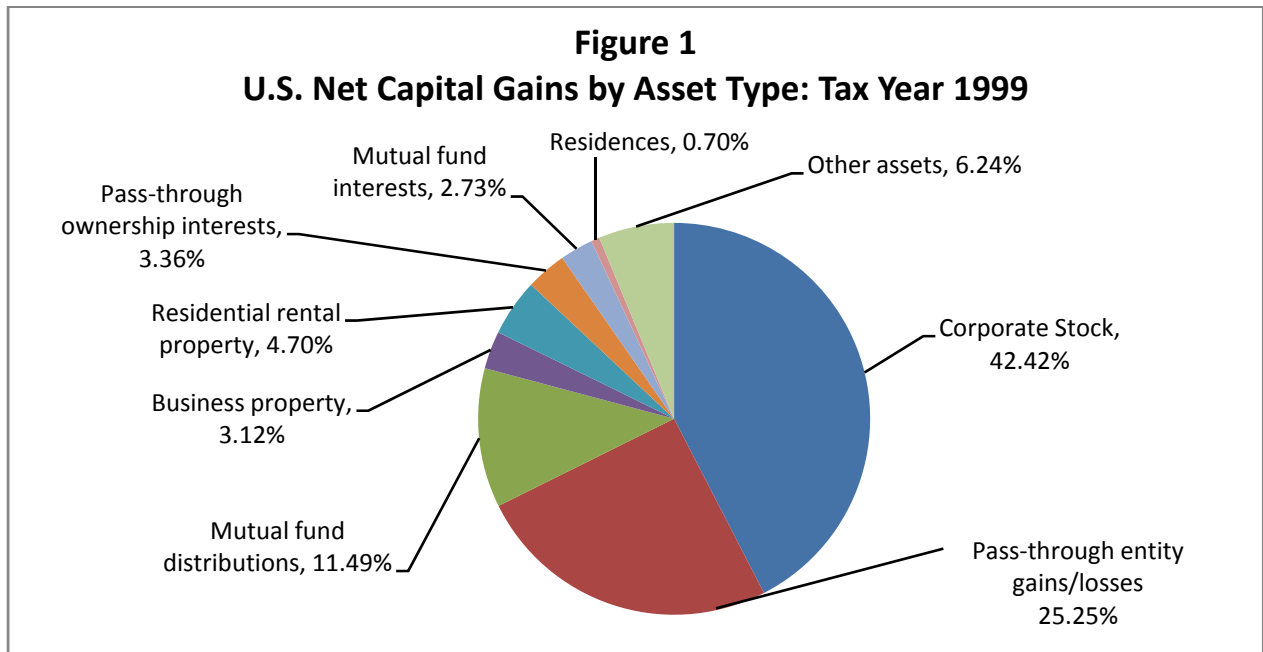
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## Background

Capital gains are defined as changes in the value of capital assets (most property not held for resale by taxpayers). Gains may accrue on a wide variety of assets. Figure 1 presents I.R.S. estimates of net capital gains by asset type for tax year 1999 for all U.S. individual income taxpayers. Gains on corporate stock are the single largest component at 42%. Pass-through entity distributions are next at 25% and mutual fund distributions are next at 11.5%. Only a small portion of gains on personal residences are subject to tax under federal and state law.

Over 90% of net capital gains in 1999 were classified as long term gains, i.e. the asset had been held for more than one year.



Source: I.R.S. Statistics of Income Division, Summer 2003 Bulletin, "Sales of Capital Assets Reported on Individual Income Tax Returns, 1999," Janette Wilson.

## **Present law: federal treatment of individuals**

The theoretically correct way to tax gains would be to tax them as they are accrued on a year-to-year basis. However, taxing unrealized gains can be problematic from an administrative standpoint since some assets may be hard to “mark to market.” Also, taxing unrealized gains may raise “ability to pay” problems for some taxpayers. Thus, federal tax law has traditionally taxed gains only upon realization. In the past, a partial exclusion of gains was allowed, but since 1987, realized gains are fully included in federal Adjusted Gross Income (“AGI”), but long term gains – on assets held for more than one year – are taxed at a lower rate than “ordinary” income. Long term gains are taxed at a maximum 15% rate. Capital losses can be used to offset capital gains and a maximum of \$3,000 of capital losses can offset ordinary income. Unused capital losses are carried forward to future years. Taxpayers may exclude up to \$250,000 (\$500,000 on joint returns) of gains on principal residences. This exclusion can be used multiple times, but only once in a given two-year period. Accrued gains on assets held at death are not taxed under the income tax, although they may be taxed under the estate tax. Capital gains of C-corporations are fully taxed at regular corporate rates.

The Obama Administration has proposed maintaining a preferential rate for capital gains, although it would be higher than that under present law. The maximum rate on long term capital gains would be 20% compared with a top rate of 39.6% on ordinary income.

## **Arguments for and against tax preferences for capital gains**

### ***Arguments for a tax preference:***

*Inflation:* Inflation erodes the purchasing power of gains. If tax were imposed on the full amount of nominal gains, the effective tax rate on real (after inflation) gains could be significantly higher than the statutory rate. Although the theoretically correct way to address this problem is “indexing” – i.e. increasing the “basis” or deductible value of the asset to reflect inflation, this option entails substantial administrative complexity.

*Administration and compliance:* The \$3,000 limit on the offset of capital losses against ordinary income forces taxpayers to delay the recognition of the losses, which reduces the present value of their tax deductions, effectively increasing the tax rate on gains income.

*Lock-in effects:* Taxing gains upon realization may create incentives for taxpayers to defer sale of assets, creating a lock-in effect. Economic inefficiency results if taxpayers put off sale of assets they would otherwise sell due to tax considerations. These incentives grow larger as a person approached the end of their life because of the income tax exclusion for gains passed on at death. A tax preference may help to reduce these inefficiencies.

*Behavior responses:* Economic evidence suggests that realizations are responsive to changes in tax rates, with larger responses in the short run than in the long run. This evidence has been cited to justify reducing tax on gains to stimulate investment. Evidence is unclear as to whether the increase in realizations in response to lower tax rates is sufficient to fully offset the revenue loss.

***Arguments against a tax preference:***

*Deferral:* When tax on gains is deferred until the asset is sold, the deferral reduces the “present value” of the tax. Deferral of tax until gains are realized effectively reduces the tax rate below the statutory rate, which would argue against the need for any further tax preference.

*Depreciation:*<sup>1</sup> The lock-in effect can be reversed in the case of depreciable assets. Capital gain on a depreciable asset is the sales price less the basis, and the basis is the original cost less the depreciation deductions already taken. The combination of depreciation allowances and the exclusion of a portion of capital gains could lead to a negative tax rate – i.e. depreciation deductions in excess of taxable income – which would create an incentive to sell rather than hold the asset. As a partial remedy for this problem, tax law has required that depreciation on equipment – which is usually more generous than real property depreciation -- be recaptured.

*Horizontal equity:* An argument can be made against preferential treatment of capital gains on the grounds that it unfairly favors one type of capital income over other types (and over labor income). As indicated in the following table, only a minority of assets qualify for the preferred capital gains treatment.

Asset category	Applicable Tax Rate	Tax Deferral?	Share of All Financial Assets
Deposits & Money Market Funds	Ordinary	No	12.6%
Taxable bonds	Ordinary	No	4.0%
Tax-exempt bonds	None	NA	1.5%
Corporate equity	Dividend/Capital Gains	Yes	23.2%
Mutual fund shares	Dividend/Capital Gains	Some	9.0%
Life insurance reserves	Ordinary	Yes	2.2%
Pension reserves	Ordinary	Yes	29.2%
Personal trusts	Ordinary	Yes	3.2%
Non-corporate equity	Capital Gains	Yes	13.0%
Miscellaneous	Varied	Possibly	2.0%

Source: James Poterba, “Taxation, Risk-Taking and Household Portfolio Behavior,” in Handbook of Public Economics, Vol. 3, A.J. Auerbach and M. Feldstein eds., 2002, Elsevier Science B.V.

*Income conversion:* Providing a lower tax rate for capital gains creates an incentive for taxpayers to convert ordinary income into capital gains. For example, employees could be

<sup>1</sup> See Gravelle, pages 133 – 136 for a thorough discussion of these issues.

compensated with stock rather than salary. Prior to the 1986 TRA, expenses on some investments could be deducted against ordinary income while the capital gains on the investment were taxed at lower tax rates.

***Summary:***

Taxation of capital gains has generated an enormous amount of research but a consensus of opinion remains elusive. Although economic evidence suggests that realizations are indeed responsive to tax rates – at least in the short run – many economists remain uncomfortable with the preferential treatment of capital gains. The appropriate treatment of capital gains raises a large number of questions about other aspects of the system of taxing capital income. Additionally, the institutional landscape for investments is continually changing, requiring a re-thinking of tax policy criteria. In any case, federal lawmakers seem to have concluded for the time being that a preferential rate should be maintained.

**State tax treatment and history**

Until the Tax Reform Act of 1986, exclusion was provided for 60% of capital gains income, reducing state income tax for those states like New Mexico that “piggyback” on federal AGI. Under present federal law, capital gains are fully included in income, thus they remain in the state income tax base of any state like New Mexico that piggybacks on the federal definition of AGI, even if given preferential treatment under federal law

New Mexico present law allows a deduction for the greater of \$1,000 or 50% of capital gains income. Until 2003, New Mexico provided a deduction not to exceed \$1,000 of capital gain income. Governor Richardson’s personal income tax reduction package included additional capital gain deductions, phased-in ten percent annual increments, reaching 50% percent of capital gain income in 2007 and subsequent years. The following table presents total capital gains realizations by New Mexico taxpayers and calculations of their state tax liability on those gains as well as estimates of the state revenue foregone due to the deduction. Realizations have fluctuated widely in recent years, falling by more than half in the “dot.com” bust, then growing by a factor of three during the 2004 to 2006 stock market boom.<sup>2</sup> Fiscal impacts of the deductions had reached \$68 million by tax year 2006. The table illustrates the difficulty of forecasting capital gains. The FIR for HB 167 in 2003 estimated 2006 gains would be \$1.2 billion, only 43% of the actual value of \$2.8 billion.

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<sup>2</sup> The growth from 2000 to 2001 is overstated in the table because of the delay in filing returns due to the Cerro Grande fire.

### New Mexico Fiscal Impacts of Capital Gains Realizations

Dollar amounts in millions.

Tax Year	Net Capital Gains Realizations	Estimated NM PIT due to C. Gains	Estimated Impacts of Percentage Deduction	Estimated Impacts of \$1,000 Deduction
1997	\$1,414	\$107	NA	NA
1998	\$1,561	\$116	NA	NA
1999	\$1,874	\$134	NA	(\$7)
2000	\$1,111	\$75	NA	(\$6)
2001	\$2,079	\$153	NA	(\$8)
2002	\$825	\$59	NA	(\$6)
2003	\$917	\$56	(\$6)	(\$6)
2004	\$1,503	\$75	(\$19)	(\$8)
2005	\$2,227	\$84	(\$36)	(\$7)
2006	\$2,781	\$90	(\$60)	(\$8)

Source: Capital gains realizations from I.R.S. Statistics of income Division  
Fiscal impacts calculated by NMTRI.

### Tax policy issues in the state taxation of capital gains

*Vertical equity:* As illustrated in the following table, capital gains are concentrated in higher income brackets and therefore the preferential rate can be criticized as regressive tax policy. Since the individual income tax is probably the most progressive element in the state's tax system, an argument could be made for preserving that progressivity by not providing a deduction for capital gains. The counter to this argument is that economists disagree on whether states should redistribute income and whether that redistribution should be carried out through the tax system. If states are too aggressive in redistributing income, they run the risk of creating a "race to the bottom," whereby higher-income taxpayers leave the state to avoid high tax burdens and low-income taxpayers are attracted to the state for enriched benefits. The end result might even be higher tax burdens for low-income households due to a shrinking tax base of high-income households.

**Individual Income Tax Returns of New Mexico Residents: 2006**

Item	All returns	Under \$50,000	Size of adjusted gross income			
			\$50,000 Under \$75,000	\$75,000 under \$100,000	\$100,000 Under \$200,000	\$200,000 or more
Total number of returns	887,176	646,552	106,295	59,336	58,554	16,439
Share of all returns	100.0%	72.9%	12.0%	6.7%	6.6%	1.9%
Returns with net capital gains	134,822	55,303	22,337	17,712	27,015	12,455
Amount of net capital gains (\$1,000)	\$2,781,309	\$152,308	\$106,855	\$132,899	\$417,364	\$1,971,882
Share of all capital gains	100.0%	5.5%	3.8%	4.8%	15.0%	70.9%
Capital gains as percent of AGI	7.1%	1.3%	1.6%	2.6%	5.4%	24.7%

Source: I.R.S. Statistics of Income division.

*Revenue elasticity:* Because capital gains constitute an especially volatile component of taxable income, allowing a deduction reduces to some degree the volatility of the state’s individual income tax collections. This means reducing the speed of growth during a boom period but reducing the rate of decline during a bust.

*Competitiveness:* Since capital gains represent a relatively large share of income for taxpayers in the highest income brackets, the lower tax rate may have influence the willingness of these taxpayers to live in New Mexico. One case has drawn particular attention in the policy debate, the case of an owner of a business with large amounts of accrued gains. This taxpayer could avoid state income tax entirely if they are willing to change their residence to a state with no income tax. Some have argued that New Mexico faces the loss of these taxpayers due to our higher tax on capital gains. While the basic logic of this argument is correct, it does not follow that it justifies the deduction in present law. If the concern is over this particular fact pattern, the state could target that type of transaction for tax relief without foregoing tax on all other capital gains. As illustrated in Figure 1, the vast majority of capital gains income derives from investments other than sole proprietor interests.

*Targeting:* Since the majority of capital gains income for most taxpayers derives from investments in financial assets that have no geographical connection with New Mexico, it could be argued that foregoing tax on this income provides little in the way of economic stimulus for the state.

*Blue Ribbon Tax Reform Commission:* In 2004, citing vertical equity in addition to adequacy and noting that the personal income tax cut package of 2003 reduced overall progressivity of the

tax system, the Commission recommended capping the capital gain deduction. In order to retain anticipated economic development benefits, the Commission also recommended exempting capital gains from the sale of closely held businesses.

### **What Do Our Neighbors Do?**

Other state treatment varies. The appendix that is a part of this presentation illustrates the tax treatment of capital gains in surrounding states, as well as their tax rate structures. Of the states imposing an income tax (TX and NV do not), California and Arizona do not provide tax preferences for capital gains, whereas Oklahoma, Colorado, and Utah do. Those three states provide more limited relief than New Mexico. All three states limit capital gain preferences to certain gains under varying but limited conditions that appear to be designed to promote investment and economic development.

### **Conclusions**

Capital gains represent a small and volatile component of total income. Gains account for about 5% of total income, but can be as much as 25% of income for those in the top income brackets. Between the bottom and the top of the business cycle, gains can grow by over 400% in the span of just a few years.

Federal tax law provides preferential treatment for capital gains in the form of a reduced tax rate. This policy is justified as an incentive to investment. Economic analysis of federal policy is largely inconclusive, but the Obama Administration has recommended a continuation of preferred treatment.

States take a varied approach to taxing capital gains. Some provide tax preferences, but most that do limit the preferences to investments within their state's borders.

New Mexico's current policy of excluding the greater of \$1,000 or 50% of capital gains is unusually generous compared with other states. The policy trades off reduced progressivity of the income tax in order to attract high-income taxpayers to live in the state. The capital gains deductions reduced state revenue by \$68 million in Tax Year 2006.

If the Legislature is contemplating changes in capital gains policy, the options include:

- Limiting tax relief to New Mexico investments, which would reduce cost and achieve some of the desired policy goals;
- Reducing or eliminating the deductions to restore some progressivity to income tax structure; or

- Expanding the deduction for economic development purposes. Although the current fiscal reality doesn't likely allow for that, it is a relatively "cheap" time to make the change because gains realizations will be low for the next year or two.

Policymakers should be aware that reducing or eliminating the deductions at this time will yield relatively little extra revenue because many taxpayers are realizing losses that limit their net income from capital gains. Additional revenue would grow after the economy returns to more normal growth.

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