Full Review: Capital Gains Exclusion

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Background–Capital Gains

- Defined as the profits resulting from the sale of a capital asset
  - Stocks, bonds
  - Business or real estate
  - Works of art or collectibles
- Classified as long or short term
  - Long term= asset held for one year or longer
- Subject to personal income tax rates in Vermont because they are a part of Adjusted Gross Income

CG Exclusion: What is it?

- Vermont-specific deduction, acts as a subtraction from VT Taxable Income (VTI)
- Taxpayers have two options
  - Flat exclusion of $5,000 on total capital gains, short or long-term
  - Exclusion equal to 40% of capital gains from the sale of assets held for more than 3 years.
    - Limited to sales of primarily businesses, farms, investment properties
- Amount cannot exceed 40% of more of VTI

A little history…

- Prior to 2002, Vermont income taxes were a set percentage of Federal liability
- Bush Tax Cuts in 2002 led to changes in VT's income tax code
  - New, separate system with new rates based upon Federal Taxable Income
- Capital gains had been taxed at lower rates than ordinary income for decades at Federal level
- Vermont decided to keep preferential treatment for Capital Gains when it made the change to an independent system

Statutory Purpose

- 32 V.S.A. § 5813(b)
- Three parts:
  - “. . . increase savings and investment by making the effective tax rate on capital gains income lower than the effective tax rate on earned income.”
  - “. . .exempting a portion of the capital gain that may represent inflation.”
  - “The 40 percent business capital gains exclusion mitigates the impact of one-time realizations in a progressive tax structure.”

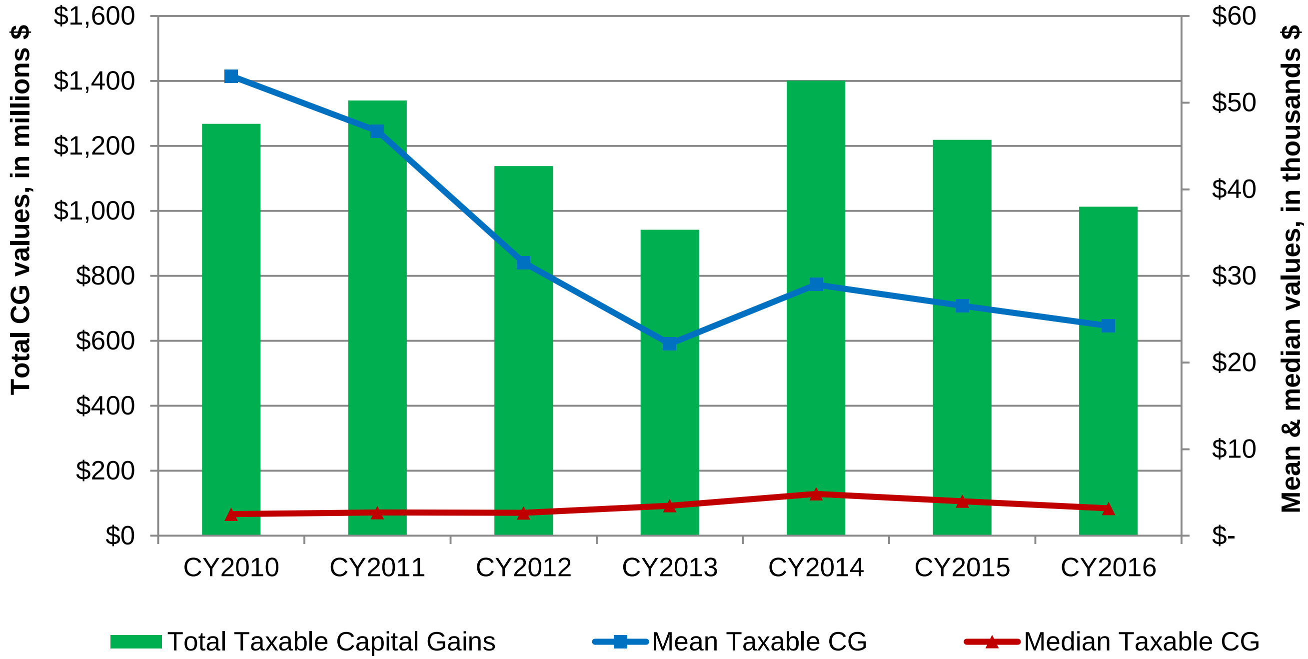
Quick Facts

- CY2016:
  - 41,865 taxpayers claimed the exclusion
  - $303.5 million in capital gains excluded
  - Roughly $15 million tax expenditure, although fluctuates depending on the year

Quick Facts

Capital gains tend to fluctuate from year to year but are always heavily skewed towards large capital gains

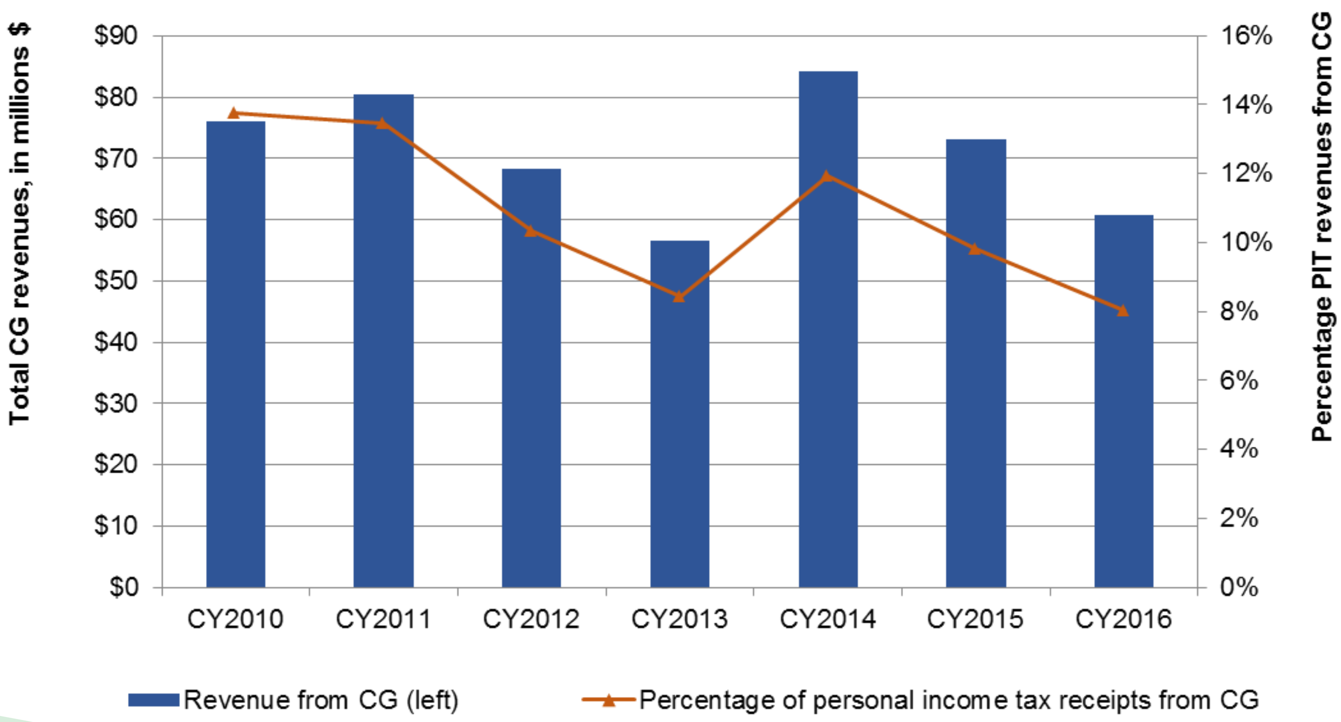
Figure 1: Total, mean, and median taxable capital gains in Vermont



Quick Facts

Capital gains represent between 8-14% of Personal Income Tax revenues

Figure 2: Estimated personal income tax revenues from capital gains

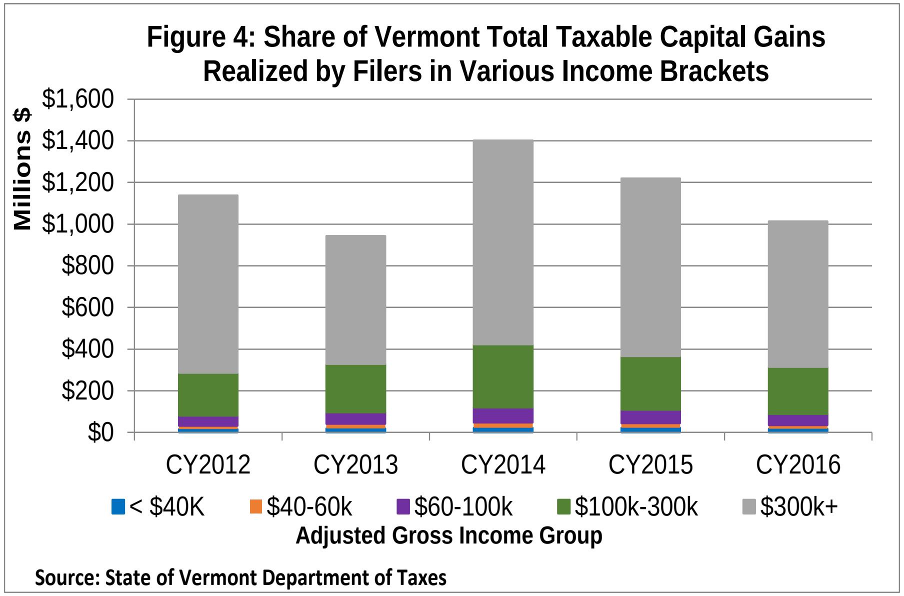


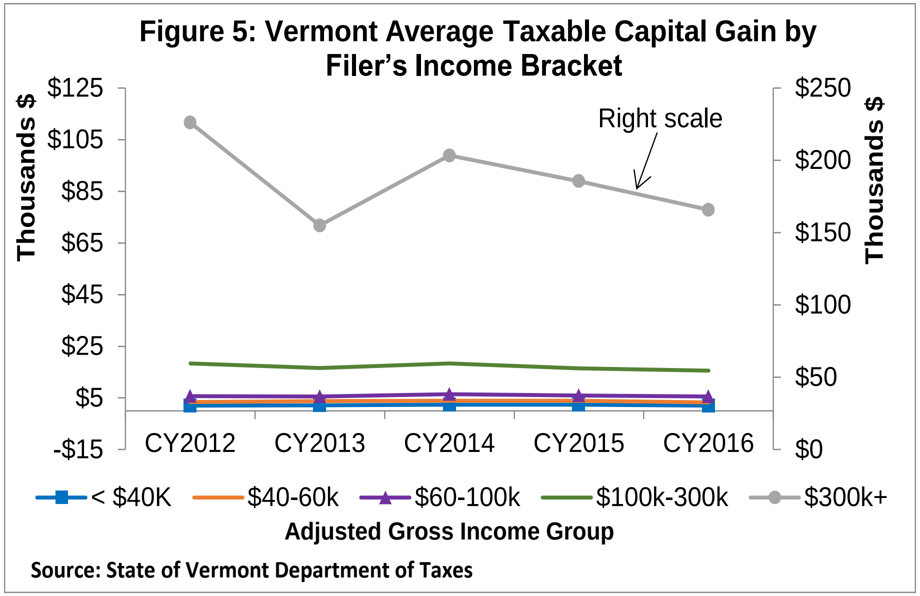
Key Finding #1

- **Higher-income, older taxpayers account for the majority of capital gains and exclusions**
  - 60% of total capital gains exclusions went to filers with AGI above $300,000
  - 18% of total capital gains exclusions went to filers with AGI below $100,000
  - Average capital gains exclusions:
    - Filers above $300,000 AGI: $43,000
    - Filers below $100,000 AGI: $4,600
  - 65% of total capital gains exclusions came from taxpayers 55 and older

Key Finding #1

Higher income taxpayers have the most capital gains….





Key Finding #1

…so they also account for most of the Capital Gains Exclusion

Table 1: Taxable Capital Gains and Exclusions by Filers in Various Income Groups in CY2016

Adjusted Gross Income	Accounts Reporting Capital Gains	Total Taxable Capital Gains	Average Taxable Capital Gain	Total Capital Gains Excluded From Income	Percent of Total Capital Gains Exclusions	Average Capital Gains Exclusion
Less than $40,000	8,236	$17,043,548	$2,069	$13,099,367	4%	$1,591
$40,000 to $60,000	5,321	$17,296,454	$3,251	$13,106,240	4%	$2,463
$60,000 to $100,000	9,484	$53,310,460	$5,621	$28,139,032	9%	$2,967
Below $100,000	23,041	$87,650,462	$3,804	$54,344,639	18%	$2,359
$100,000 to $300,000	14,595	$227,328,649	$15,576	$67,006,896	22%	$4,591
$300,000 and above	4,229	$698,636,678	$165,201	$182,148,940	60%	$43,071
Total	**41,865**	**$1,013,615,789**	**$24,212**	**$303,500,475**		**$7,250**

Key Finding #2

- For the vast majority of taxpayers, the exclusion's tax benefit declines as income rises.
- For those who can take the 40% exclusion (business owners, farmers, property investors), higher-income taxpayers receive a greater tax benefit.

Key Finding #2

95% of exclusion-takers use the $5,000 exclusion. The remaining 5% use the 40% exclusion

Table 4: Capital Gains Exclusions by Type and Income Group in CY2016							
	40% Exclusion				$5,000 Exclusion		
AGI Group	Returns Taking	Total Amount Excluded Under 40% Exclusion	Under 40% Exclusion		Returns Taking $5,000 Exclusion	Excluded Under $5,000 Exclusion	Average Exclusion Under $5,000 Exclusion
Less than $40,000	66	$455,957	$6,908		8170	$12,643,410	$1,548
$40,000 to $60,000	157	$1,452,702	$9,253		5164	$11,653,538	$2,257
$60,000 to $100,000	416	$4,982,877	$11,978		9068	$23,156,155	$2,554
$100,000 to $300,000	1040	$25,380,023	$24,404		13555	$41,626,873	$3,071
$300,000 and above	552	$167,000,704	$302,538		3677	$15,148,236	$4,120
Total	**2231**	**$199,272,263**	**$89,320**		**39,634**	**$104,228,212**	**$2,630**

Key Finding #2

- Who takes the 40% Exclusion?
  - Is it people who have one-time, large sales of capital assets like farms or businesses?
    - In CY2016, 2,231 taxpayers took the 40% exclusion
      - 1,110 of them claimed it in at least one other year between CY2012 and CY2015
      - 470 claimed it 3 or more times

  - Is it farmers selling off their assets?
      - Less than 200 of the 2,231 taxpayers who took 40% reported any farm income
      - Less than $8 million in capital gains exclusions, out of the total $199 million excluded under the 40% exclusion

Key Finding #2

- Who takes the 40% Exclusion?
  - Is it people who are selling an asset for use as a next egg?

Table 5: Age Distribution of Filers Who Took the 40% Exclusion: CY2016			
Age Group	**Number of Returns**	**Average Capital Gains Exclusion**	**Total Taxable Capital Gains Excluded**
< 18	Less than 10	…	…
18-35	86	$122,100	$10,500,614
35-45	166	$77,623	$12,885,453
45-55	361	$127,412	$45,995,694
55-65	612	$76,330	$46,713,719
65+	999	$80,880	$80,798,722
Unreported	Less than 10	…	…
Total	**2,231**	**$89,320**	**$199,272,263**

Key Finding #2

Table 2: Hypothetical Examples of Capital Gains Incentives (2017 Tax Year)

		$5,000 Exclusion (95% of CG filers)		40% Exclusion (5% of CG filers)		Federal Tax Benefit	
		Vermont Taxes		Vermont Taxes		Federal Taxes	
Adjusted Gross Income	Long-Term Capital Gains (based on observed data)	Tax Benefit of Exclusion	Tax Benefit of Exclusion as Percent of AGI	Tax Benefit of Exclusion	Tax Benefit of Exclusion as Percent of AGI	Federal Tax Benefit	Tax Benefit of Lower Rates as Percent of AGI
$40,000	$2,000	$71	0.2%	$71	0.2%	$228	0.6%
$60,000	$3,500	$125	0.2%	$125	0.2%	$525	0.9%
$100,000	$5,600	$340	0.3%	$340	0.3%	$675	0.7%
$300,000	$15,000	$440	0.1%	$528	0.2%	$2,700	0.9%
$500,000	$65,000	$440	0.1%	$2,288	0.5%	$11,704	2.3%
$1,000,000	$150,000	$447	0.0%	$5,370	0.5%	$29,400	2.9%
$2,000,000	$300,000	$447	0.0%	$10,740	0.5%	$58,800	2.9%

Note: The higher income examples assume various levels of itemized deductions:

$300,000 Example: $34,000 in itemized deductions

$500,000 Example: $75,000 in itemized deductions

$1,000,000 Example: $105,000 in itemized deductions

$2,000,000 Example: $135,000 in itemized deductions

Federal tax benefits are significant

Key Finding #3

- **The capital gains exclusion helps Vermont remain tax competitive with neighboring states that do not have special tax treatment for capital gains but have lower top marginal tax rates.**
  - Compared to other states:
    - VT's $5,000 exclusion provides a much greater tax benefit for taxpayers below $100,000 AGI
    - For taxpayers above $100,000 who can't take 40% exclusion, lower marginal tax rates in other states are better
    - For taxpayers above $100,000 who can take 40% exclusion, VT's tax on capital gains is among most favorable in region

Key Finding #3

$5,000 exclusion is tax-advantageous for low-income filers, but less so for high-income filers with large capital gains

Table 9: Marginal Capital Gains Taxes of New England States												
		Vermont				Massachusetts	New Hampshire	Maine	Connecticut	Rhode Island	New York
		40% Exclusion		$5000 Flat Exclusion		5.2% tax rate on capital gains	0% tax rate all income except dividends and interest	Individual income tax rates on capital gains	Individual income tax rates on capital gains	Individual income tax rates on capital gains	Individual income tax rates on capital gains
Adjusted Gross Income	Long-Term Capital Gains (based on observed data)	40% Exclusion	Marginal Tax on Capital Gains	$5000 Exclusion	Marginal Tax on Capital Gains	Marginal Tax on Capital Gains	Marginal Tax on Capital Gains	Marginal Tax on Capital Gains	Marginal Tax on Capital Gains	Marginal Tax on Capital Gains	Marginal Tax on Capital Gains
$40,000	$2,000	N/A	$0	$2,000	$0	$104	$0	$116	$60	$75	$90
$60,000	$3,500	N/A	$0	$3,500	$0	$182	$0	$236	$175	$131	$207
$100,000	$5,600	N/A	$40	$5,000	$40	$291	$0	$400	$280	$266	$361
$300,000	$15,000	$6,000	$788	$5,000	$875	$780	$0	$1,073	$900	$899	$998
$500,000	$65,000	$26,000	$3,413	$5,000	$5,250	$3,380	$0	$4,648	$4,225	$3,894	$4,453
$1,000,000	$150,000	$60,000	$7,875	$5,000	$12,688	$7,800	$0	$10,725	$10,350	$8,985	$10,275
$2,000,000	$300,000	$120,000	$15,750	$5,000	$25,813	$15,600	$0	$21,450	$20,970	$17,970	$20,550

Note: The higher income examples assume various levels of itemized deductions

Other state income tax rates do not include local income taxes

Key Finding #3

40% exclusion is tax-advantageous for high-income filers compared to other states

Table 9: Marginal Capital Gains Taxes of New England States

		Vermont				Massachusetts	New Hampshire	Maine	Connecticut	Rhode Island	New York
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Other state income tax rates do not include local income taxes

Key Finding #3

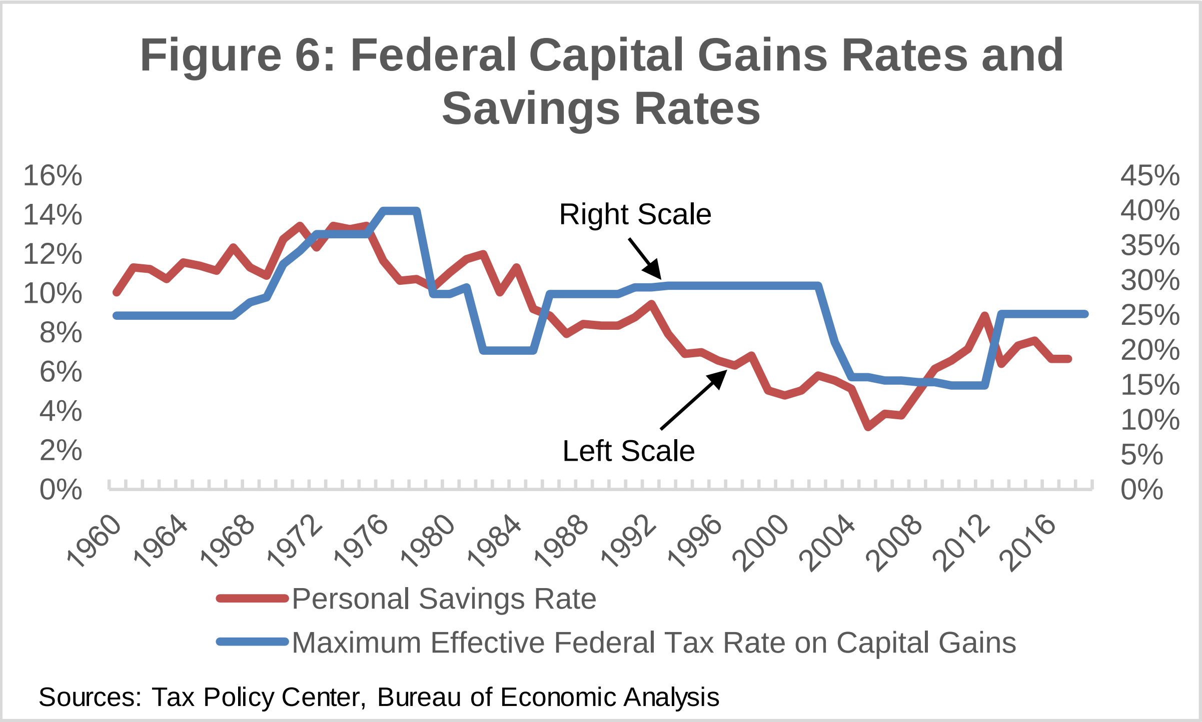
Table 8: State Tax Breaks for Capital Gains	
State	**Tax Treatment of Capital Gains**
Vermont	Capital gains exclusion: $5,000 of long-term capital gains or 40% of capital gain from sale of business, farm, or investment property.
Arizona	25% deduction of capital gains from taxable income
Arkansas	50% exclusion of net capital gains from taxable income
Hawaii	Capital gains taxed at lower rates than ordinary income
Montana	Credit equal to up to 2% of net capital gains
New Mexico	50% exclusion of net capital gains from taxable income
North Dakota	40% exclusion of net capital gains from taxable income
South Carolina	44% exclusion of net capital gains from taxable income
Wisconsin	30% exclusion of net capital gains from taxable income, 60% exclusion for farm assets

- Some states have exclusions related to sales of in-state assets (Colorado, Louisiana, Oklahoma, Idaho)

Key Finding #4

- **It is unlikely that the Vermont capital gains exclusion is encouraging savings and investment.**
  - Nationwide research on the effect of capital gains on savings and investment is mixed at best, although most studies show little to no effect
  - Tax benefits of Vermont's capital gains exclusion are significantly smaller than Federal tax benefits
    - Unlikely the Vermont exclusion is enough to drive savings and investment behavior

Key Finding #4



Key Finding # 4

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$2,000,000 Example: $135,000 in itemized deductions

Key Finding #5

- Exempting a portion of capital gains from taxation creates and inconsistency in the Vermont tax code
  - Dividends, interest income, rents do not receive any preferential tax treatment, even though they are more affected by inflation

Areas for Legislative Consideration

- **1) Review or reassess the statutory purpose, particularly around the goals of increasing savings or investment**
  - Link between capital gains taxes, and savings and investment is weak
  - Lack of clarity surrounding the purpose:
    - Is the goal of the exclusion to increase savings for savings sake? Or is it to increase savings for investment?
    - Is the exclusion intended to boost Vermont savings and investment? Or savings and investment in general?

Areas for Legislative Consideration

- **2) Review the reasoning behind giving preferential tax treatment to capital gains**
  - Does Vermont need to further encourage savings and investment on top of the Federal tax treatment?
    - Is the incentive large enough?
    - Would removing the 40% exclusion cause people to hold on to assets rather than selling them?
  - If the goal is to increase savings, and high-income filers generally have high savings rates, are capital investments the type of savings to incentivize?
  - How important is it to be tax competitive with other states?

Areas for Legislative Consideration

- 3) Potential reconfigurations depending upon Legislative intent:
  - Provide tax incentives for all savings types:
    - Lowering 40% exclusion but extending exclusion to dividends and interest or other types of savings.
  - Boosting Vermont-specific investment:
    - Making the exclusion applicable to capital gains from Vermont-domiciled assets.
  - Maintaining tax competitiveness
    - Eliminating the exclusion entirely and lowering income tax rates
- Note: None of these options has been formally proposed by any legislator. They represent options should legislators decide to change exclusion to better meet its goals.