Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Dutton	Analyst:	Gail Hall	Bill Number:	SB 472
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 26, 2009
		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, as specified.

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 be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2009, and before January 1, 2012. The provisions added by this bill would be repealed by their own terms on December 1, 2012.

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.

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

Board Position:			Department Director	Date
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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 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 PITL taxpayers to apply maximum tax rates from 0 percent to 28 percent to the taxation of a net capital gain, whereas under CTL, capital gains are taxed at ordinary income tax rates.

"<u>Net capital gain</u>" 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.

<u>STATE LAW</u>

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) 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.

<u>THIS BILL</u>

For taxable years beginning on or after January 1, 2009, and before January 1, 2012, this bill would amend PITL and CTL by allowing 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.

<u>IMPLEMENTATION CONSIDERATIONS</u>

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

1. 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 was to maintain the current netting rules for capital gains and losses, amendments would be necessary.

2. 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.

LEGISLATIVE HISTORY

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 is currently in the Senate Revenue and Taxation Committee.

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 is currently in the Assembly Revenue and Taxation Committee.

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

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

Estimated Revenue Impact of SB 472 Effective for Taxable years BOA 1/1/2009 and before 1/1/2012 Assumed Enacted after 6/1/2009			
2009-10	2010-11	2011-12	2012-13
-$2.5 Billion	-$2.35 Billion	-$1.5 Billion	-$.25 Billion

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 this bill would reduce PIT capital-gain tax from $10.76 billion to $6.77 billion, a revenue loss of -$3.99 billion for the 2007 taxable year. The -$3.99 billion revenue loss was extrapolated to -$1.616 billion for taxable year 2009 based on the Department of Finance's (DOF) forecast of capital gain income.[4] The 2009 estimated revenue loss is smaller than the 2007 revenue loss due to DOF’s forecasted drop in capital gain income for taxable years 2008 and 2009.

Second, the $1.616 billion estimated revenue loss for taxable year 2009 was adjusted downward to account for potential increases of sales of capital assets due to the 50 percent 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 increase the 2009 revenue loss from -$1.616 billion to -$1.738 billion, an approximate 7.6 percent adjustment.

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

Third, The -$1.738 billion revenue loss was converted to fiscal year estimates and shown in the table above. For example, the revenue loss of -$2.5 billion for the 2009-10 fiscal years consists of a loss of -$1.60 billion from the 2009 taxable year (-$1.738 - $.138) and a loss of -$.900 billion from the 2010 taxable year. The -$.138 billion of the revenue loss from taxable year 2009 was applied to taxable year 2010 because of estimated late tax payments from taxpayers.

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. This bill would encourage the sale of capital assets purchased prior to January 1, 2009. If this bill is intended to provide an incentive for future investments, the operative date should be revised to apply to the gains from the sale or exchange of capital assets purchased on or after January 1, 2009, with the repeal date extended appropriately.

3. 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.

LEGISLATIVE STAFF CONTACT

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