INDIVIDUAL INCOME TAX
Capital Gains Exclusion

March 10, 2011

	Yes	No
DOR Administrative Costs/Savings	X	

Department of Revenue
Analysis of H.F. 711 (Wardlow)

	Fund Impact			
	F.Y. 2012	**F.Y. 2013**	**F.Y. 2014**	**F.Y. 2015**
	(000's)			
General Fund	($102,800)	($245,000)	($229,600)	($241,100)

Capital gains exclusion effective for tax years beginning after December 31, 2010.
Limitation of FY 2012-2013 general fund expenditures effective the day after final enactment.

EXPLANATION OF THE BILL

Current Law: For the Minnesota individual income tax, capital gains are treated the same as other income; no exclusion or lower rate applies.

Proposed Law: The bill would allow a subtraction from taxable income equal to a percentage of the adjusted net capital gain, as defined, to the extent that it is included in federal taxable income. The percentage is 20% for tax year 2011, 40% for tax year 2012, and 60% for tax years 2013 and after. The subtraction would also apply in computing alternative minimum taxable income for purposes of the alternative minimum tax.

The bill also includes a provision that limits general fund expenditures in the FY 2012-2013 biennium. This provision specifies that general fund expenditures are limited to the forecasted general fund revenues in the FY 2010-2011 biennium plus the forecasted growth in general fund revenues in the FY 2012-2013 biennium over the previous biennium minus the estimated revenue reduction resulting from the capital gains exclusion.

REVENUE ANALYSIS DETAIL

- The House Income Tax Simulation (HITS 5.9) Model was used to estimate the tax year revenue impact. These simulations assume the same economic conditions used by Minnesota Management and Budget for the forecast published in February 2011. The model uses a stratified sample of 2008 individual income tax returns compiled by the Minnesota Department of Revenue.
- This revenue estimate and the February forecast take into consideration the recently-enacted two year extension of the 2001 and 2003 federal tax cuts. Included in the provisions that are extended are lower capital gains rates for 2011 and 2012 which will then increase in 2013.
- Tax year impact was allocated to the following fiscal year.

Number of Taxpayers: An estimated 149,300 returns would receive a reduction in tax at an average of $689 per return in tax year 2011.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.taxes.state.mn.us/taxes/legal_policy

hf0711_1/mjr

Capital Gains Behavioral Response Addendum

Our estimates do not take account of behavioral changes, but it is possible to assess the relative magnitude of the impact such behavioral change might have. Using information from the professional economics literature, it is possible to model the potential behavioral response. Such modeling uses "elasticities" – estimates of how responsive capital gains realizations are to changes in the combined federal and state tax rate on capital gains income (taking into account the deductibility of state income taxes on federal tax returns).

For **permanent** changes in the effective tax rate on capital gains, an estimate incorporating a behavioral response in the range suggested by recent research might reduce the static estimate by 5% to 12%. In that case, the cost of the reducing the tax rate on capital gains would still be 88% to 95% as large as is shown in the static estimate.

> For example, a 50% exclusion of capital gains in tax year 2011 would reduce the effective tax rate on capital gains income for an itemizer in the 35% federal tax bracket from 15%+7.85%*(1-0.35) = 20.1% to 15%+0.5*7.85% *(1-0.35) = 17.6%. So the effective tax rate on capital gains would have been reduced by about one-eighth. With an assumed elasticity of 0.8, capital gains realizations would rise by 10%. A static estimate of this 50% exclusion would assume that capital gains revenue falls by half. In contrast, the behavioral adjustment would cut revenue by 50% minus one-tenth of 50%, or 45%. The behavioral change would in this case cut the static revenue estimate by 10%.

In contrast, if a rate reduction is **phased in**, accounting for behavioral response is likely to *increase* the static estimate. The phase-in creates an incentive to delay realization of gains during the period of the phase-in. Income tax revenue could fall significantly during those years. A revenue estimate that included behavioral effects could far exceed the static estimate during the phase-in.

Some other issues involved in trying to determine taxpayer response are:

- Do taxpayers respond to state tax changes in the same way they respond to federal tax changes? Elasticities based on federal law changes may not apply at the state level. Taxpayer response will depend upon the extent to which individual tax planning is state-specific.
- Will taxpayers consider the change to be permanent or temporary? In general, the response to a permanent change is smaller.
- A state tax reduction will have a larger impact in years when the federal tax rate for capital gains is 15% (2011 and 2012) than when it is 20% (2013 and later).

Given the uncertainty surrounding these behavioral effects, they are not incorporated into our revenue analyses.