

# POLICY BRIEF



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## Unchain the Gain

*Capital Gains Tax Policy and Arizona's Investment Climate*

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*“The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital... the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy.”*

-- President John F. Kennedy,  
1963

### Key Points

*Capital gains are highly cyclical and among Arizona's most volatile sources of tax revenue.*

*The federal government taxes capital gains income at a preferential rate, but Arizona taxes capital income at the same rate as ordinary income.*

*Evidence suggests that reductions to capital gains tax rates spurs economic growth by encouraging investment and generates incremental tax revenue as a result of that growth and the unlocking of pent up investment gains.*

### Introduction

The taxation of capital gains has been a subject of much debate in the United States since the enactment of the federal income tax in 1913. The debate continues today in Washington D.C. and in state legislatures across the country. Evidence suggests that reducing capital gains rates spurs economic growth by encouraging investment and generates incremental tax revenue as a result of that growth and the unlocking of investment gains that have built up over time. This debate has primarily been one at the federal level but can equally be an opportunity for the states to stimulate investment, jobs and ultimately tax revenue. This brief will explain the key points related to capital gains tax policy, compare the treatment of capital gains income at the state and federal levels, and identify the opportunity for potential reforms to the tax in Arizona.

### Types of Income

Income can be divided into two broad categories: ordinary income and investment income. For individuals, examples of ordinary income include salaries, wages, tips, and interest. Examples of investment income include dividends and capital gains. This brief will focus on the tax treatment of investment income, particularly capital gains.

### What is a Capital Gain?

A capital gain is realized when an investor sells a capital asset for a price that exceeds the acquisition cost (the basis) of the asset. Likewise, a capital loss is realized when an investor sells a capital asset for a price that is less than the basis. “Capital asset” is broadly defined by the IRS to include almost everything used for personal or investment purposes.<sup>1</sup> Examples of capital assets include household furnishings, vehicles, homes, and investments like stocks and bonds. For the purposes of this brief, capital asset will refer to assets used for investment purposes.

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To illustrate, consider a simple example whereby an investor purchases one share of Company A stock for \$20 and one share of Company B stock for \$40. The basis of the Company A stock is \$20 and the basis for the Company B stock is \$40. Two years later, the investor sells the Company A stock for \$30 and the Company B stock for \$35. The investor realizes a \$10 capital gain (\$30-\$20=\$10) on the Company A stock and a \$5 capital loss (\$35-\$40=-\$5) on the Company B stock. The \$10 gain is partially offset by the \$5 loss, so for income tax purposes the investor reports a \$5 net capital gain.

**Federal Tax Treatment of Capital Gains: Individual Income**

The taxation of long term capital gains income began in 1913 with the enactment of the Federal income tax. Prior to 1922, capital gains income was taxed at the same rate as ordinary income but for 87 of the next 90 years, capital gains revenue has been taxed at a lower rate than ordinary income. During this time, the top capital gains tax rate has fluctuated between 12.5% and 35% while the top ordinary income tax rate reached 92% in the early 1950's.<sup>2</sup>

As table #1 shows, the United States currently taxes net long term capital gains income at a lower rate than ordinary income and short term capital gains. A capital gain is considered long term if the investor held the asset for one year or longer.

*Capital Loss Carryover*

If capital losses exceed capital gains during a given year, up to \$3,000 of the net capital loss can be deducted from gross income for that year. If an investor's net capital losses for a given year exceed \$3,000, the balance can be carried forward and deducted from gross income in future years. For example, consider a married couple who earned \$50,000 in 2010 and sold a portfolio of stocks at a \$5,000 loss. On their 2010 tax return, the couple would be allowed to reduce their income to \$47,000. Additionally, they will be allowed to reduce 2011 income by the remaining \$2,000.

*Primary Residence*

Gains realized through the sale of real property are subject to capital gains taxation, except that taxpayers may exclude up to \$250,000 (\$500,000 if married and filing jointly) of a gain derived from the sale of a primary residence. In order to exclude this income, the taxpayer must have owned and lived in the home for at least two out of the previous five years.

**Federal Tax Treatment of Capital Gains: Corporate Income**

Unlike capital gains earned by individuals, capital gains earned by corporations are not taxed at a preferential rate. Instead, the income is subject to the marginal corporate tax rates, as outlined in table #2.

**Table #1**  
Federal Individual Ordinary Income and Capital Gain Tax Rates by Income Level  
(Taxpayer is Married and Filing Jointly)

Annual Income	Ordinary Income/Short Term Capital Gain Rate	Long Term Capital Gains Rate
Less than \$17,000	10%	0%
\$17,000 - \$69,000	15%	0%
\$69,000-\$139,350	25%	15%
\$139,350-\$212,300	28%	15%
\$212,300-\$379,150	33%	15%
More than \$379,150	35%	15%

Source: Tax Foundation. Federal Individual Income Tax Rates History and Federal Capital Gains Tax Rates 1988-2011.

**Table #2**  
Federal Corporate Income Tax Rate by Income Level

Annual Income	Ordinary Income/ Capital Gain Rate
Less than \$50,000	15%
\$50,000 - \$75,000	\$7,500 + 25% of amount over \$50,000
\$75,000-\$100,000	\$13,750 + 34% of amount over \$75,000
\$100,000-\$335,000	\$22,250 + 39% of the amount over \$100,000
\$335,000-\$10,000,000	\$113,900 + 34% of the amount over \$335,000
\$10,000,000-\$15,000,000	\$3,400,000 + 35% of the amount over \$10,000,000
\$15,000,000-\$18,333,333	\$5,150,000 + 38% of the amount over \$15,000,000
More than \$18,333,333	35%

Source: IRS Form 1120.

Prior to the Tax Reform Act of 1986, an alternative tax rate system did exist for corporate capital gains and the rate fluctuated between 25% and 30%.<sup>3</sup>

## Rationale for Taxing Capital Gains at a Reduced Rate

### Inflation

Governments levy a tax on capital gains income in order to capture a portion of the profit that is realized when an asset increases in value. However, the capital gains tax is levied on the nominal increase in the value of the capital asset rather than the inflation-adjusted real value. For example, consider an asset that increased in value by 20% from \$100 to \$120 over a two year period. Assuming 5% annual inflation over this time period, \$10.25 of this increase is due to the effects of inflation while the remaining \$9.75 is due to the change in value of the underlying asset. However, the capital gains tax is applied to the full \$20 increase rather than the \$9.75 real increase in value. Lower capital gains tax rates reduce, but do not eliminate, the impact of this inflation tax.

### Lock-In Effect

The capital gains tax is the money that must be paid to the government in order to liquidate an asset that increased in value. No tax liability is generated until a transfer of ownership occurs, so tax can be deferred by simply holding onto the asset. This disincentive to realize gains by selling assets can lead to a misallocation of capital within the economy.

For example, consider a start-up company that is seeking a \$1 million investment. An investor with a \$1 million investment portfolio meets with the company and is willing to provide the \$1 million in capital. However, in order to make the investment in the start-up, the investor needs to realize capital gains on previous investments. The sale generates a tax liability and reduces the amount of capital that is available to make the investment. As a result, the investor may elect to forego investment in the startup until the portfolio grows by an amount that would generate \$1 million in after-tax income. This incentive to hold assets in order to avoid the generation of tax liability is known as the “lock-in effect” and it reduces economic efficiency by inhibiting the free flow of capital to otherwise profitable investment opportunities. Lower capital gains tax rates reduce, but do not eliminate, the negative impacts of the lock-in effect.

## Recent Capital Gains Tax Cuts

In the past fifteen years, Congress has twice reduced the tax rate on capital gains income. In 1997, President Clinton signed the *Taxpayer Relief Act of 1997* which included a reduction in the top capital gains tax rate from 28% to 20%. As shown in table #3, both capital gains realizations and tax revenues increased in the years following the tax cut.<sup>4</sup>

When the U.S. economy experienced a mild recession during the early 2000’s, capital gains realiza-

**Table #3**  
Federal Capital Gain Realizations and Tax Revenues  
(Billions of 2008 Dollars)

Year	Top Long Term Tax Rate	Capital Gains Realizations	Capital Gains Tax Revenue
1996	28%	\$355	\$90
1997	28%/20%	\$482	\$105
1998	20%	\$575	\$115
1999	20%	\$703	\$142
2000	20%	\$802	\$158
2001	20%	\$421	\$79
2002	20%	\$315	\$58
2003	20%/15%	\$373	\$59
2004	15%	\$562	\$82
2005	15%	\$757	\$112
2006	15%	\$847	\$125
2007	15%	\$950	\$141
2008	15%	\$498	\$69

Source: U.S. Department of Treasury, Office of Tax Analysis, December 30 2010.

tions fell to \$315 billion and revenues fell to \$58 billion. In the aftermath of that recession, Congress passed and President Bush signed the *Jobs and Growth Tax Relief Reconciliation Act of 2003*. The legislation further reduced the top capital gains tax rate from 20% to 15%. During the subsequent years, investors “unlocked” billions of dollars of capital by selling assets and realizing capital gains. As a result, both capital gains realizations and tax revenues rose steadily from 2003 to 2007 before declining sharply in 2008 as a result of the financial crisis. Additionally, critical U.S. business investment in fixed assets, equipment and software, and structures grew from \$1.6 trillion to \$2.2 trillion between 2003 and 2006.<sup>5</sup>

### State Tax Treatment of Capital Gains

Arizona is among the majority of states that do not provide broad preferential treatment to capital gains income. Arizona makes no tax distinction between ordinary and capital income. As a result, individual capital gains are taxed according to the individual income tax brackets and corporate capital gains are taxed at the 6.968% corporate income tax rate. Earlier this year, Arizona did enact a targeted capital gains tax exclusion for small business investments. Starting in tax year 2014, capital gains derived from investments in businesses with less than \$10 million in assets will be fully excluded from Arizona income tax.<sup>6</sup>

Eight states provide broad preferential tax treatment to capital gains income. There are two primary techniques used by states to reduce the effective tax rate on capital gains income. One technique is to follow the lead of the federal government by creating a separate tax rate for capital gains income. The other, more popular option is to exclude or deduct a portion of the capital gain. This has a similar effect as reducing the rate.

#### Arkansas

Since 1999, Arkansas taxpayers have been able to exclude 30% of net capital gains from income. The remaining 70% is taxed at the ordinary income tax rate, resulting in an effective tax rate of 4.9%.<sup>7</sup>

#### Hawaii

Since 1987, Hawaii has taxed capital gains income at a preferential rate. The top capital gains rate is 7.35%, compared to a top individual income tax rate of 11%.<sup>8</sup>

#### Montana

Capital gains are taxed as ordinary income and in 2003 Montana created a tax credit equal to 1% of net capital gains. This credit increased to 2% in 2007, resulting in an effective tax rate of 4.9%.<sup>9</sup>

#### New Mexico

In 2003, New Mexico enacted a capital gains income tax exclusion. It was expanded in 2007, and is equal to the greater of:

- The taxpayer’s net capital gain, up to \$1,000
- 50% of the taxpayer’s net capital gain. This results in an effective tax rate of 2.85%.<sup>10</sup>

#### North Dakota

North Dakota enacted a 30% income tax exclusion for net long term capital gains in 2001, resulting in an effective tax rate of 3.88%.<sup>11</sup>

#### South Carolina

Since 1991, South Carolina has offered a 44% deduction of net long term capital gains income. This results in an effective tax rate of 3.92%.<sup>12</sup>

**Table #4**

Arizona Individual Income Tax Rate by Income Level  
(Taxpayer is Married and Filing Jointly)

Annual Income	Individual Income Tax Rate
Less than \$20,000	2.59%
\$20,001 - \$50,000	2.88%
\$50,001-\$100,000	3.36%
\$100,001-\$300,000	4.24%
More than \$300,000	4.54%

Source: Tax Foundation. *State Individual Income Tax Rates, 2000-2011*.

## Vermont

Vermont has provided special treatment for capital gains income since 2002. Starting in tax year 2011, taxpayers in Vermont will be able to reduce taxable income by either:

- \$5,000 of net long term capital gain income or
- 40% of net long term capital gains derived from the sale of business assets held for at least 3 years. This results in an effective tax rate of 5.37%.<sup>13</sup>

## Wisconsin

Prior to 2009, Wisconsin provided for a 60% deduction of net long term capital gains income. In 2009, the deduction was reduced to 30%, resulting in an effective tax rate of 4.73%. In July of 2011, Wisconsin enacted two additional changes to the tax treatment of capital gains income:

- Long term capital gains are fully excluded from income tax if they are reinvested in Wisconsin-based companies.
- Capital gains earned on investments in Wisconsin based companies will be fully excluded if the asset is held for at least five years.<sup>14</sup>

Table #5 provides a summary of the effective tax rates from above.

**Table #5**

Effective State Tax Rates on Capital Gains Income

State	Top Marginal Rate	Effective Rate on Capital Gains
Arkansas	7.0%	4.9%
Hawaii	11%	7.35%
Montana	6.9%	4.9%
New Mexico	4.9%	2.85%
North Dakota	4.86%	3.88%
South Carolina	7.0%	3.92%
Vermont	8.95%	5.37%
Wisconsin	7.75%	4.73%

## New Mexico Capital Gains Tax Cut

In 2003, New Mexico enacted major tax reform that cut the capital gains tax by half and phased in a reduction in the individual income tax rate from 8.2% to 4.9%. The package passed through the legislature with just two dissenting votes and was signed into law by Governor Bill Richardson.

In the years since, New Mexico has experienced steady improvement in the state's per capita personal income rank. The year 2003 marked the fourth consecutive year that New Mexico ranked 47th in per capita personal income, but by 2009 the state had climbed to 42nd. Like most of the states, New Mexico personal income grew during the mid 2000's from \$25,748 in 2003 to \$33,389 in 2008. However, the improvement in rank indicates that New Mexico performed better relative to the rest of the country. Even during the recent recession caused per capita personal income to decline to \$32,992 in 2009, New Mexico's rank improved from 43 to 42.<sup>15</sup>

## Capital Gains and Arizona's Budget

Capital gains tax revenues are among the most cyclical sources of government funding. A recent report from the Seidman Research Institute at Arizona State University found that on average between 1988 and 2009, capital gains generated \$300 million annually for Arizona's general fund (in inflation adjusted 2009 dollars). However, in a strong economy capital gains generated as much as \$725 million and in a weak economy as little as \$125 million. Similar revenue fluctuations existed across the U.S. during this time period, but Arizona's exposure to the real estate boom of the mid 2000's drove capital gains even higher than the national average.<sup>16</sup> For state policy makers, it is important to understand this fluctuation and its impact on state finances. The roots of structural budget deficits can often be traced to permanent spending increases that are enacted during periods of economic expansion that generate high levels of tax revenue. When the revenue growth slows but the spending continues, the result is a budget deficit. The volatility of capital gains tax revenue in particular contributes to this dynamic. Financing government through more stable sources such as income and sales taxes would reduce this risk as both are less sensitive to fluctuations in the economy.

## Possible Capital Gains Reforms in Arizona

By aligning more closely with the federal government on the taxation of capital gains, Arizona would be able to address some of the distortions and disincentives created by capital gains taxes while providing a more competitive environment for capital investments. One potential reform is to discount the tax rate on capital gains income using the same proportion of ordinary to capital income as the federal government. For the top federal income

tax bracket of 35%, the capital gains income tax rate is discounted by 57%. Applying that same discount to the top Arizona income tax bracket would yield a top capital gain rate of 1.95%. Additionally, the federal capital gains rate for those earning less than \$69,000 is 0%. Using that model and Arizona's existing tax brackets, the rate could be reduced to 0% for those earning less than \$50,000. Alignment with the federal government could also be achieved using an exclusion or deduction rather than a rate reduction. The same effective tax rate would be achieved by excluding or deducting 57% of capital gains income.

### **Conclusion**

In light of the recent economic downturn, Arizona policy makers have shown a strong desire to create a more diverse and sustainable state economy. In order to make this transition, Arizona needs to be an attractive location for investment capital to flow. Reducing the tax burden on capital income in Arizona could improve the efficiency of capital allocation in the economy and create more profitable investment opportunities that could serve as the catalyst for the transformation of Arizona's economy.

## Notes

<sup>1</sup> Internal Revenue Service. <http://www.irs.gov/taxtopics/tc409.html>

<sup>2</sup> "Individual Capital Gains Income: Legislative History." Congressional Research Service. May, 2006. Accessed at <http://opencrs.com/document/98-473/2006-05-18/>.

<sup>3</sup> "The Character and Determinants of Corporate Capital Gains." Mihir Desia and William Gentry. November 2003. Accessed at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=472181](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=472181).

<sup>4</sup> "Capital Gains and Taxes Paid on Positive Capital Gains 1954-2008." U.S. Department of Treasury, Office of Tax Analysis. December 30, 2010. Accessed at <http://www.treasury.gov/resource-center/tax-policy/Documents/OTP-CG-Taxes-Paid-Pos-CG-1954-2008-12-2010.pdf>.

<sup>5</sup> "The Bush Capital Gains Tax Cut after Four Years: More Growth, More Investment, More Revenues." Stephen Moore and Tyler Grimm. January, 2008. Accessed at <http://www.ncpa.org/pub/st307>.

<sup>6</sup> Arizona Revised Statutes 43-1022.

<sup>7</sup> Arkansas Department of Finance and Administration. [http://www.dfa.arkansas.gov/offices/policyAndLegal/Documents/moving\\_2\\_arkansas.pdf](http://www.dfa.arkansas.gov/offices/policyAndLegal/Documents/moving_2_arkansas.pdf)

<sup>8</sup> "Small Business and Entrepreneurship Council's 2011 Business Tax Index." Accessed at <http://www.sbecouncil.org/businessstaxindex2011/report.pdf>.

<sup>9</sup> Montana Department of Revenue Office of Tax Policy and Research. [http://revenue.mt.gov/content/committees/2011-legislative-session/schedule\\_d\\_and\\_e\\_income\\_study.pdf](http://revenue.mt.gov/content/committees/2011-legislative-session/schedule_d_and_e_income_study.pdf)

<sup>10</sup> New Mexico Taxation and Revenue Department. [http://www.tax.newmexico.gov/SiteCollectionDocuments/Tax-Library/Tax-Policy-and-Revenue-Program-History/Presentations-and-Reports/FY09-Presentations/rstp\\_presentation\\_7-15-09\\_capital\\_gains\\_taxation\\_7-9-09.pdf](http://www.tax.newmexico.gov/SiteCollectionDocuments/Tax-Library/Tax-Policy-and-Revenue-Program-History/Presentations-and-Reports/FY09-Presentations/rstp_presentation_7-15-09_capital_gains_taxation_7-9-09.pdf)

<sup>11</sup> North Dakota Office of State Tax Commissioner. [http://www.nd.gov/tax/indincome/pubs/newsletter/nl\\_01-06.pdf](http://www.nd.gov/tax/indincome/pubs/newsletter/nl_01-06.pdf)

<sup>12</sup> South Carolina Department of Revenue. <http://www.sctax.org/Publications/mov2sc.html>.

<sup>13</sup> Vermont Department of Taxes. [http://www.gfc.com/pdf/Tax%20Services/2011-03-15\\_01\\_VT\\_changes\\_tax\\_to\\_capital\\_gains.pdf](http://www.gfc.com/pdf/Tax%20Services/2011-03-15_01_VT_changes_tax_to_capital_gains.pdf)

<sup>14</sup> Wisconsin Budget Project. [http://www.wccf.org/pdf/capital\\_gains\\_taxation.pdf](http://www.wccf.org/pdf/capital_gains_taxation.pdf). Wisconsin Department of Revenue. [http://www.revenue.wi.gov/news/20110627\\_01.pdf](http://www.revenue.wi.gov/news/20110627_01.pdf).

<sup>15</sup> "Governor Richardson's Positive Economic Legacy: New Mexico Personal Income Growth Shows Upward Prosperity since 2003 Tax Cuts." Rio Grande Foundation. July 2010. Accessed at [http://www.riograndefoundation.org/downloads/rgf\\_personal\\_income\\_study.pdf](http://www.riograndefoundation.org/downloads/rgf_personal_income_study.pdf).

<sup>16</sup> "Capital Gains in Arizona and the Effect on State Government General Fund Revenues." Dennis Hoffman. July 2011. Accessed at <http://wpcarey.asu.edu/seid/ccpr/upload/Capital-Gains-Final.pdf>.