Rich Huddleston, Executive Director

Kathryn Hazelett, Research & Fiscal Policy Director

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Revisiting the Arkansas Capital Gains Tax Cut:

Is it Time to Reconsider?

by Richard Huddleston

In 1999, the Arkansas General Assembly passed Act 1005, legislation cutting the Arkansas capital gains tax. Since that time, recent events have dramatically altered the fiscal landscape at both the federal and state levels. In response to an Arkansas Supreme Court mandate, the Arkansas legislature enacted a large sales tax increase in 2004 to fund education. In 2003, the U.S. Congress dramatically cut the federal capital gains tax, and is now on the verge of passing a federal budget that cuts low-income programs and imposes new costs on states. Given recent events, is it now time for Arkansas to reconsider the capital gains tax cut enacted in 1999?

Capital gains are profits or income from the sale of assets, such as stocks, bonds, real estate, etc. Income taxes are paid on these profits only when the assets are sold or "realized." The capital gain (or income to be taxed) is the difference between the original buying price and the price at the time of sale.

Under Act 1005 of 1999, 30 percent of capital gains income is exempt from the Arkansas income tax, with the remaining 70 percent being taxed as regular income. The act also changed the rate of tax. The Arkansas tax rate on the capital gain now ranges from 1 to 7 percent, depending on the taxpayer's total taxable income. Arkansas taxpayers do not bear the full cost of any state taxes they pay on capital gains income. Approximately 20 percent of any state capital gains tax can be written off on a taxpayer's federal income tax (in effect shifting the burden to taxpayers in other states).

In 2004, Arkansas enacted a large sales tax increase (nearly $400 million) to fund education reform. The state sales tax rate was increased by 7/8s of one cent, while a number of small business services were added to the state sales tax base. Low- and middle-income families have borne a disproportionate share of the burden of this tax increase. Low- and middle-income families now pay 12 cents of every dollar they earn in state and local taxes, compared to just 6 cents on the dollar for the top 1 percent of Arkansas' wealthiest taxpayers.

What would be the impacts of eliminating Arkansas' current 30 percent exemption and fully taxing capital gains income? Few low or middle-income taxpayers would be impacted by eliminating the exemption. In fact, middle-income taxpayers would have an average tax increase of $2. Their share of the total tax increase would be only 1 percent. This is not surprising given that high-income taxpayers, especially our wealthiest taxpayers, own most of the assets that are sold and are ever subject to taxes on capital gains.

Impact of Repealing the Capital Gains Tax Cut by Income Group

Income Group	Income Range	Avg. Income	Avg. Tax Increase	Share of Tax Increase
Lowest 20%	< $14,000	$9,000	$0	0%
Second 20%	$14,000-$26,000	$20,000	$0	0%
Middle 20%	$26,000-$43,000	$34,000	$2	1%
Fourth 20%	$43,000-$69,000	$55,000	$2	1%
Next 15%	$69,000-$125,000	$90,000	$35	15%
Next 4%	$125,000-$276,000	$168,000	$143	16%
Top 1%	$276,000 or more	$659,000	$2,252	66%

Source: ITEP estimates, December 2005

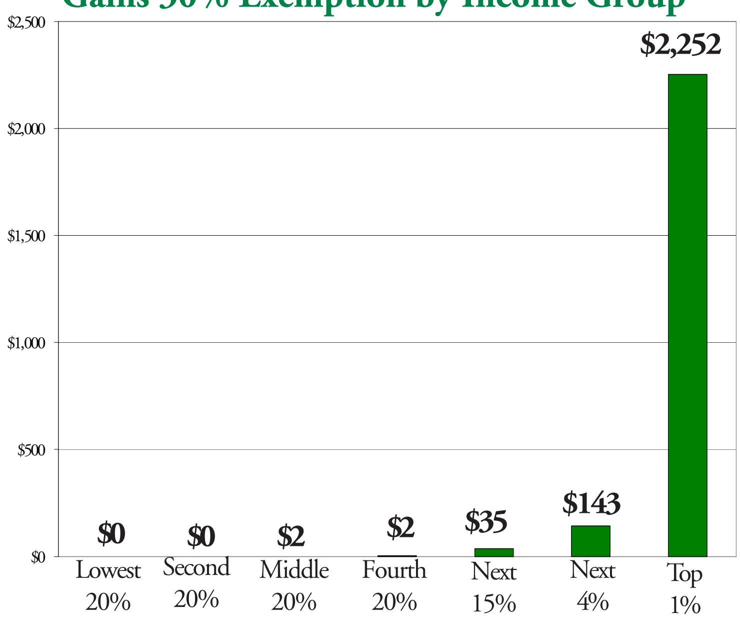
The burden of eliminating the 30 percent exemption would fall mostly on taxpayers with incomes over $276,000 (average income of $659,000). For this group, the average tax increase would be $2,252. Their share of the total tax increase would be 66 percent.

The state general revenue impact of eliminating the capital gains exemption would be $41 million. However, the actual impact on taxpayers would be about $33 million because about 20 percent of the state tax increase could be written off on federal tax returns.

The revenue increase resulting from such a change could be used to help fund low-income programs such as Medicaid, revenue that might be needed given recent federal budget changes that impose new costs on the state. Another option would be to use the revenue to improve tax fairness, such as establishing a state Earned Income Tax Credit (EITC) for low-income working families. Arkansas is currently one of the few states that does not offer a state EITC or some type of relief from the state sales tax on food.

Opponents of capital gains taxes argue that such tax breaks are needed to encourage economic development by rewarding investment. Capital gains tax breaks have not been shown to be an effective way to promote state economic development. The main reason is that there is no guarantee that any investment from untaxed capital gains income will benefit the Arkansas economy. New investment is just as likely to take place in other states or elsewhere in the word.

Tax Increase from Repealing Arkansas' Capital Gains 30% Exemption by Income Group



Source: ITEP, December 2005

It's also very unlikely that simply eliminating our 30 percent exemption on capital gains income will encourage out-migration of wealthy taxpayers to surrounding states. Most of our surrounding states – Mississippi, Louisiana, Missouri, and Oklahoma – are already close to full taxation on capital gains (although each offers a very limited exemption of some type, such as Missouri's 25 percent exclusion for sales of low-income housing). Two surrounding states—Texas and Tennessee—already fully exempt capital gains income (Texas has no income tax). The small tax increase resulting from eliminating the 30 percent exemption, about $2,252 for a taxpayer with an average income of $659,000, is unlikely to cause more out-migration. Wealthy taxpayers whose major motivation is to pay no state income tax are likely to have already established residence in Texas.

Short of eliminating the 30 percent exemption, Arkansas may want to consider ensuring that any state capital gains tax break encourages in-state economic development. Arkansas could restructure its 30 percent exemption so that it's contingent on re-investing in Arkansas-based companies. This would help ensure the exemption does what it is supposed to do—help the Arkansas economy and Arkansas families.

The Mission of AACF and State Fiscal Analysis Initiative (SFAI)

The mission of Arkansas Advocates is to ensure that all children and families have the resources and opportunities to lead healthy and productive lives and to realize their full potential. The goal of our SFAI project is to improve the economic well-being of the state's families with children by providing timely and credible analysis to policymakers, the media, and the public and promoting a more informed public debate about state tax and budget issues.

Support AACF's Work

AACF is a non-profit organization. If you would like to support our work you may donate online at www.aradvocates.org or mail contributions to the address listed below.

For More Information:
Richard Huddleston
rhuddleston@aradvocates.org

www.aradvocates.org

Arkansas Advocates for Children & Families
Union Station, Suite 306
1400 West Markham
Little Rock, AR 72201
(501) 371-9678