Bill Analysis

Peter A. Cooper *Legislative Service Commission*

H.B. 626

126th General Assembly
(As Introduced)

Rep. Calvert

BILL SUMMARY

- Reduces the maximum income tax rate on individuals' net capital gains over three years, to 5% in 2007, 4% in 2008, and 3% in 2009 and thereafter.

- Retains current tax treatment of most capital losses.

CONTENT AND OPERATION

Taxation of capital gains

Current law

Under current law, all taxable income is taxed under the same tax rate schedule regardless of the source or form of the income. Wages, interest, dividends, capital gains, and all other forms of income are subject to one uniform tax rate schedule. The schedule is graduated so that a higher rate applies to income exceeding specified dollar thresholds, but the graduated schedule does not cause any one form of income to bear a higher rate than any other form: all forms of income are combined into a single sum, and the rate schedule applies to that whole sum.

The only special treatment of capital gain income under current law is a deduction for capital gains realized from selling or otherwise disposing of tax-exempt "public obligations"--i.e., bonds and other securities issued by Ohio, an Ohio instrumentality, or an Ohio local government and fractionalized interests in such securities. Losses on such securities are added to federal adjusted gross income to the extent the losses were deducted in computing FAGI in order to preclude federally deducted losses from offsetting other items of taxable income.

Proposed reduction in tax rate

The bill distinguishes net capital gains from all other forms of taxable income for the purpose of applying lower tax rates to capital gains. The proposed capital gains tax rate is reduced in three stages. The proposed rate reduction is presented below, in comparison to the highest marginal tax rate scheduled for the corresponding period under current law.

Proposed capital gains tax rate reduction		
Taxable years beginning in:	Capital gains tax rate (proposed)	Highest marginal tax rate* (current law)
2007	5%	6.555%
2008	4%	6.24%
2009 or thereafter	3%	5.925%

* Applies only to taxable income above $200,000

Hold harmless

For many filers, their highest marginal tax rate is lower than the proposed capital gains tax rate. For any of those filers who also report a net capital gain, the bill does not cause an increase in their tax liabilities. Each taxpayer's income tax would be computed in two ways, applying the proposed capital gains rate and applying the current rate schedules, and the taxpayer would owe tax on the basis of the computation producing the lower of the two tax amounts.

Personal exemptions

Current law allows every taxpayer to claim personal exemptions for the taxpayer, the taxpayer's spouse, and each dependent. The personal exemptions are subtracted from the taxpayer's adjusted gross income, which reduces tax liability. Each exemption equaled $1,350 in 2005, and is adjusted each year on the basis of an index of general price inflation.

Because the bill divides taxable income into two parts--capital gains and all other taxable income--the bill also prescribes how the personal exemptions are to be applied for taxpayers whose capital gains will be taxed at the proposed rates. The exemptions are to be subtracted first from the taxpayer's other, non-capital gain income, and any remaining balance is subtracted from capital gain income. This ensures that the exemptions reduce tax liability to the greatest degree because they reduce the income that is subject to the higher marginal tax rate--i.e., non-capital gain income--before applying to capital gain income.

"Net capital gain"

The reduced tax rates apply to any net capital gain reflected in federal adjusted gross income. This includes net capital gain reportable on Schedule D of Form 1040 and capital gains distributions not reportable on Schedule D. Net capital gain equals net long-term capital gain minus net short-term capital loss. Capital gains distributions are capital gains accrued through mutual funds or real estate investment trusts, including long-term gains not distributed by a mutual fund or REIT.

Treatment of capital losses

The bill's proposed capital gain rate reduction applies only in computing tax liability if there is a net capital gain, not if there is a net capital loss. Generally, the tax computation for a taxpayer having a net capital loss is not changed by the bill. A net capital loss, to the extent it is reflected in federal adjusted gross income, reduces a taxpayer's total income by the amount of the loss (generally, up to $3,000, except for certain kinds of assets). The loss therefore reduces tax liability by the amount of the loss multiplied by the marginal tax rate. The bill preserves this treatment; it does not provide that losses reduce liability at the lower proposed capital gain tax rate. Thus, net capital losses would not result in a higher tax liability than they do under current law.

The only difference in treatment of losses under the bill is how losses from public obligations are treated. Under current law, those losses are added to federal adjusted gross income (FAGI) to the extent the taxpayer deducted the loss in computing FAGI, as explained above. Under the bill, the loss is not added back into FAGI. This treatment accords with the bill's treatment of gains from public obligations, as explained above.

"Adjusted gross income"

Under current law, Ohio adjusted gross income is not only the tax base for computing income tax, but also serves as the basis for the school district income tax and serves a few other functions, most notably in the computation of a school district's parity aid. Because the bill separates net capital gains from Ohio adjusted gross income in order to apply a different tax rate to net capital gains, the bill specifies that for any other use of "Ohio adjusted gross income," the term continues to include net capital gains. Without this specification, adjusted gross income as used in other contexts would cause the income measure to decrease and could distort computations that use the measure.

COMMENT

The bill is intended to apply the capital gains tax rate reduction only to gains realized by individuals. However, because of a drafting error, the bill includes unintended language permitting estates and trusts to deduct net capital gains in computing the estate's or trust's taxable income.

HISTORY

ACTION	DATE
Introduced	06-29-06

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