

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Harkey Analyst: Gail Hall Bill Number: AB 876
See Legislative
Related Bills: History Telephone: 845-6111 Amended Date: April 14, 2009
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Exclusion/Gain From Sale Or Exchange Of Capital Asset Purchased During 2009 Calendar Year & Held More Than One Year

SUMMARY

This bill would allow taxpayers to exclude from gross income any capital gain, as specified.

SUMMARY OF AMENDMENTS

The April 14, 2009, amendments removed provisions relating to capital losses and added provisions relating to the exclusion of capital gains from gross income for capital assets purchased during the 2009 calendar year and held for more than one year.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to encourage capital investment in the state and provide an incentive for companies to remain in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2009, but would only apply to capital gains from the sale of a capital asset purchased in calendar year 2009. As a result, only sales of capital assets in 2010 and thereafter would qualify under this bill's provisions.

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.

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

Board Position:	Department Director	Date
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When a capital asset is sold, 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.

Under Personal Income Tax Law (PITL) and Corporation Tax Law (CTL) 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 PITL.

Under PITL, an example of a federal provision that allows an exclusion of a capital gain from gross income is a gain 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 stock² may exclude 75 percent³ 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 PITL taxpayers to apply maximum tax rates from 0 percent to 28 percent to the taxation of a capital gain, whereas under CTL, capital gains are taxed at ordinary income tax rates.

"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 exceptions:

- Capital gains are taxed at ordinary income tax rates under PITL,
- Small business stock exclusion equals 50 percent,
- Small business stock exclusion rules require certain California activity, and
- 50 percent of the excluded small business stock gain is an (AMT) tax preference item.

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% (rather than 50% or 60%) for exchanges of small business stock held more than 5 years and acquired after February 17, 2009, and before January 1, 2011.

THIS BILL

This bill would exclude from gross income the gain on the sale or exchange of a capital asset purchased in calendar year 2009 and held more than one year. The bill applies to PITL and CTL.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this concern and any other concerns that may be identified.

This bill has no requirement for the netting of capital gains and losses before determining the amount of capital gain exclusion. This conflicts with current federal and state laws relating to capital gains and losses. If the intent of the author is to maintain the current netting rules for capital gains and losses, amendments would be necessary.

LEGISLATIVE HISTORY

SB 472 (Dutton, 2009/2010) would amend PITL and CTL and allow a 50 percent exclusion from gross income for any gain from the sale or exchange of a capital asset held for more than three years. SB 472 is currently in the Senate Revenue and Taxation Committee.

SB 568 (Hollingsworth, 2009/2010) would apply to PITL and CTL and allow a taxpayer to elect to pay a 2 percent tax on any "net capital gain" as defined under federal law. This bill is currently in the Senate Revenue and Taxation Committee.

AB 1897 (Zettel, 2001-2002) was introduced February 6, 2002, and contained the same language as SB 472 discussed above. 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 gain 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

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 876 Effective for Taxable years BOA 1/1/2009. Enacted after 6/1/2009 (\$ in millions)			
2009-10	2010-11	2011-12	2012-13
-\$130	-\$435	-\$625	-\$625

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

Revenue Discussion

The revenue impact was estimated using a microsimulation model. This model simulates the tax liability of each individual taxpayer under current and proposed tax laws based on personal and financial data such as filing status, taxable income, capital gains, and tax rates. Included below is an explanation of how the 2009/2010 fiscal year revenue estimate was calculated. The same process was applied to fiscal years 2010/2011, 2011/2012, and 2012/2013 fiscal years.

The revenue impact of fiscal year 2009/2010 was estimated as follows:

First, data was gathered from a sample of 2007 personal income tax (PIT) returns. Simulation results show that the amount of PIT on capital gains is \$10.392 billion for the 2007 taxable year. The \$10.392 billion was extrapolated to \$5.261 billion for taxable year 2010 based on the Department of Finance's (DOF) forecast of capital gain income.⁴ Only fractions of future taxes on capital gains come from assets purchased in 2009. These fractions vary by year, and are estimated using the holding period data from the 2007 capital gain sample. It is estimated that for tax year 2010, approximately 6 percent, or \$316 million of 2010's total tax on capital gains will come from assets purchased in 2009. (\$5.261 billion x 6%).

Second, the \$316 million estimated tax from capital gains for taxable year 2010 was adjusted downward to account for potential increases of sales of capital assets due to the exclusion provision under this bill. In addition, the estimate is adjusted upward to account for the surcharge of 0.25 percent in PIT tax rates for the 2009 and 2010 taxable years. The revenue impact for individuals is adjusted upward to account for the additional impact of this bill on corporations and partnerships. The revenue impact for corporations and partnerships is assumed to equal 6.6 and 5 percent of the impact for individuals respectively. These adjustments reduce the estimated 2010 revenue loss from -\$316 million to -\$305 million, an approximate 3 percent adjustment.

⁴ DOF Forecast For Capital Gain Income: -55%, -10%, +25%, and +21% for 2008, 2009, 2010, and 2011, respectively.

Third, The -\$305 million revenue loss was converted to fiscal year estimates and shown in the table above. It was estimated that 42 percent, or approximately \$130 million of the \$305 million revenue loss would be realized in fiscal year 2009/2010, and 58 percent, or approximately \$175 million, would be realized in fiscal year 2010/2011.

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. The bill would allow investments in other states to qualify for the capital gain exclusion. If the author's intent is to encourage investment in California, it is suggested that the bill be amended to limit qualified investments to those in California.

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