WASHINGTON STATE BUDGET & POLICY CENTER

CLOSING THE TAX BREAK ON CAPITAL GAINS

To Build A Better Future For Our Children

Currently, our state tax code caters to the wealthiest Washingtonians by giving them generous tax breaks on their capital gains – which are the profits they make from the sale of corporate stocks, bonds, gold bars, and other high-end financial assets. Such financial assets are exempt not only from state and local sales taxes, but also from property taxes, and most business & occupation (B&O) taxes. The simplest and most equitable way to effectively close these state tax breaks is to enact a state excise tax on high-end capital gains. Doing so would generate substantial new resources for Washington state's schools and other investments that foster thriving communities. Eliminating the tax breaks on profits from capital assets in this way would represent a significant step toward turning Washington's inequitable, upside-down tax code – in which people with low incomes pay seven times as much in state and local taxes as a share of income as the wealthiest 1 percent – right-side up. Here are some commonly asked questions about the capital gains tax proposed by House Democrats in the 2017 legislative session.

FREQUENTLY ASKED QUESTIONS

1. What are capital gains?

Capital gains are profits from the sale of corporate stocks, bonds, and other high-end financial assets.[1]

2. Who would pay the Washington state capital gains tax?

More than 92 percent of the tax would be paid by the richest 1 percent of households in Washington state – those with incomes of $600,000 per year or more. Among those households, state taxes would increase by 1.5 percent of annual household income, on average.[2] Only 1.3 percent of Washington taxpayers, almost exclusively those at the very top of the income scale, would pay any capital gains taxes.[3]

3. What would the capital gains tax rate be?

Seven percent. That's less than the combined state and local sales tax rate in every city in Washington state.[4] Under current law, working Washingtonians pay up to 10.4 percent in sales taxes when they buy clothes, toiletries, and other common household goods.[5] Yet, millionaires pay nothing when they reap huge profits from the sales of high-end assets. A state capital gains tax would help to correct that fundamental imbalance in our state's tax code.

4. Would the excise tax on capital gains apply to all profits on the sale of financial assets?

No. The tax proposed by House Democrats during the 2017 legislative session would only apply to capital gains in excess of $25,000 ($50,000 for a married couple) per year.[6]

5. How much revenue would the tax generate and how would those funds be spent?

The tax would generate about $715 million per year in new resources.[7] Under the House Democrats' proposal, all revenues from the tax would be devoted to keeping excellent teachers in every K-12 classroom, reducing class sizes, and ensuring all students have access to the counselors, nurses, and other education professionals they need to succeed.[8] The untenable and unsustainable alternative to raising revenue to pay for schools and other priorities is to make devastating cuts to other crucial investments. This approach would hurt our communities in the short and long term.

6. Would I owe any capital gains taxes on stocks that I donate to charity?

No. Gifts of stock or other assets to a charity or nonprofit are not subject to federal capital gains taxes and wouldn't be subject to the Washington state capital gains tax either. In fact, gifts of stock are deductible from federal income taxes.

7. I have a lot of stocks and other investments in my retirement plan. Would the capital gains tax apply to my retirement savings?

No. The tax, which is based on federal law, would not apply to assets that are invested in a pension plan, a 401(k) plan, an Individual Retirement Arrangement (IRA), Roth IRA, or other retirement plan that is recognized by the IRS for federal tax purposes. Nor would the tax apply when funds from those plans are drawn down during retirement.[9]

8. Do other states have capital gains taxes?

Yes. Forty-two other states tax capital gains. Twelve states tax capital gains at or above the 7 percent rate proposed for Washington state, including our neighboring states of Idaho (7.4 percent), Oregon (9.9 percent), and California (13.3 percent).[10]

9. Would I pay the capital gains tax when I sell my home?

No. Washington state would exempt profits on the sale of residential properties, including houses, condominiums, residential houseboats, duplexes, and triplexes, from the tax.

10. Would investments in college savings accounts be subject to a state capital gains tax?

No. Similar to retirement accounts, funds invested in college savings accounts, such as 529 plans or the state Guaranteed Education Tuition plan, would not be subject to the state capital gains tax.[11]

11. Would I owe capital gains taxes if I inherit a large amount of stock or other assets?

No. All capital gains taxes are forgiven when an asset holder dies. If you inherit capital assets, you would only pay capital gains tax if and when you sell those assets. Even then, you would not owe taxes on gains that accrued before you inherited them. You would only pay taxes on gains (in excess of the $50,000/$25,000 exemption) that accrued after you inherited the assets.[12]

12. Would a state capital gains tax apply to dividend payments?

No. Dividends, which are payments from corporations to shareholders, would not be taxed under the proposal. The tax would only apply to profits from the sale of corporate stocks and other financial assets that exceed $50,000 per year for a married couple (or $25,000 for single filers).

13. Isn't this an income tax?

No. Under Washington state law, a capital gains tax would be a form of excise tax, which is a tax that applies to a transaction, like the sale of real estate or gas at the pump. Capital gains are much different than ordinary paycheck income. While working people must pay taxes on their paycheck incomes as a matter of course, investors have control over when and if they pay a capital gains tax, because they decide when and if to buy and sell stock and other financial assets.[13]

14. How would enacting a capital gains close a tax break?

There are a number of special carve-outs in Washington's tax code for capital assets. "Intangible assets," which include corporate stocks, bonds, trademarks, and other financial assets, are exempt from state and local property taxes. As a result, those who choose to invest their wealth in stocks and other assets get an enormous tax advantage over those who choose to invest in real estate. Sales of stocks, bonds, gold bullion, and other financial assets are also excluded from state and local sales taxes, providing those who choose to spend their money on these assets with yet another major tax break.

15. Would a capital gains tax be good for Washington's economy?

Yes. The tax would help grow the state economy by providing new resources for schools, job retraining, child care, health care, and other investments proven to create jobs and foster robust growth. There is no evidence linking higher taxes on capital gains to lower economic growth.[14, 15] Nor is there any credible evidence to support the claim that a capital gains tax would significantly impact wealthy families' decision to move out of state.[16]

16. Would a capital gains tax harm small businesses?

No. The tax only applies to households, not businesses. Some extremely wealthy households own stock in a private partnerships, exclusive investment clubs, or private corporations, which are sometimes technically considered to be small businesses. Sometimes these entities are able to avoid higher federal corporate taxes by passing windfall stock market profits through to the individual shareholders. Wealthy households would pay taxes on such windfalls to the extent that they exceed $50,000 per year for a married couple (or $25,000 for single filers).[17] More information on how small businesses would benefit from an excise tax on capital gains is available here.

17. Wouldn't a capital gains tax be a form of double taxation?

No. The tax would only apply to the gain in a stock's value since it was originally purchased. The tax wouldn't apply to the original purchase price of the stock, which would automatically be deducted along with any taxes paid at the time of its purchase. The gain, or profit, from the sale of a stock is taxed just once.

18. Would the tax be deductible for federal tax purposes?

Very likely. The few who would pay the tax would most likely be able to deduct those payments when calculating their federal taxes. That means up to 39.6 percent of Washington state capital gains tax payments could be recouped in the form of lower federal tax payments.

19. Why should we enact a capital gains tax?

Washington state has the most upside-down tax code in the nation. That means that low- and middle-income families in our state pay up to seven times more in state and local taxes than what the top 1 percent pay in taxes as a share of income.[18] To make solid investments in excellent early learning and K-12 classrooms, world-class universities, accessible health care, responsive emergency services, and other programs that create jobs and promote a strong state economy, we all have to pitch in. Closing the tax break on capital gains would ask the wealthiest Washingtonians, who benefit significantly from our state's robust community investments, to pay their share.

ENDNOTES

1. See IRS publication 544 (p. 22) for a list of capital assets that could result in taxable capital gain when sold, http://www.irs.gov/pub/irs-pdf/p544.pdf.
2. Washington State Budget & Policy Center analysis of data from Institute on Taxation and Economic Policy, April 2017.
3. Washington State Budget & Policy Center analysis of data from Institute on Taxation and Economic Policy, April 2017.
4. Washington State Department of Revenue, Local Sales & Use Tax Rates, 2017, Quarter 2. http://dor.wa.gov/Docs/forms/ExcsTx/LocSalUseTx/LocalSlsUseFlyer_17_Q2_alpha.pdf. There is no taxing district with a combined state and local tax rate less than 7 percent. One taxing district, the unincorporated areas of Klickitas County, has a combined sales tax rate of 7 percent.
5. See endnote 4.
6. See fiscal note for House Bill 2186, prepared by Office of Fiscal Management, https://app.leg.wa.gov/CMD/Handler.ashx?MethodName=getdocumentcontent&documentId=ZDaBzVAWkh8&att=false.
7. See endnote 6.
8. All revenues would be deposited into the state Education Legacy Trust Fund Account, which supports a broad array of K-12 activities.
9. See IRS publication 550, http://www.irs.gov/publications/p550/ar01.html. Capital gains taxes are not applied to gains that accrue to investments held in federally recognized retirement plans – like pension plans, 401(k) plans, 403(b) plans, IRAs, and Roth IRAs. And although distributions from those plans are generally taxed as ordinary income for federal tax purposes, distributions would not be subject to any state capital gains taxes, because Washington state does not have an income tax.
10. Federation of Tax Administrators, https://taxadmin.memberclicks.net/assets/docs/Research/Rates/ind_inc.pdf.
11. See 529 Plans: Questions and Answers, IRS, http://www.irs.gov/uac/529-Plans:-Questions-and-Answers.
12. See Publication 559, from the IRS, http://www.irs.gov/publications/p544/ch03.html#en_US_2013_publink100072611.
13. Hugh Spitzer, "Memorandum: Character of Proposed State Capital Gains Tax," 2011. In a legal memo provided to the Washington State Budget & Policy Center, Hugh Spitzer, an attorney and constitutional law professor at the University of Washington School of Law, argues that a state capital gains tax would be upheld be the State Supreme Court as a legal, ". . . one-time transaction tax, measured by the profit received upon sale or transfer, rather than a tax on 'income' from capital gains."
14. Thomas Hungerford, "The Economic Effects of Capital Gains Taxation," The Congressional Research Service, 2010, http://fas.org/sgp/crs/misc/R40411.pdf. Hungerford reviews the literature on capital gains taxation and economic growth and concludes, "capital gains tax rate reductions are unlikely to have much effect on the long-term level of output or the path to the long-run level of output (*i.e.*, economic growth). . . . A tax reduction on capital gains would mostly benefit very high income taxpayers who are likely to save most of any tax reduction. Economists note that a temporary capital gains tax reduction possibly could have a negative impact on short-term economic growth."
15. Chye-Ching Huang, Chuck Marr, "Chart Book: 10 Things You Need to Know About the Capital Gains Tax," Center on Budget and Policy Priorities, 2012, http://www.cbpp.org/cms/index.cfm?fa=view&id=3798. Huang and Marr cite a number of studies that find no relationship between capital gains tax rates and economic growth as measured by a variety of indicators.
16. Michael Mazerov, "State Taxes Have a Negligible Impact on Americans' Interstate Moves," Center on Budget and Policy Priorities, 2014, http://www.cbpp.org/research/state-budget-and-tax/state-taxes-have-a-negligible-impact-on-americans-interstate-moves. Mazerov reviews extensive economic literature on the relationship between state taxes and interstate moves and concludes, "Taken as a whole, the research strongly refutes the claim that state and local taxes have a significant impact on migration."
17. Jane Gravelle, "Capital Gains Taxes, Innovation and Growth, Congressional Research Services Report for Congress," http://wikileaks.org/wiki/CRS:_CAPITAL_GAINS_TAXES,_INNOVATION_AND_GROWTH,_July_14,_1999. Gravelle reviews literature and economic theory on the relationship between venture capital – investments in small, start-up businesses – and capital gains taxes. She finds that the vast majority (88 percent) of venture capital is supplied by entities that are not subject to individual capital gains taxes, like insurance companies, pension plans, endowments, and foundations. She also notes that the small number of individual venture capital investors have been shown to be insensitive to capital gains tax rates. In fact, venture capital from individuals increased following the federal tax reforms in 1986 and 1987, which involved significant increases in the federal capital gains tax rates. She concludes "The pattern of venture capital provided over time does not support a strong role for a capital gains tax."
18. Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in All 50 States," fourth edition, 2013, http://www.itep.org/pdf/whopaysreport.pdf.

