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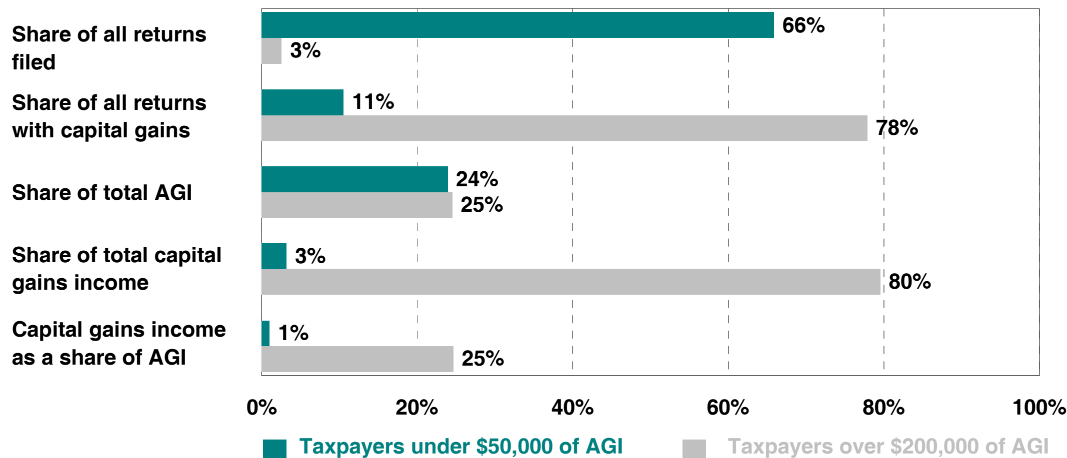
Repealing Rhode Island's Tax Break for Capital Gains Would Ease Budget Woes and Improve Tax Fairness

Rhode Island is one of just nine states offering a significant tax break for capital gains income. The state allows preferential income tax rates for income from both short- and long-term capital gains. This tax break costs the state as much as $49 million in 2008; repealing it would help ease Rhode Island's budget woes, make its tax system more fair, and keep valuable dollars in the state economy.

Capital gains income is income earned from the sale of stocks, bonds, and other assets. This income isn't taxed unless and until the capital gains are "realized" – that is, unless and until the asset is sold. An investor who owns a stock over many years does not owe any taxes on the value of that stock as it appreciates from one year to the next; she owes taxes only when the stock is sold. When that stock is sold, the realized capital gain is, in general, calculated by taking the difference between the original purchase price and the sale price. Note that two of the most common assets held by working Americans, their retirement investments and their homes, are generally not treated as taxable capital gains when they are sold.

Capital gains income is concentrated among the very wealthiest Rhode Islanders.

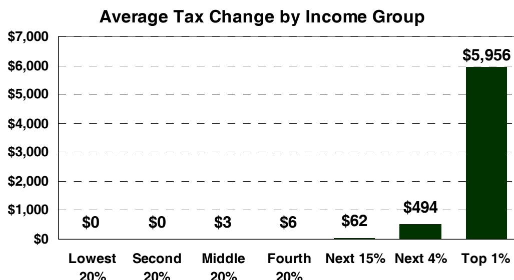
Only the very wealthiest Rhode Islanders have a significant amount of taxable capital gains. Internal Revenue Service data from 2006 show that the very wealthiest Rhode Islanders – individuals and families with reported incomes in excess of $200,000 – receive the vast majority of such income. Taxpayers with adjusted gross income of less than $50,000 comprised 66 percent of all federal returns filed by Rhode Islanders in 2006, but constituted just 11 percent of returns with income from capital gains. In fact, taxpayers in this income group received just 3 percent of total capital gains income reported by Rhode Islanders on their federal tax returns that year.

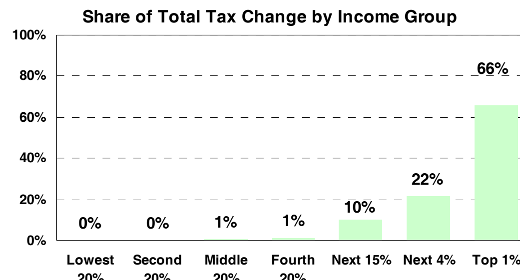


Ending the capital gains tax break would have almost no impact on working Rhode Islanders while generating needed revenue.

In terms of revenue loss, the consequences of Rhode Island's capital gains tax break are substantial. In tax year 2008, Rhode Island will lose $49 million, or about 5 percent of its income tax revenue because of this poorly targeted tax break. Yet, given the concentration of capital gains income among affluent Rhode Islanders, it should come as no surprise that this tax break primarily affects only those more fortunate taxpayers.

Virtually all – 98 percent – of the tax reductions arising from Rhode Island's special treatment of capital gains income are realized by the richest 20 percent of taxpayers in the state; the remaining 80 percent of taxpayers collectively receive just 2 percent of the overall capital gains tax break. Stated slightly differently, the average tax cut for the bottom 80 percent of the income distribution is just $5 on average, but the average tax cut for the richest 20 percent is $444. Worse still, the average tax cut for the top 1 percent of taxpayers – those taxpayers with incomes in excess of $400,500 in 2008 – is $5,956. By extension then, the impact of repealing capital gains tax preferences in order to address state budget needs would largely be limited to the most affluent taxpayers in a given state.





Rhode Island's policymakers should consider repealing the capital gains tax break.

Rhode Island's capital gains tax break is costly, inequitable, and ineffective. The preferential rates for capital gains income deprive Rhode Island of millions of dollars in needed funds, benefit almost exclusively the very wealthiest members of society, and fail to promote economic growth in the manner its proponents claim. In the current fiscal and economic climate, state policymakers cannot afford to maintain this tax break any longer.

Source: Institute on Taxation and Economic Policy
A Capital Idea: Repealing State Tax Breaks for Capital Gains Would Ease Budget Woes and Improve Tax Fairness, March 2009.
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