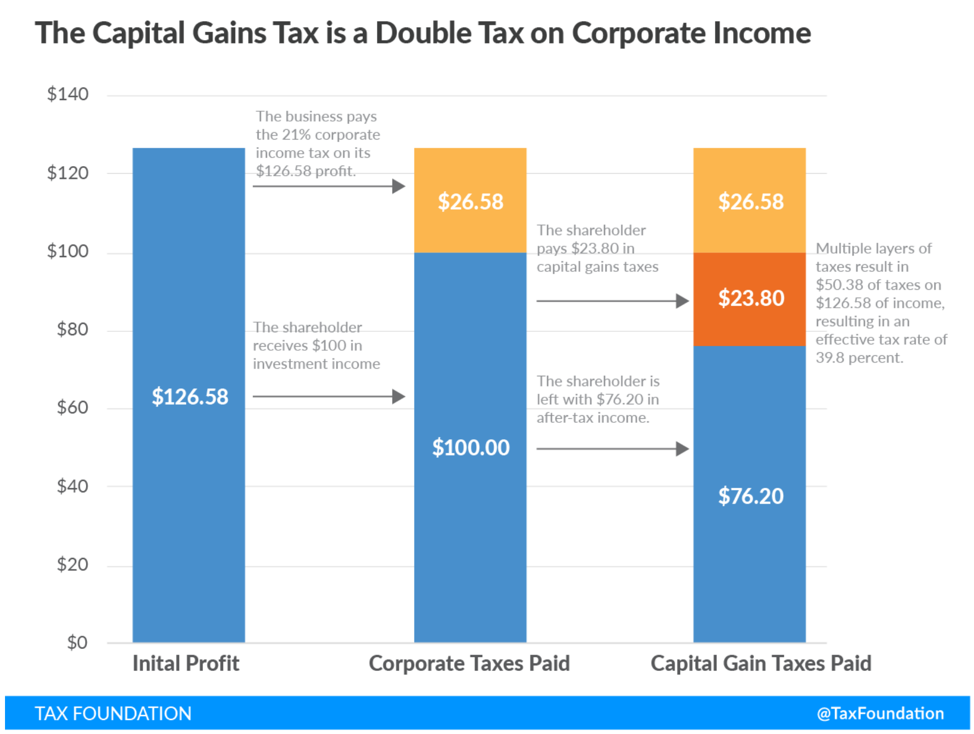
State-Level Taxes on Capital Gains

Taxes on capital gains are on the profit from selling an asset.
The tax is imposed on the difference between the original purchase price ("basis") and the price when sold ("realization"). When sold at a loss, it is a capital loss. While all gains are subject to capital gains tax, the most common assets are stocks, bonds, cars, cryptocurrency, jewelry, farms, and art. Assets sold after a year are long-term capital gains or losses; other sales are short-term capital gains or losses. Sales of primary homes are exempt in the U.S. up to $250,000 in gain, as are unrealized gains (assets that have not yet been sold).

The federal government and 42 states impose taxes on capital gains.
The federal government imposes a tax on capital gains as part of the federal income tax. The tax on long-term capital gains is at a preferential rate (15%, 20%, or 23.8% depending on income). All 41 states (plus DC) with an income tax impose it on capital gains, plus Washington has a special capital gains tax (7% on gains of $250,000 or more in a year). One state (Minnesota) has an extra tax (1%) on capital gains on top of the income tax; one state (Montana) has a lower rate (4.1%, compared to 5.9% income tax). 6 states exempt a share of capital gains from their income tax: Arizona (25%), Arkansas (50%), New Mexico (40%), North Dakota (40%), South Carolina (44%), and Wisconsin (30%).

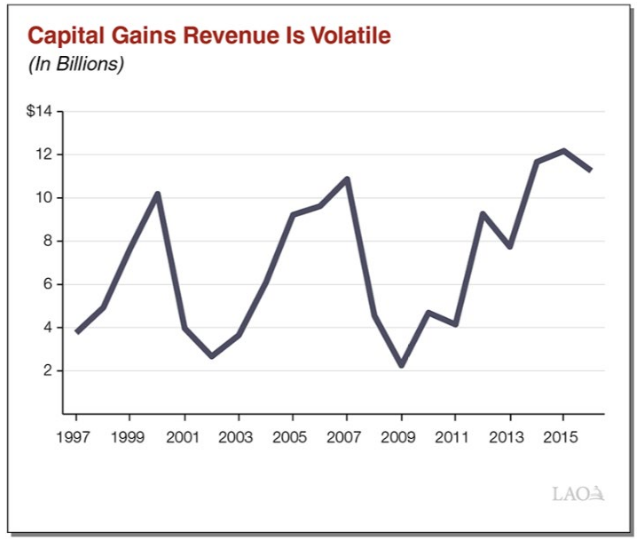
California has the highest tax on capital gains (13.3%), followed by New York (10.9%), DC and New Jersey (10.75%), and Oregon (9.9%), all on top of the federal income tax. Eight states have no tax on capital gains: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, and Wyoming.

Taxes on capital gains are a double tax on investing activity.
When imposed on earnings from corporate income (such as stocks or bonds), they are a second layer of tax on top of the corporate income tax, discouraging business activity.



Taxes on capital gains are an unstable revenue source.

Taxes on capital gains are primarily on high-income earners with volatile incomes that rise sharply in booms and fall sharply in recessions – magnifying state budget effects. California's Legislative Analyst Office has concluded that capital gains taxes are three times more volatile than income taxes generally and contribute to California budget instability. The Pew Center on the States found that capital gains are the most volatile income component, more than business income or wages. A Congressional Research Service review of federal tax data found capital gains realizations in recent years has fluctuated widely between 2 percent and 8.7 percent of gross domestic product: a yearly range between –80% and +50%.



Capital gains tax increases and cuts have clear incentive effects

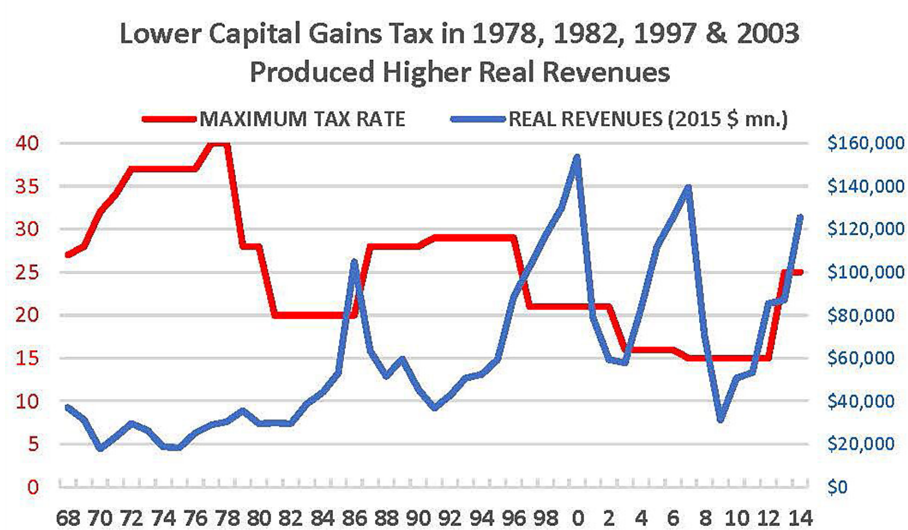
Increased sales, increased income, and increased tax revenue have accompanied federal capital gains tax cuts. Capital gains tax increases are preceded by a sharp increase in revenue before the increase takes effect, and then a steep drop-off (see chart below).

High capital gains taxes cause "lock-in," impeding mobility.

Since capital gains tax is imposed on sale, investors will sell assets less frequently if capital gains taxes are high. One-third of capital gains are business sales.

Taxes on capital gains often tax fictitious income.

No inflation adjustment is made to an asset's basis, resulting in tax being paid on what appears to be a gain but is really a loss or a smaller gain after adjusting for inflation.



Policy Options:

- Exempt all (as 8 states do) or some (as 7 more states do) capital gains from state tax.
- Dedicate capital gains tax collections for one-time expenses only to mitigate volatility.
- Ask revenue officials to study past collections and volatility from the tax on capital gains.

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