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ISSUE BRIEFS: HOW STATES CAN TAX WEALTH

State Taxes on Capital Gains

By Elizabeth McNichol

A historically large share of the nation's wealth is concentrated in the hands of a few. As a result, millions of American families have less wealth, and therefore fewer opportunities, than they otherwise would. Further, since wealthy people are overwhelmingly white, this extreme wealth concentration reinforces barriers that make it harder for people of color to make gains. One way states can build more broadly shared prosperity is by strengthening their taxes on capital gains — the profits an investor realizes when selling an asset that has grown in value, such as shares of stock, mutual funds, real estate, or artwork.

Most state and local tax systems are upside down: the wealthy pay a *smaller* share of their income in these taxes, on average, than low- and middle-income people do, even though they are best able to afford to pay more. Capital gains, which go overwhelmingly to the wealthiest households, receive special tax preferences in a number of states, such as a partial exemption. States with such preferences should eliminate them. States also have several options to boost capital gains revenue to support investments that benefit the state as a whole.

How Are Capital Gains Taxed?

While the value of an asset can increase in each year that it is owned, the capital gain is taxed only when the asset is sold. For example, consider a taxpayer who bought 100 shares of stock for $10 each (total cost of $1,000) and sold them for $15 each (total value of $1,500). The increase in value of $500 is the amount of capital gains income "realized" by the taxpayer. If the sale occurs within a year of the purchase, these are considered short-term capital gains for tax purposes; if more than a year after purchase, they are considered long-term gains. Under current state and federal law, these capital gains are reported and taxed as income in the year that they are realized.

The amount of capital gains (and thus, the revenue generated by taxing them) varies by state, depending in large part on the state's relative wealth. (See Table 1.)

Some States Have Tax Preferences for Capital Gains

The federal government taxes income generated by wealth, such as capital gains, at lower rates than wages and salaries from work. The highest-income taxpayers pay 40.8 percent on income from work but only 23.8 percent on capital gains and stock dividends.[1]

While most states tax income from investments and income from work at the same rate, nine states — Arizona, Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont, and Wisconsin — tax all long-term capital gains *less* than ordinary income.[2] These tax breaks take different forms. Typically, these states allow taxpayers to exclude some or all of their capital gains income from their taxable income, but others levy a lower rate than the state tax on ordinary income or provide a credit equal to a percentage of the taxpayer's capital gains. (See Table 2.) In addition, a handful of states (including Colorado, Idaho, Louisiana, and Oklahoma) provide breaks only for capital gains on investments in in-state businesses, and a few states target preferences to investments in specific industries, like technology businesses in Virginia and the livestock industry in Kansas.[3]

Capital Gains Go Overwhelmingly to Wealthy, White Households

Capital gains are generated by wealth. Because wealth is highly concentrated, so is capital gains income. About 80 percent of capital gains go to the wealthiest 5 percent of taxpayers; 69 percent go to the top 1 percent of taxpayers.[4] (See Figure 1.) Wealthy households are disproportionately white: white families are three times likelier than families of color to be in the top 1 percent.[5]

Capital Gains Tax Breaks Don't Drive State Economic Growth

Proponents of capital gains tax breaks often argue that they spur economic growth by encouraging investment. But historically, "there is no obvious connection between tax rates on capital gains and economic growth" at the national level, tax policy expert Leonard Burman notes.[6] There is even less reason to expecting a *state* tax break on capital gains to boost the state's economy. The companies, bonds, and other assets generating capital gains for a state's residents could be

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[1] The 23.8 percent figure includes the top tax rate on capital gains plus the 3.8 percent tax on investment income for high-income taxpayers, which helps fund the Affordable Care Act's health coverage expansions.

[2] "The Folly of State Capital Gains Tax Cuts," Institute on Taxation and Economic Policy, August 2016,https://itep.org/wp-content/uploads/Capital-Gains-2016.pdf.

[3] The legality of limiting capital gains tax reductions to in-state investments has been questioned, as it may violate the U.S. Constitution's interstate commerce clause.

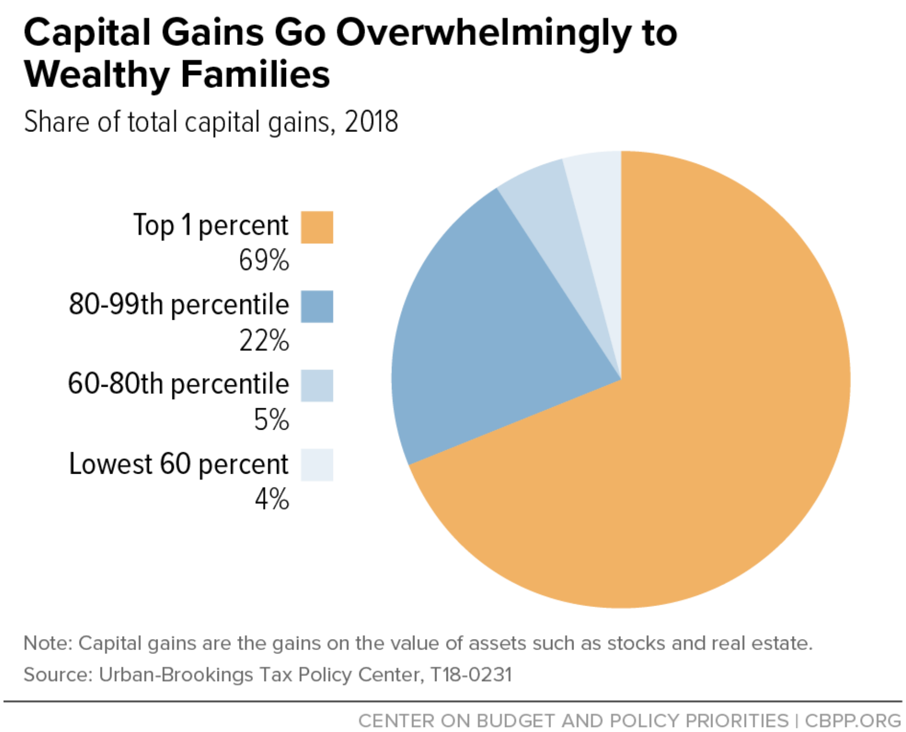
[4] Tax Policy Center, T18-0231 - Distribution of Long-Term Capital Gains and Qualified Dividends by Cash Income Percentile, 2018, November 16, 2018, https://www.taxpolicycenter.org/model-estimates/distribution-individual-income-tax-long-term-capital-gains-and-qualified-30.

[5] "[W]hile 1.2 percent of White families earn enough to place them among the top 1 percent of earners, just 0.4 percent of Latino and Black families are members of this group." Meg Wiehe *et al.,* "Race, Wealth, and Taxes," Institute on Taxation and Economic Policy and Prosperity Now, https://prosperitynow.org/sites/default/files/resources/ITEP-Prosperity_Now-Race_Wealth_and_Taxes-FULL%20REPORT-FINAL_5.pdf.

[6] Chye-Ching Huang, "The Myth That Low Capital Gains Rates Are Very Important to the Economy," Center on Budget and Policy Priorities, September 20, 2012, https://www.cbpp.org/blog/the-myth-that-low-capital-gains-rates-are-very-important-to-the-economy.

located anywhere in the country or the world, so any possible economic benefit from wouldn't necessarily go to the state giving the tax break.

FIGURE 1



Moreover, capital gains taxes generate revenue to support three major building blocks of thriving communities: K-12 and higher education, health care, and transportation. And, by increasing the share of state revenues paid by the wealthy, they allow states to keep taxes lower on people with moderate incomes, who spend (rather than save) a larger share of their incomes to boost local economies.

How to Address Volatility in Capital Gains

Capital gains income — and thus capital gains tax revenue — can rise or fall rapidly in response to economic changes. States can manage this volatility by, for example, relying on a variety of taxes, some of which respond less dramatically to swings in the business cycle.[7]

But the best way to address volatility in capital gains and other taxes is to establish a "rainy day" fund and make deposits when strong economic growth boosts revenues, so these funds can smooth

[7] Elizabeth McNichol, "Strategies to Address the State Tax Volatility Problem," Center on Budget and Policy Priorities, Center on Budget and Policy Priorities, April 18, 2013, https://www.cbpp.org/research/strategies-to-address-the-state-tax-volatility-problem.

out revenue downturns.[8] States can tie these provisions directly to capital gain taxes, if desired. For example, Massachusetts deposits all capital gains revenue above a specific threshold ($1 billion) into its rainy day fund.[9] Similarly, in Connecticut, when income taxes collected through quarterly payments from taxpayers and at the time of filing (as opposed to those withheld during the year) exceed a specified threshold, the "surplus" is deposited into the state's reserves. These are mainly taxes on investment income.[10]

States With Capital Gains Preferences Should Eliminate Them

States that tax capital gains income at a lower rate than wage, salary, and other ordinary income should eliminate this special treatment. Taxing capital gains at the same rate as ordinary income would mitigate the increase in wealth concentration and could raise significant revenues.

Eliminating capital gains preferences in the eight states that had them in 2011 would raise some $500 million per year, the Institute on Taxation and Economic Policy estimates.[11] Rhode Island's elimination of its capital gains preference in 2010 brings in over $50 million in additional revenue per year.[12] Vermont and Wisconsin scaled back their preferences to raise revenue in the wake of the Great Recession.

Only one state without an income tax (New Hampshire) taxes capital gains at all. The remaining non-income-tax states could levy a tax on just this type of income, as Washington State recently considered.[13]

Ways to Boost State Revenues From Capital Gains

The remaining 41 states and the District of Columbia, which currently tax capital gains at the same rate as ordinary income, should resist cutting these taxes and instead raise them to generate revenue they can invest in broadly shared prosperity. They have several options:

Raise the capital gains income tax rate. States could simply levy a higher rate on capital gains income than on income from wages, salaries, and other sources, or raise the rate just on short-term capital gains.

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8 "Rainy Day Funds: Best Practices to Mitigate Revenue Volatility," Pew, June 7, 2017, https://www.pewtrusts.org/en/research-and-analysis/articles/2017/06/rainy-day-funds-best-practices-to-mitigate-revenue-volatility.

9 Massachusetts General Laws Chapter 29, Section 5G, https://malegislature.gov/Laws/GeneralLaws/PartI/TitleIII/Chapter29/Section5G.

10 Connecticut's "volatility cap" requires that all income tax revenue collected when taxpayers file their tax returns that exceeds a specific threshold ($3.15 billion in 2017) be deposited in the state's rainy day fund. The income tax revenue collected at the time of filing is called "estimates and finals," as distinguished from the income taxes withheld during the year. See http://www.ctvoices.org/blog?page=1#volcap.

11 "A Capital Idea: Repealing State Tax Breaks for Capital Gains Would ease Budget Woes and Improve Tax Fairness," Institute on Taxation and Economic Policy, January 2011, https://itep.org/wp-content/uploads/capitalidea0111.pdf.

12 Institute on Taxation and Economic Policy estimate, November 2018.

13 Joseph O'Sullivan, "Washington House Democrats propose taxing capital gains, ignoring Supreme Court on K-12 school funding," *Seattle Times,* February 20, 2018, https://www.seattletimes.com/seattle-news/politics/washington-house-democrats-propose-capital-gains-tax-and-ignore-supreme-court-on-k-12-school-funding/.

Eliminate "stepped-up basis." Under current state and federal law, people who inherit assets such as stocks, bonds, or real estate pay no taxes on any appreciation of those assets that occurred before they inherited them. (Technically, the value of those assets is "stepped up" from the original purchase price to their value on the date of inheritance.) As a result, a large share of capital gains are never taxed.

For example, consider a taxpayer who bought 100 shares of stock for $10 each and held them until her death, when their value had risen to $50 per share. She left them to her daughter, who sold them a number of years later, after their value had risen to $55 per share. Under current law, the daughter's taxable capital gains would reflect the $5-per-share increase that occurred while she owned the stock, not the $45-per-share increase that occurred since her mother bought it.

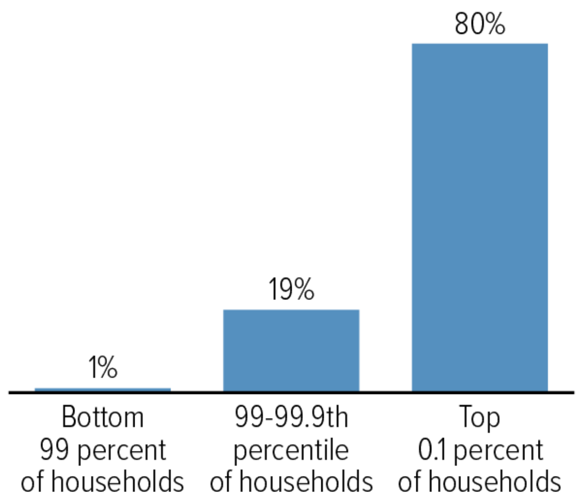
State estate taxes used to help compensate for stepped-up basis by taxing assets at the time they were inherited. But most states no longer have an estate tax, and the tax thresholds in states that do have the tax are generally so high that very few estates actually owe it.[14]

Stepped-up basis primarily benefits the wealthiest families because they have the most unrealized capital gains. Also, they can afford to hold on to their assets until they die and pass them on to their heirs rather than use them to pay expenses in retirement. Families of color have lower savings than white families and are less likely to have pension income, so are less likely than white families to benefit from this tax break. Some two-thirds of black and Latino working-age households own no assets in a retirement account, compared to 37 percent of white households.[15]

FIGURE 2

Eliminating Stepped-Up Basis Would Raise Taxes on Very Wealthy Households

Percent of revenue raised, by income group



Note: Stepped-up basis is the adjustment of the value of an appreciated asset (such as stocks or real estate) for tax purposes upon inheritance, so that the heirs pay no taxes on any appreciation of those assets that occurred before they inherited them.

Source: U.S. Department of Treasury, 2015 estimate

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[14] "2017 Tax Law Weakens Estate Tax, Benefiting Wealthiest and Expanding Avoidance Opportunities," Center on Budget and Policy Priorities, June 1, 2018, https://www.cbpp.org/research/federal-tax/2017-tax-law-weakens-estate-tax-benefiting-wealthiest-and-expanding-avoidance; Elizabeth McNichol, "State Estate Taxes: A Key Tool for Broad Prosperity," Center on Budget and Policy Priorities, May 11, 2016, https://www.cbpp.org/research/state-budget-and-tax/state-estate-taxes-a-key-tool-for-broad-prosperity.

[15] Nari Rhee, "Race and Retirement Insecurity in the United States," National Institute on Retirement Security, December 2013, https://www.nirsonline.org/reports/race-and-retirement-insecurity-in-the-united-states/.

Eliminating stepped-up basis would result in taxation of the asset's full increase in value since its original purchase. This would have a very progressive impact: fully *99 percent* of the revenue from eliminating stepped-up basis would come from the top 1 percent of filers, and 80 percent would come from the top 0.1 percent, according to the Treasury Department.[16] (See Figure 2.)

Another way states could tax the full increase in value of capital assets is by taxing capital gains each year as they are earned, instead of waiting until the assets are sold. This would be relatively easy for assets like publicly traded stocks and bonds, but applying this type of tax to other assets, such as real estate, might prove unworkable due to the difficulty of estimating their annual increase in value.[17]

Close the "carried interest" loophole. Managers of private equity and hedge funds, many of whom are among the highest-income taxpayers in the country[18], benefit from special treatment of a large share of their income. Typically, they receive both a management fee, or a percentage of the value of the assets they manage, and a performance fee, which equals a share of the gains they have generated for their clients. The latter is called carried interest.

The federal tax code taxes carried interest at the same rate as capital gains income rather than the higher rate imposed on ordinary income, even though carried interest is compensation for work the managers perform in managing the investments, not a return on capital of their own that they invested.

States could offset this federal tax preference and generate more capital gains revenue by levying a separate tax on carried interest. If an individual state imposed such a tax, fund managers could fairly easily move their businesses to evade it, so some states have formed regional compacts. For example, New Jersey lawmakers adopted a bill in 2017 to tax carried interest that will only take effect if neighboring states adopt a similar provision. Lawmakers in in New York, Rhode Island, Illinois, and California have also considered bills to tax carried interest.[19] State initiatives to tax carried interest would not only raise revenue directly but also encourage the federal government to eliminate this loophole by calling attention to the issue.

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[16] Lily Batchelder, "The 'silver spoon' tax: how to strengthen wealth transfer taxation," Washington Center for Equitable Growth, October 31, 2016, https://equitablegrowth.org/silver-spoon-tax/.

[17] "Taxing Capital: Paths to a fairer and broader U.S. tax system," Section 3, Washington Center for Equitable Growth, August 10, 2016, https://equitablegrowth.org/research-paper/taxing-capital/?longform=true.

[18] Ashley Adams-Mott, "How Much Do Hedge Fund Managers Make?" Chron, updated August 27, 2018, https://work.chron.com/much-hedge-fund-managers-make-23556.html.

[19] "Recent carried interest proposals in New Jersey, Rhode Island and Illinois," PwC, January 2018, https://www.pwc.com/us/en/services/tax/state-local-tax/library/newsletters/salt-insights/recent-carried-interest-proposals-in-nj-ny-ri-and-il.html.

TABLE 1

Capital Gains as Share of Residents' Total Adjusted Gross Income (AGI), by State

2016	Net Capital Gains		2016	Net Capital Gains	
	Millions	Percent of AGI		Millions	Percent of AGI
NV	$9,835.7	11.1%	**AZ**	$8,716.9	4.9%
WA	$24,072.6	8.7%	**AR**	$3,258.2	4.8%
NY	$65,595.3	8.5%	**MN**	$9,090.3	4.6%
CA	$114,954.8	8.1%	**KS**	$3,807.5	4.6%
FL	$47,572.0	7.9%	**NC**	$12,209.7	4.5%
CO	$15,019.9	7.7%	**RI**	$1,530.1	4.5%
MA	$23,050.9	7.6%	**WI**	$7,995.3	4.5%
CT	$11,266.5	6.9%	**NJ**	$16,594.0	4.5%
DC	$2,184.0	6.8%	**SC**	$5,560.3	4.5%
MT	$1,851.5	6.6%	**VA**	$12,625.9	4.3%
ID	$2,661.9	6.4%	**GA**	$11,166.2	4.1%
UT	$5,229.2	6.2%	**MI**	$11,594.8	4.0%
IL	$26,869.5	6.1%	**NM**	$1,873.6	4.0%
VT	$1,167.9	6.0%	**LA**	$4,443.2	4.0%
SD	$1,544.5	6.0%	**MO**	$6,526.1	4.0%
OR	$7,398.2	6.0%	**KY**	$4,096.7	3.9%
HI	$2,472.3	5.8%	**MD**	$8,556.2	3.8%
TX	$42,671.8	5.5%	**AL**	$4,121.4	3.6%
NH	$2,819.7	5.5%	**IN**	$6,399.4	3.6%
WY	$2,084.0	5.4%	**MS**	$2,085.0	3.5%
ND	$1,275.1	5.3%	**OH**	$11,128.3	3.4%
TN	$9,203.1	5.3%	**DE**	$988.1	3.4%
NE	$2,834.1	5.1%	**IA**	$2,919.1	3.3%
ME	$1,845.5	5.0%	**AK**	$695.5	3.0%
PA	$19,920.7	4.9%	**WV**	$811.9	2.1%
OK	$4,536.4	4.9%	**US**	$618,949.6	6.1%

Source: Internal Revenue Service

TABLE 2

State Tax Preferences for Capital Gains

Arizona	Only 75% of capital gains are taxed
Arkansas	Only 50% of capital gains are taxed
Hawaii	Capital gains are taxed at 7.2%, lower than rate for ordinary income of up to 11%
Montana	Credit of 2% of capital gains
New Mexico	Deduction of 50% of capital gains or up to $1,000, whichever is greater
North Dakota	40% of capital gains are excluded from taxation
South Carolina	44% of capital gains are excluded from taxation
Vermont	40% of gains from certain assets held more than three years or up to $5,000 of capital gains are excluded from taxation
Wisconsin	30% of capital gains (60% for farms) are excluded from taxation