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Moving Families Forward

PAYCHECK$ and POLITICS

Arkansas Advocates for Children and Families

Issue 52: December 2010

MILLIONAIRE'S GAIN: The Impact of Cutting Arkansas Capital Gains Taxes

By Rich Huddleston

The Arkansas General Assembly will likely consider one or more proposals to eliminate or reduce state taxes on capital gains during the 2011 legislative session. While the Arkansas state budget situation is not as bad as that of some states, it's clear that state general revenue will be tight during the next two years. Proposals to cut taxes on capital gains will have to be carefully examined in light of the potential impact they could have on the state budget. Three issues will be central to this debate:

1. What is the impact on state general revenue?
2. What is the potential impact on the balance of the Arkansas tax system among working families at different income levels?
3. What is the impact on state economic development?

What are Capital Gains?

First, some background. Capital gains are profits from the sale of an asset, such as stocks and bonds, investments, vacation homes, art and other items. Capital gains taxes are not owed when an asset appreciates in value from one year to the next. They are owed only when an asset is sold and profits are made. The capital "gain" that is taxed is the difference between the original purchase price and the price of the asset at the time of sale.

Two of the most common types of assets held by working Arkansans—assets in retirement accounts and their homes—generally are not treated as taxable gains when they are sold. Assets in 401(k) and Individual Retirement Accounts are considered ordinary income and are not eligible for capital gains tax breaks. Similarly, the profit resulting from the sale of a homeowner's primary residence is generally exempt from federal and state taxes (typically up to the first $500,000 of profit).

Most of the 41 states that levy income taxes treat capital gains as regular income. According to the Institute on Taxation and Economic Policy, Arkansas is one of eight states that offer generous tax breaks on capital gains. Arkansas currently levies the same tax rate on capital income as it does regular income, but exempts 30 percent of capital income from taxes.

Who Earns Capital Gains Income in Arkansas?

Capital gains income is earned disproportionately by those with higher incomes. This is no surprise because higher income earners have more disposable income and more assets with which to invest. The percentage of all Arkansas taxpayers earning capital gains income is relatively small. Only 9 percent of taxpayers earn capital gains income. If you are lucky enough to be among the state's top 1 percent of taxpayers, however, your likelihood of earning capital gains income is pretty high. Nearly three-fourths (74 percent) of Arkansas taxpayers with incomes above $352,000 earn capital gains income.

Capital Gains Income by Income Group, Arkansas 2010

Income	Income Range	Average Income	% of Cap Gains Income Earned by Group	% of Taxpayers in Group Earning Capital Gains
Lowest 20%	Less than $15,000	$10,000	0%	0%
Second 20%	$15,000- $27,000	$21,000	0%	1%
Middle 20%	$27,000- $45,000	$36,000	1%	10%
Fourth 20%	$45,000-$71,000	$57,000	1%	10%
Next 15%	$71,000-$139,000	$93,000	6%	20%
Next 4%	$139,000-$352,000	$201,000	16%	39%
Top 1%	$352,000 or more	$902,000	75%	74%

Source: Institute on Taxation and Economic Policy (ITEP) Microsimulation Tax Model, November 2010

For 2010, the poorest 80 percent of Arkansas taxpayers (those with incomes less than $71,000) are projected to earn only 2 percent of the capital gains income earned by the state's taxpayers. In contrast, the top 1 percent of Arkansas taxpayers, those with incomes of $352,000 or more, will likely earn 75 percent of all capital gains income in Arkansas. The concentration of capital gains income has obvious implications for who pays capital gains taxes in Arkansas and who would benefit from reducing or eliminating the tax. Any reduction in capital gains taxes would disproportionately benefit the state's wealthiest taxpayers and provide little relief to middle-income taxpayers.

Who Benefits from Eliminating the Tax on Capital Gains?

As stated earlier, currently 30 percent of capital gains income is exempted from Arkansas income taxes. What would be the impact on Arkansas taxpayers if the remaining 70 percent of capital gains income currently subject to Arkansas taxes was removed from the tax base? Since upper-income taxpayers earn most of the capital gains income in the state, they would disproportionately benefit from removing capital gains from the tax base.

- The top 1 percent of Arkansas taxpayers, those with incomes above $352,000, would see an average tax cut of $7,142. Fifty-eight percent of the taxpayers in this top group would benefit from eliminating taxes on capital gains.
- In contrast, lower and middle income taxpayers would receive little, if any benefits. The poorest 20 percent of Arkansas taxpayers, those with incomes less than $15,000, would get nothing out of a tax cut.
- The middle 20 percent of Arkansas taxpayers, those with incomes between $27,000 and $45,000, would see an average tax cut of $2 per year. Less than 7 percent of middle-income taxpayers would benefit from eliminating the tax on capital gains. In all, only 6 percent of all Arkansas taxpayers would be impacted.

What would be the Fiscal Impact?

For calendar year 2010, the Institute on Taxation and Economic Policy estimates that eliminating the state tax on capital gains would have reduced state taxes by $118 million. Any reduction in state taxes would be partially offset by an increase in federal taxes paid by Arkansas taxpayers on their federal returns (currently state taxes paid on capital gains income can be partially offset or "written off" on federal returns, thereby reducing the amount of federal taxes owed). About 14 percent, or $16 million, of the $118 million in state taxes on capital gains paid by Arkansas taxpayers is offset by higher federal taxes owed. The net impact of eliminating the state tax on capital gains for Arkansas taxpayers would be $102 million ($118 million reduction in state taxes minus $16 million in increased federal taxes).

What would be the Impact on State Economic Development?

There's a false claim that reducing or eliminating the tax on capital gains spurs investment and promotes economic development. But there's little connection between lower capital gains taxes and economic growth, especially at the state level. Why? Two reasons. First, it's unlikely that any new investment resulting from

Impact of Removing Capital Gains From the Tax Base

2010 Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $15,000	$15,000 – $27,000	$27,000 – $45,000	$45,000 – $71,000	$71,000 – $139,000	$139,000 – $352,000	$352,000 – Or More
Average Income in Group	$10,000	$21,000	$36,000	$57,000	$93,000	$201,000	$902,000
Tax Change as % of Income	—	–0.0%	–0.0%	–0.0%	–0.0%	–0.2%	–0.8%
Average Tax Change	$0	$0	-$2	-$5	-$43	-$331	-$7,142
Group's Share of Total Tax Cut	0%	0%	0%	1%	7%	14%	77%
% of Arkansans in Income Group Affected by Cut	0%	0%	7%	4%	13%	30%	58%

Source: Institute on Taxation and Economic Policy (ITEP) Microsimulation Tax Model, November 2010

reducing or eliminating the state tax on capital gains would benefit the Arkansas economy because investors are free to invest the savings anywhere in the nation or in the world. There is no requirement that they reinvest the tax cut in Arkansas and they are just as likely to invest it elsewhere, yielding no benefit to the Arkansas economy.

Second, as stated earlier, part of the state tax cut that Arkansas taxpayers would receive (14 percent) would be offset by higher taxes on federal returns and that money would flow mostly to taxpayers in other states. Imagine a state economic development program that sent 14 percent of its cash out of state never to be seen again. By any standard, that would be an inefficient way to promote state economic development.

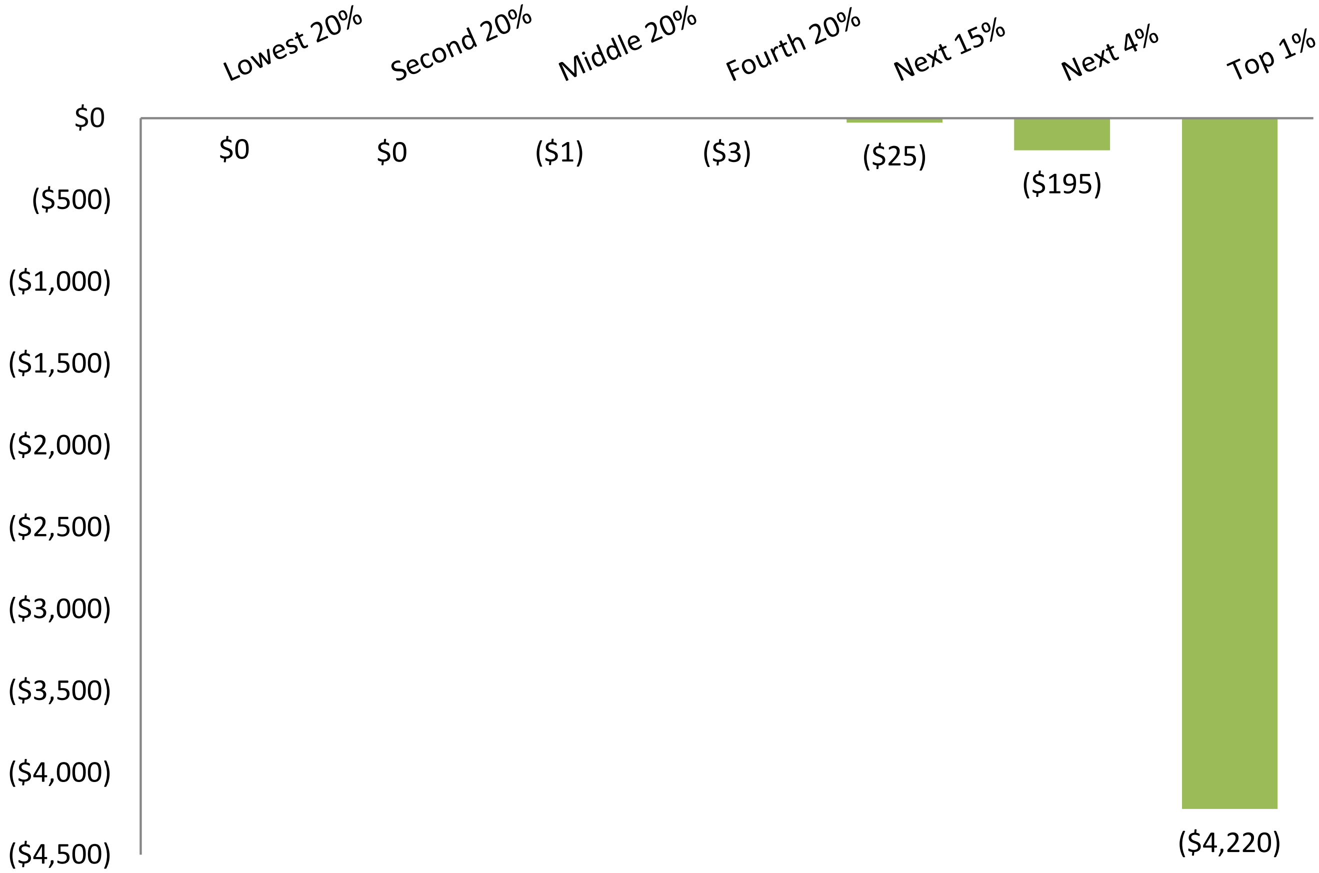
Finally, it is worth noting that many experts say that factors other than taxes are more important in business location decisions and state economic development: a highly educated and healthy workforce, a strong education system, access to markets and distribution networks, high quality public infrastructure, public amenities and general quality of life. Eliminating the state tax on capital gains comes at a time when state tax revenue is tight. Removing $118 million from the state tax base could endanger critical public services, such as K-12 education, higher education, corrections, economic development, Medicaid and more. These core services are critical to the well-being of the state's children and families, Undermining them would hurt the state's long-term economic competitiveness.

Impact and Tax Fairness of House Bill 1002

One bill to reduce state capital gains taxes in Arkansas has been pre-filed for the 2011 session of the Arkansas General Assembly. House Bill 1002 would exempt 100 percent of "Arkansas capital gains." "Arkansas capital gains" are basically capital gains earned on investment in-state and represent a smaller subset of total capital gains income received by Arkansas taxpayers. They are defined to include only real property located in Arkansas, tangible personal property located in Arkansas for one year, intangible property located in Arkansas for one year, and the stock or other investments in businesses headquartered in Arkansas. The cost of that bill (meaning the loss in state revenue) is estimated to be $55 million to $65 million for each year of the biennium).

The distribution of "Arkansas capital gains" by income group is likely to be basically identical to the distribution of total capital gains income, albeit on a smaller scale. Based on that assumption, the Institute on Taxation and Economic Policy estimates that the bottom 40 percent of taxpayers, those with incomes less than $27,000, would get nothing from a tax cut. The middle 20 percent of Arkansas taxpayers, those with incomes between $27,000 and $45,000, would see an average tax cut of just $1. Removing "Arkansas

Average Tax Change by Income Group Under House Bill 1002



Source: Institute on Taxation and Economic Policy (ITEP) Microsimulation Tax Model, November 2010

Capital Gains" from the tax base would disproportionately benefit the top 1 percent of taxpayers, those with incomes of more than $352,000 (average income of $902,000). This group would see an average tax cut of $4,220.

What is one of the biggest flaws in House Bill 1002, other than the loss of revenue? There is no requirement that investors reinvest their savings from the capital gains tax cut back into Arkansas based businesses. This raises the likelihood that investors will reinvest any savings outside the state where they might earn a higher rate of return (or simply where they prefer to invest their money), thus limiting its potential impact on state economic development.

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