.Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Bill Campbell	Analyst:	Norm Catelli	Bill Number:	AB 1842
Related Bills:	See Legislative History	Telephone:	845-5117	Introduced Date:	01/28/2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclusion/50% of Gain From Sale or Exchange of Capital Asset Held More Than One Year

SUMMARY

This bill would allow taxpayers to include in income only 50% of a capital gain, as specified.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to increase savings and investment and act as an engine of economic growth.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Internal Revenue Code (IRC) Sections 1201 through 1257 provide rules for defining "Capital Assets," identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset. Complex rules allow non-corporate taxpayers to apply maximum tax rates from 8% to 28% to the taxation of the gain.

Additionally, holders of small business stock, a special security subject to rules designed to encourage small business, may exclude 50% of the gain on the sale of the stock. For alternative minimum tax (AMT) purposes 42% of the excluded gain is considered a tax preference item.

Federal law also allows an exclusion of the capital gain from the sale of a principal residence, subject to certain limitations. An individual may exclude up to $250,000 of gain, while a married couple filing a joint return may exclude up to $500,000.

California law generally follows federal law with the following exceptions:

- Capital gains are taxed at ordinary income tax rates,
- Small business stock exclusion rules require certain California activity, and
- 50% of the excluded small business stock gain is a tax preference item.

Board Position:			Department Director	Date
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THIS BILL

This bill would change present law, which taxes the entire capital gain, by excluding 50% of any gain from the sale or exchange of a capital asset that is held for more than one year, as defined in the IRC, from the calculation of gross income.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

AB 1897 (Zettel; 2001-2002) was introduced February 6, 2002, and contains the same language as this bill. AB 7 (Campbell; 1999-2000), SB 37 (Baca; 1999-2000), and SB 34 (Brulte; 1999-2000) would have excluded from gross income any gain from the sale or exchange of a capital asset held for five years or more. These bills were held in committee. AB 9 (Campbell; 1997-1998) would have excluded 29% of any gain if the capital asset was held for less than five years and 36% of the gain if the capital asset was held for five years or more. This bill was held in committee.

OTHER STATES' INFORMATION

Florida, Illinois, Michigan, Minnesota, and *New York* laws do not provide favorable treatment of capital gains comparable to the treatment of capital gains allowed by this bill. *Massachusetts* has a freestanding personal income tax system that treats capital gains favorably, on a sliding scale based on holding period with taxation eliminated on capital assets held for six or more years.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses as follows:

Estimated Revenue Impact of AB 1842 As Introduced January 28, 2002 Effective for income years BOA 1/1/2002 Enacted after 6/30/2002 $ Millions			
2002-03	2003-04	2004-05	2005-06
-$2,130	-$2,730	-$2,920	-$2,975

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The above revenue impact was estimated as follows. First, the revenue loss due to this 50% capital gain exclusion under PIT law was simulated for 1999 using a sample of PIT tax returns for 1999 tax year. Next, the simulated 1999 revenue loss was extrapolated to future years based on the Department of Finance's December-2001 projected annual growth rates of PIT capital gains.

ARGUMENTS/POLICY CONCERNS

Since most assets used in a trade or business are excluded from the definition of "Capital Assets" and are generally controlled by IRC Section 1231, *Special Rules for Determining Capital Gains and Losses, Property used in the trade or business and involuntary conversions*, the impact of this legislation on corporations would be minimal.

Existing federal and state laws provide for an AMT liability, which ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation. Legislation creating the IRC Section 1202 and R&TC Section 18152.5 also created AMT tax preferences for a part of the excluded income. Similar treatment of the exclusions proposed by this legislation would maintain fairness in the tax system.

If this bill is intended to provide an incentive for future investments, the inclusion of a prospective operative date applying to assets purchased after a future date may be appropriate to more fully act as an inducement for future action or behavior, rather than providing a benefit for action taken without regard to this exclusion.

As the bill is written, it would provide additional benefits to already existing gross income exclusions. For example, this bill would allow a further reduction of the gain on small business stock provided by R&TC Section 18152.5. Similarly, the gross income exclusion of gain from the sale of a principal residence pursuant to R&TC Section 17152 needs consideration.

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