Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Hollingsworth	Analyst:	Gail Hall	Bill Number:	SB 568
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 27, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Gain On Sale Or Disposition Of Any Capital Asset/Taxpayer May Elect To Pay 2 percent Of Any Net Gain

SUMMARY

This bill would allow taxpayers to elect to pay a lower tax rate on certain capital gains.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to reward taxpayers for investing in capital assets and create a more equitable rate for taxing capital gains that is similar to federal law.

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.

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 section 1221 defined the term "capital asset."

Board Position:			Department Director	Date
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The tax treatment of net capital gains and losses depends on whether the gain and losses are long-term or short-term and whether a taxpayer files under the federal Corporation Tax Law (CTL) or under the federal Personal Income Tax Law (PITL). 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.

"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, 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.

For tax years beginning after 2010, under PITL, long-term capital gains now taxed at a rate of 0 percent will be taxed at a rate of 10 percent (8 percent for assets held over five years), and long-term capital gains now taxed at a rate of 15 percent will be taxed at a rate of 20 percent (18 percent for assets held over five years).

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, except capital gains are taxed at ordinary income tax rates under PITL and ordinary franchise/income tax rates under CTL as shown in the table below:

Description	2008 Tax Rates
S Corporation	1.5%
C Corporation	8.84%
Bank and Financial	10.84%
Financial S Corporation	3.5%
Individuals	1% to 9.3%
Mental Health Tax For Taxable Income > $1 Million	1%

THIS BILL

This bill would allow a taxpayer to elect to pay a 2 percent tax on any "net capital gain" as defined under federal law.[2] The 2 percent tax would be in lieu of any other tax that would otherwise be imposed on the net capital gain. This bill would apply to PITL and CTL.

IMPLEMENTATION CONSIDERATIONS

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

1. It is unclear what is meant by "elect to pay a tax in the amount of 2 percent of net capital gains." If the intent of the author is to allow a taxpayer to elect to have a 2 percent tax rate imposed on net capital gains, it is recommended that the language be amended to be consistent with other provisions of California tax law that impose specific tax rates, such the state mental health services tax provision.
2. The bill lacks specific rules for taxpayers and the department to follow relating to making an election, which could result in disputes and the inability for the department to administer the election. It is suggested that the bill be amended to provide additional clarity relating to the election.

TECHNICAL CONSIDERATIONS

On page 2, line 9, after "January 1, 2009," the author should insert "in the case of" for clarity and consistency with the language in the added PITL provision.

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.

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 to be excluded 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 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.

[2] IRC section 1221(11)

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*, *Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws.

Research found that *Florida*, *Illinois*, *Minnesota*, and *New York* have no special tax rates for capital gains.

Massachusetts taxes income derived from interest, dividends, wages, partnerships, trades or businesses, pensions, alimony, unemployment compensation, IRA/Keogh distributions, and rentals at 5.3 percent. Short-term capital gains and short- and long-term gains arising from the sale of collectibles are taxed at 12 percent.

FISCAL IMPACT

This bill would require income from capital gains to be taxed at a different tax rate from ordinary income. As a result, this bill would impact the department's processing and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

The present forms have limited space available for additional lines. If these changes, along with other pending legislation, increase the forms from two to three pages, the department would incur costs of over $2 million for revising the forms and instructions, printing, systems changes, processing, and storage. The department will ask for an appropriation for these costs through the normal budgetary process.

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 568 Effective for Taxable years BOA 1/1/2009 Assumed Enacted after 6/1/2009			
2009-10	2010-11	2011-12	2012-13
-$5.050 Billion	-$4.900 Billion	-$5.750 Billion	-$6.950 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 for 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 from capital gains from $10.76 billion to $2.33 billion, a revenue loss of -$8.43 billion for the 2007 taxable year. The -$8.43 revenue loss was extrapolated to approximately $-3.47 billion for taxable year 2009 based on the Department of Finance's (DOF) forecast of capital gain income.[3] The 2009 estimate revenue loss is smaller than the 2007 estimated revenue loss due to DOF's forecasted drop in capital gain income for taxable years 2008 and 2009.

Second, the -$3.47 billion estimated revenue loss for taxable year 2009 was adjusted downward to account for potential increases of sales of capital assets due to bill's lower tax rates on capital gains. 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 was adjusted upward to account for the additional impact of this bill on corporations and partnerships. The revenue impact for corporations and partnerships was assumed equal to 6.6 and 5 percent of the impact for individuals respectively. These adjustments increase the 2009 estimated revenue loss from -$3.42 billion to -$3.55 billion, an approximate 4 percent adjustment.

Third, the -$3.55 billion revenue loss was converted to fiscal year estimates and shown in the table above. For example, the revenue loss of -$5.050 billion for the 2009/2010 fiscal year consists of a loss of -$3.20 billion from the 2009 taxable year and a loss -$1.85 billion from the 2010 taxable year. The -$.35 billion of the revenue loss from taxable year 2009 was applied to taxable year 2010 because of estimated late payments from taxpayers.

LEGISLATIVE STAFF CONTACT

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