



Commission on the 21ST Century Economy

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MEMORANDUM

Date: March 25, 2009

To: Chair and Commissioners

From: Staff, Commission on the 21st Century Economy

Re: Income Averaging for Capital Gains

This memorandum is in response to questions and comments made by commissioners during the Commission's initial hearing in San Diego. During the hearing, the option of income averaging for purposes of capital gains taxation was raised. Commissioners requested staff to examine the feasibility of using averaging as a means of increasing the stability of revenues derived from this income source.

Background

Capital gains income produces the greatest portion of revenue volatility in the California tax system. By averaging capital gains income over a period of several years, it would be possible to reduce revenue volatility without significantly reducing tax rates or materially affecting the current distribution of the tax burden. Over 90 percent of capital gains are received by taxpayers in the top 5 percent of the income distribution; therefore, creating preferential treatment for capital gains income would primarily affect high-income taxpayers.

While the idea of income averaging for capital gains is an interesting concept, there are several obstacles to successful implementation. The primary issues and concerns raised by this type of policy are addressed below. Overall, staff's initial view of the income averaging option is that significantly more research would need to be conducted in this area if this were a policy approach that the Commission decided to pursue.

We were unable to find any other state that currently uses (or has used in the past) income averaging for the purpose of taxation of capital gains. At the federal level, income averaging existed for a period of time until it was repealed by the Tax Reform Act of 1986. Under the federal approach, income averaging was used on a comprehensive basis when a filer's taxable income for the current year exceeded 140% of the average taxable income in the preceding three years. The tax was then based on the average of the total of the current year's income and that of the preceding three years. Income averaging continues to be a limited option for farmers and commercial fisherman, as permitted by Internal Revenue Code section 1301. Qualified individuals can use income averaging if taxable income is high in the current year relative to taxable income in the preceding three years. The income that may averaged is limited to the amount of income attributable solely to farming and fishing activities.

Administrative Feasibility

On the administrative and implementation side, there are four main concerns with income averaging:

- 1) **Transition Costs.** Successful implementation of an income averaging program would require widespread taxpayer education to ensure compliance. Education and training of tax administrators would also be necessary in order to ensure proper implementation. Existing tax preparation software would need to be reprogrammed to reflect California's change in tax policy. Finally, phasing in a comprehensive income averaging policy in order to avoid double taxation would necessarily result in a substantial loss of revenue to the state during the first several years of implementation.

- 2) **Tax Enforcement.** The disparity between federal and state tax treatment resulting from the policy would increase the difficulty of compliance monitoring by state auditors. This is because examining tax returns for discrepancies between federal and state reporting is one of the principal means by which auditors monitor compliance. Income averaging at the state level would place California out of conformity with federal capital gains treatment and make this process less effective.
- 3) **Changes in Tax Units.** Changes in tax units present difficulties for consistent levying of the tax. Changes in tax units can result from events such as marriage, divorce, death, relocation into or out of California, or the dissolution of estates or trusts. Any changes in the tax unit over the averaging period would make it difficult to uniformly apply the tax before and after the change in the tax units because of the difficulty in accurately attributing the income from capital gains.
- 4) **Administrative Complexity.** The policy change would result in a significant increase in administrative complexity and make taxpayer compliance more difficult. If capital gains income were to be averaged over a period of three years, for example, taxpayers would need to refer to documentation of their capital gains income from past years to determine their current tax liability. In addition, taxpayers who realize capital gains in most years would have ongoing differences between federal and state taxable income. Differences between federal and state treatment of capital gains could lead to taxpayer confusion and reduced compliance.

Impact on Volatility

Capital gains income averaging could dramatically reduce volatility for individual taxpayers. This is particularly true for those who receive substantial one-time capital gains (e.g. from the sale of a business) during one year and considerably lower realizations in other years. While volatility would be greatly reduced for individual taxpayers, the impact on aggregate volatility would likely be less dramatic because business sales and other large gains occur in the aggregate every year. A longitudinal studying following individual taxpayers would more accurately predict the impact of capital gains income averaging on volatility in the state's revenues. Income averaging for capital gains could improve the accuracy of revenue forecasting, as it would decelerate both up and down swings in revenue, facilitating more effective budgeting.

Revenue Impact

Averaging capital gains income would reduce personal income tax revenue to the extent it resulted in a reduction of the effective tax rate on gains. Also, the increased complexity of the system, discrepancies between the federal and state systems, increased difficulty for compliance, and the increased cost and difficulty of auditing compliance, could lead to a decrease in revenues if a policy of income averaging were undertaken solely at the state level.