Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Dutton	Analyst:	Gail Hall	Bill Number:	SBX6 10
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 24, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclusion/50 Percent Of Gain From Sale Or Exchange Of Capital Asset Held More Than 3 Years

SUMMARY

This bill would allow taxpayers to exclude from gross income 50 percent of a capital gain.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to encourage investment in California and stimulate growth during the severe economic downturn.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately and specifically operative for taxable years beginning on or after January 1, 2012, and before January 1, 2015. In addition, the provisions of this bill would only apply to capital assets purchased on or after the effective date and held for more than three years. The provisions added by this bill would be repealed by their own terms on December 1, 2015.

POSITION

Pending.

ANALYSIS

FEDERAL LAW

Internal Revenue Code (IRC) sections 1201 through 1257 provide the rules governing the tax treatment of capital gains and losses, identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset. In general, property held for personal use or investment purposes is a capital asset.[1] Examples of capital assets include held-for-investment stocks and securities as well as an owner-occupied personal residence. Property used in a taxpayer's trade or business is not a capital asset.

When a capital asset is sold or exchanged, the difference between the selling price and the asset's adjusted basis, which is usually what was paid for the asset, is a capital gain or loss.

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[1] Internal Revenue Code (IRC) section 1221(a).

Board Position:			Department Director	Date
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Under federal law, there are circumstances when a percentage of a capital gain may be excluded from a taxpayer's gross income. Because capital assets are personal in nature versus used in a trade or business, provisions related to capital gains and losses are more commonly found under the income tax laws for individuals.

For example, federal law allows a capital gain exclusion from the sale of a personal residence. An individual may exclude up to $250,000 of gain, while a married couple filing a joint return may exclude up to $500,000. A second example is a holder of small business stock[2] may exclude 75 percent[3] of the gain on the sale or exchange of the stock. For tax years beginning before 2011, 7 percent of the amount of capital gain excluded from gross income on the disposition of small business stock is an alternative minimum tax (AMT) preference item.

Complex rules allow non corporate taxpayers to apply maximum tax rates from 0 percent to 28 percent to the taxation of a net capital gain, whereas for corporate taxpayers, capital gains are taxed at ordinary income tax rates.

Generally, capital gains and losses are classified as long-term or short-term, depending on how long the property was held before it was sold. Current federal law provides that property held more than one year will result in long-term capital gain or loss. If the property is held less than a year, the capital gain or loss is short-term. These distinctions are essential to arrive at the correct amount of net capital gain or loss.

"Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. When calculating the net capital gain also called "netting," the following definitions apply:

- The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.
- The term "net long-term capital loss" means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.
- The term "net short-term capital loss" means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.
- The term "net short-term capital gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

STATE LAW

California generally follows the federal rules for defining capital assets, identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset with the following modifications:

- Capital gains are taxed at ordinary income tax rates under personal income tax law,
- Small business stock exclusion equals 50 percent,
- Small business stock exclusion rules require certain California activity, and
- Small business stock gain 50 percent exclusion is an AMT preference item.

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[2] A special security subject to rules designed to encourage investment in small business.
[3] The American Recovery and Reinvestment Act of 2009 (P.L.111-5) changed the exclusion percentage to 75 percent (rather than 50 percent or 60 percent) for exchanges of small business stock held more than 5 years and acquired after February 17, 2009, and before January 1, 2011.

THIS BILL

For taxable years beginning on or after January 1, 2012, and before January 1, 2015, this bill would amend Personal Income Tax Law (PITL) and Corporate Tax Law (CTL) by allowing a 50 percent exclusion from gross income for any net capital gain from the sale or exchange of capital assets acquired after the effective date that are held for more than three years.

LEGISLATIVE HISTORY

SB X8 43 (Dutton) was introduced February 12, 2010, and contained language identical to the language in this bill. That bill is currently awaiting assignment by the Senate Rules Committee.

SB 472 (Dutton) would allow taxpayers to exclude from gross income 50 percent of a capital gain, as specified. This bill is similar to SB 472. SB 472 was introduced February 26, 2009, and failed to pass out of the Legislature by the constitutional deadline.

SB 568 (Hollingsworth, 2009/2010) would allow a taxpayer to elect to pay a 2 percent tax on any "net capital gain" as defined under federal law. SB 568 failed to pass out of the Legislature by the constitutional deadline.

AB 876 (Harkey, 2009/2010) would amend PITL and CTL and allow the gain on sale of a capital asset purchased in calendar year 2009 and held more than one year an exclusion from gross income. AB 876 failed to pass out of the Legislature by the constitutional deadline.

AB 1897 (Zettel; 2001-2002) was introduced February 6, 2002, and contained the same language as this bill. This bill was held in committee.

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 percent of any gain if the capital asset was held for less than five years and 36 percent of the gain if the capital asset was held for five years or more. This bill was held in committee.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were reviewed because their tax laws are similar to California's tax laws. Review found that these states generally follow the federal capital gains rules for excluding certain capital gains from gross income.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SBX6 10 Operative for Taxable Years Beginning On or After January 1, 2012 and Before January 1, 2015 Assumed Enactment After June 30, 2010 ($ in Millions)				
2010-11	2011-12	2012-13	2013-14	2014-15
-$0	-$6	-$82	-$530	-$360

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

ARGUMENTS/POLICY CONCERNS

1. Existing federal and state laws provide for an alternative minimum tax, commonly called AMT, which ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation. Legislation creating the federal and state exclusion of gain from the sale or exchange of small business stock includes a tax preference item for a portion of the excluded income. Similar treatment of the exclusion proposed by this bill would maintain fairness in the tax system.

2. As introduced, the bill would allow investments in other states to qualify for the 50 percent exclusion. If the author's intent is to encourage investment in California, it is suggested that the bill be amended to provide such a limitation. Alternatively, adding a requirement that would allow the exclusion only for properties located in California may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

3. It appears this bill's 50 percent exclusion could be applied in addition to the small business stock or personal residence capital gain exclusions. If this was not the intent of the author, amendments are necessary.

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