Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Miller	Analyst:	David Scott	Bill Number:	AB577
Related Bills:	See Legislative History	Telephone:	845-5806	Amended Date:	March 31, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclusion / Capital Gain From Sale Or Exchange Of Capital Asset Purchased During 2011 Or 2012 Calendar Year Held For More Than One Year

SUMMARY

This bill would allow taxpayers to exclude certain capital gains from gross income.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Amendments

The March 31, 2011, amendments deleted legislative intent language regarding the encouragement of investing in California by providing incentives and added provisions to exclude capital gains from gross income on capital assets if they are purchased during the 2011 and 2012 calendar year and held for more than one year.

Summary of Suggested Amendments

Amendments one to four are suggested to permit the Franchise Tax Board (FTB) to provide rules, guidelines, and procedures for reporting the amount of capital gain being excluded under this provision.

PURPOSE OF THE BILL

The purpose of this bill appears to be to encourage investment and stimulate growth during the economic downturn.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately and would be specifically operative for taxable years beginning on or after January 1, 2011.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL/STATE 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.

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. As a second example, 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.

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

[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.

"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 gain" means the excess of short-term capital gains for the taxable year over the short-term capital losses 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.

In 1969, Congress enacted a minimum tax on "tax preferences" as a method of preventing taxpayers from avoiding all tax liability by using exclusions, deductions and credits. After a few years this became known as the AMT. Tax preference items (TPIs) are certain items that are accorded favorable tax treatment because they have the effect of reducing regular taxable income or regular tax. If an item is treated as a TPI, taxpayers with that item on their returns may become subject to an increased AMT.

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. California law is different from federal law as followings:

- 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
- The 50 percent exclusion on gain of a small business stock is an AMT preference item.

Generally, California law follows the federal AMT rules with modifications. California law differs from federal law for certain items, including tax exempt interest, foreign tax credits, exemption and phaseout amounts, the AMT rates, and the exemption for qualifying small corporations[4].

THIS BILL

For taxable years beginning on or after January 1, 2011, this bill would exclude from gross income 100 percent of any gain from the sale or exchange of a capital asset as defined in the IRC[5]) purchased in calendar years 2011 and 2012 and held for more than one year. This bill is silent as to the specific inclusion of this excluded gain being a tax preference item for AMT purposes. Therefore, the gain is not included as a tax preference item for AMT purposes.

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[4] Chapter 2.1 (commencing with 17062) of Part 10 and Chapter 2.5 (commencing with 23400) of Part 11 of the R&TC.
[5] IRC section 1221

IMPLEMENTATION CONSIDERATIONS

This bill would exclude from gross income capital gains resulting from the sale of capital assets purchased in 2011 and 2012. The bill is silent as to what information (for example, purchase and sale dates, costs and sales price) should be reported on the taxpayer's tax return for the capital gains exclusion. This could lead to disagreements between taxpayers and the FTB about what is the proper reporting method. It is suggested that language be included to permit the FTB to provide rules, guidelines and procedures for reporting the amount of capital gain being excluded. Suggested amendments 1 to 4, attached, would provide this authority.

The bill would limit the exclusion from income to capital assets "purchased" during calendar years 2011 and 2012. The term "purchased" has generally been interpreted to mean acquired in a taxable transaction. Stock received in a tax-free reorganization or a Section 351 incorporation[6], is not considered to be a "purchase." Without clarifying this issue in the bill, taxpayers could incorrectly believe the gain on stock acquired in a tax-free transaction can be excluded from income.

LEGISLATIVE HISTORY

SB X6 10 (Dutton, 2009/2010) would have allowed taxpayers to exclude 50 percent of net capital gains from gross income. This bill was introduced on February 24, 2010, and was held in the Senate Revenue and Taxation Committee.

SB X8 43 (Dutton, 2009/2010) would have allowed taxpayers to exclude 50 percent of net capital gains from gross income. This bill was introduced on February 12, 2010, but was not heard in a policy committee.

SB 472 (Dutton, 2009/2010) would have allowed taxpayers to exclude from gross income 50 percent of a capital gain. This bill was held in the Senate Revenue & Taxation Committee.

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

AB 876 (Harkey, 2009/2010) would have amended Personal Income Tax Law and Corporation Tax Law 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. The bill failed to pass out of the Assembly by the constitutional deadline.

AB 1897 (Zettel, 2001/2002) and contained the same language as SBX 6 10. This bill was held in committee.

[6] A Section 351 incorporation is where property is transferred to a corporation in exchange for stock of that corporation and no gain or loss is recognized from the transaction.

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 failed to pass out of their respective houses by the constitutional deadline.

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 states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

A review found that these states generally follow the federal capital gains rules for excluding 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 577 For Taxable Years Beginning On or After January 1, 2011 Assumed Enacted After June 30, 2011 ($ in Millions)				
2010-11	2011-12	2012-13	2013-14	2014-15
-$340	-$700	-$800	-$750	-$900

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: Proponents would argue that this bill would stimulate capital investment by California taxpayers.

Con: Opponents would argue that additional tax expenditures should be avoided given the state's current fiscal situation.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 577
As amended on March 31, 2011

AMENDMENT 1

On page 2, line 3, after "18153.", insert:

(a).

AMENDMENT 2

On page 2, between lines 7 and 8, insert:

(b) (1) The Franchise Tax Board may prescribe rules, guidelines, or procedures necessary or appropriate to carry out the purposes of this section, including any guidelines regarding the reporting of the amount of capital gain being excluded under this section.

(2) Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code does not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the Franchise Tax pursuant to this section.

(c) If a taxpayer fails to provide the information that may be required by the Franchise Tax Board under subdivision (b), then the exclusion under subdivision (a) shall not apply unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

AMENDMENT 3

On page 2, line 10, after "24996." insert:

(a).

AMENDMENT 4

On page 2, between lines 14 and 15, insert:

(b) (1) The Franchise Tax Board may prescribe rules, guidelines, or procedures necessary or appropriate to carry out the purposes of this section, including any guidelines regarding the reporting of the amount of capital gain being excluded under this section.

(2) Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code does not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the Franchise Tax pursuant to this section.

(c) If a taxpayer fails to provide the information that may be required by the Franchise Tax Board under subdivision (b), then the exclusion under subdivision (a) shall not apply unless it is shown that the failure is due to reasonable cause and not due to willful neglect.