

Vermont Legislative Joint Fiscal Office

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Taxation of Capital Gains

Capital gains are the increase in value of assets held over time. When a capital asset is sold, the difference between the sales price and the basis (usually the price paid for it) is a capital gain or a capital loss. Capital gains and losses are classified as long-term (assets held longer than one-year) or short-term (assets held one-year or less). Generally, preferential tax rates apply to net (capital gains minus capital losses) long-term capital gains. Short-term gains are usually taxed at ordinary income tax rates. Gains from collectibles, real estate transactions of primary residences, and the recapture of depreciation are treated separately.

Federal Taxation

Net, long-term capital gains receive preferential treatment under federal income tax laws. Taxpayers in the 10% or 15% brackets have a top capital gains rate of 5%. Taxpayers in all other brackets (25%, 28%, 33% and 35%) have a top rate on capital gains of 15%.¹

Vermont Taxation

Vermont taxpayers may exclude 40% of their federally defined, net, long-term, capital gains from any tax. The remaining 60% is taxed at ordinary personal income tax rates. The median amount of capital gains in Vermont was \$2,500², meaning that half of all taxpayers with a long-term capital gain had less than \$2,500 and half had more.

2007 Comparison of Ordinary Income and Capital Gains Tax Rates

Federal		Vermont	
<i>Income Tax Rates</i>	<i>Capital Gains Rates</i>	<i>Income Tax Rates</i>	<i>Effective Capital Gains Rates</i>
10.0%	5.0%	3.60%	2.16%
15.0%	5.0%	3.60%	2.16%
25.0%	15.0%	7.20%	4.32%
28.0%	15.0%	8.50%	5.10%
33.0%	15.0%	9.00%	5.40%
35.0%	15.0%	9.50%	5.70%

Arguments For Preferential Tax Treatment of Capital Gains

The arguments for preferential capital gains tax rates are primarily economic.

- Lower capital gains tax rates create greater incentives for personal saving and investment. This translates into more capital investment, especially in equities, and a higher level of economic output.
- For many taxpayers, capital gains realizations are one-time events representing income that has accrued over many years. Because income tax rates are progressive, a single large realization could push a taxpayer into a very high tax bracket.

¹ Net long-term capital gains excluding "25% gain" (recapture of depreciation based on straight-line depreciation) and "28% gain (gain on collectables).

² Tax years 2003 and 2004

- A portion of capital gains simply represent inflation. To determine gain, it is necessary to compare the amount realized expressed in current dollars with the basis expressed in dollars from an earlier period. Current and historical dollar amounts are not directly comparable because of inflation.
- Some investors postpone realizing capital gains in order to avoid the tax thus keeping economic assets “locked-up.” If the assets are held, capital gains taxes can be avoided altogether and the assets bequeathed to heirs at a stepped-up basis. Preferential rates make it advantageous to realize these gains, avoid lock-up of capital, and promote economic activity.
- Capital gains taxes are a double taxation of savings. If income is consumed immediately there is no further tax (at least under the income tax), but if additional income is earned from savings, capital gains, interest income, or dividends are all subject to additional taxes.

Arguments Against Preferential Tax Treatment of Capital Gains

The arguments against a preferential treatment of capital gains are primarily based on equity concerns.

- Lower rates on capital gains disproportionately benefit the wealthiest taxpayers.
- A rate preference for capital gains provides an unfair advantage to people who can earn a large share of their income in that form. It favors taxpayers with a great deal of flexibility about how they receive their income over those with little choice but to take their income in a more heavily taxed form, such as salaries and wages.
- The different treatment of long-term capital gains contributes a great deal of complexity to the tax system. In addition, the efforts at tax planning in order to take advantage of the preferential rates on capital gains create economic inefficiencies.
- Capital gains are only taxed when “realized”, therefore capital gains taxes may be deferred indefinitely by the taxpayer. Even without a preferential rate, capital gains are treated more favorably than other returns such as interest and dividends, which are taxed annually.

Brief Federal Capital Gains Tax History

Capital gains have been taxed at lower rates than ordinary income for most of the history of the income tax. Since 1934, capital gains tax preferences have generally been affected by means of an exclusion—that is, a portion of long-term capital gains were excluded from tax. For example, from 1982 to 1986, 60 percent of long-term capital gains were excluded from tax. Since the top tax rate on ordinary income was 50 percent, this implies a top effective tax rate on capital gains of 20 percent. Before 1978, capital gains were subject to different tax rates as well as an exclusion. Since 1991, long-term capital gains have been subject to alternative lower rates only. In 2003, the top tax rate on long-term capital gains was cut from 20 percent to 15 percent.

Brief Vermont Capital Gains Tax History

Between 1968 and 2000 Vermont was “piggybacked” to the federal personal income tax. Vermont tax liability was a percentage of federal liability, therefore all of the provisions of the federal tax code, including the preferential treatment of capital gains, was passed through to Vermont taxpayers. In 2002, as part of the restructuring of the personal income tax, the 40% exclusion of capital gains was enacted. This was an attempt to approximate the capital gains benefit received under the piggyback system.

Treatment of Capital Gains in Other States

Of the states with an individual income tax:

- 31 states do not provide preferential treatment for capital gains income
- Five states (Arkansas, North Dakota, South Carolina, Vermont, and Wisconsin) exclude a portion of capital gains income from taxable income
 - *Arkansas* excludes up to 30% of net long-term capital gains
 - *North Dakota* exempts gains realized on sale of property under eminent domain and corporate stock that relocated to N.D.
 - *South Carolina* excludes 44% of long-term capital gains
 - *Vermont* excludes 40% of net long-term capital gains
 - *Wisconsin* excludes 60% for assets held more than one year. The deduction for net capital losses limited to \$500. Gains from qualified small business stock and family business sales are excluded.
- Three states exclude all or part of the gain on property located in the state (Colorado, Idaho, and Iowa); the exclusion does not apply to gains on sale of stocks except in Colorado, where at least 50 percent of the company's payroll and property must be located in-state for the exclusion to apply to sale of stock
- Massachusetts applies a lower rate to capital gains income, depending on how long the taxpayer has held the asset. Short-term capital gains (net of capital losses) and capital gains from collectibles and pre-1996 installment sales (less certain excess deductions from a trade or business and 50% of long-term capital gains from collectibles and pre-1996 installment sales) are taxed at 12%. Other long-term capital gains are taxed at 5.4%.

Sources:

"Individual Income Tax Provisions in the States," Wisconsin Legislative Fiscal Bureau, January 2007.

<http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=540>

<http://www.house.leg.state.mn.us/hrd/issinfo/sscapgain.htm>