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Spotlight

CAPITAL GAINS

How North Carolina double taxes capital gains and what to do about it

Dr. Roy Cordato
Vice President for Research

About the Author

Dr. Roy Cordato
rcordato@johnlocke.org

Roy Cordato is Vice President for Research and resident scholar at the John Locke Foundation. From 1993-2000 he served as the Lundy Professor of Business Philosophy at Campbell University in Buies Creek, N.C. From 1987-1993 he was Senior Economist at the Institute for Research on the Economics of Taxation (IRET) in Washington, D.C. He has served as full-time economics faculty at the University of Hartford and at Auburn University and as adjunct faculty at Johns Hopkins University. His publications include a 1992 book, *Welfare Economics and Externalities in an Open Ended Universe* (Kluwer Academic Publishers, republished in 2007 by the Ludwig von Mises Institute). His articles have appeared in a number of economics journals and law reviews in addition to *The Christian Science Monitor, The Washington Times, Investor's Business Daily, The Journal of Commerce, The Congressional Record, The Orange County Register, The Freeman, Human Events, National Review Online*, *The Washington Examiner, Tax Notes*, and many other newspapers and magazines. In 2000 he received the Freedoms Foundation's Leavey Award in Free Enterprise Education. He is also a member of the Mont Pelerin Society and former executive board member of The Association of Private Enterprise Education. Cordato holds an M.A. in urban and regional economics from the University of Hartford and a Ph.D. in economics from George Mason University. He also holds a Bachelor's of Music Education from the Hartt School of Music.

Key Facts

- North Carolina's tax code, even after significant reform in 2013, double taxes returns to capital investment.
- Taxes on capital gains should be repealed.
- Complete repeal would cost the state treasury and save taxpayers about $500 million in 2017.
- This could be accomplished gradually by putting in place first a 25 percent exclusion at a state treasury cost of about $125 million and, beyond that, a 50 percent exclusion at a cost to the treasury and savings to taxpayers of $250 million.

Introduction

North Carolina has been moving in the right direction on tax reform since 2013. At that time, the legislature, with the support of Governor Pat McCrory, implemented sweeping tax reform that switched from a steeply progressive and economic growth-inhibiting rate structure, riddled with loopholes and special favors, to a low, single-rate, flat tax. It also dramatically reduced and continues to reduce the corporate income tax, thereby ameliorating the burden of a tax that is borne completely by workers, consumers, and shareholders. Corporations, as legal entities, cannot pay taxes; only people can. Lawmakers also closed a number of loopholes and special privileges in both the regular income tax and the corporate tax. The consequence of these and other policy changes has been to bring about the fastest growth rates in the country over the last three years.[1] [2]

The question then arises, in terms of further enhancing economic growth, where do we go from here? A problem area that still remains is the state's tax treatment of capital gains. Historically North Carolina has taxed returns on capital investment — in particular capital gains on stocks and real property — at the same rate as all other income. While this may sound counterintuitive, in doing so it is actually double taxing the returns from these investments, therefore creating a systematic bias against them.

Capital gains, as a return on investment, can be realized in several different ways, but they all relate to the purchase and sale of assets. Those assets can take the form of stocks or bonds, a home or other investment property, an existing business, or even a work of art, coins, or precious metals. The difference between what these assets might be purchased for or, in the case of a business, the cost of the investments and the sale price, is what is called the capital gain (or loss in the cases in which the asset loses value).

Indeed, for a business, particularly a small business, one of the most important ways that it realizes returns on its investment is through increasing its value, which, in turn, is realized when the business is sold. In North Carolina, this difference between the purchase price and the sale price, assuming that the latter is greater, is taxed as regular income.[3]

How Is The Taxation of Capital Gains Double Taxation?

To understand how North Carolina's tax system double taxes capital gains, it must first be understood that a tax on any income used for investment purposes simultaneously reduces both the principal, the amount invested or the cost of the asset purchased, and the entire income stream that would stem from that investment. In this case we are talking about capital gains, but this also applies to interest and dividends. Once this is understood, it is easy to see how a separate tax on capital gains is a form of double taxation. Because of this, it penalizes expenditures on assets that might yield future returns in the form of a capital gain relative to expenditures that would yield a more immediate return in the form of consumer satisfaction.

Because this might not be intuitively obvious, a simple example could help clarify the point. Imagine that an income earner has $100 in pre-tax income that he is deciding what to do with. The choice is between investing it in the purchase of one share of a stock or a mutual fund, for which he can expect a 10 percent gain in one year, or using it to take his wife out to dinner. In other words, the income earner makes a choice between investment and consumption. He will compare the satisfaction that he would experience from the night out to dinner — in more analytical terms, what we might call the inherently subjective "return to consumption spending," — to the expected $10 return in a year from the $100 stock investment. He will make his choice based on his individual preferences for immediate satisfaction as compared to a greater amount of satisfaction in the future after realizing the capital gain.

Now let's assume that we have a 10 percent income tax without a tax on income from capital gains. This tax reduces his returns to consumption, from $100 worth of dinner with his wife to $90, and his returns to his investment from $10 to $9. In other words, in taxing the $100 investment, in this case by 10 percent, it also taxes the income stream, i.e., the capital gain, by the same percentage. Both the returns to consumption and the returns to investment are reduced by the same amount—10 percent.

So now it is quite easy to see how an additional layer of taxation on capital gains, in essence, double taxes the investment return, reducing it by another $.90 to $8.10. This added layer of tax will bias the person's decision against making the capital investment and in favor of the dinner. In a broader economic sense, since economic growth springs from such capital investments, including the return on investments made in small businesses across the state, the taxation of capital gains is a penalty on growth.

The Goal Should Be Abolition

This suggests that a good target for future tax reform should be the complete elimination of capital gains taxes from the tax base. At the present time, North Carolina taxes gains from the sale of financial assets and real property at the same rate as other forms of income, producing the kind of double taxation bias discussed here. This flies in the face of federal tax law and the law in several other states, where capital gains are taxed at a lower effective rate than other forms of income.[4]

A static analysis of what this might mean in terms of saving to North Carolina taxpayers, and therefore a reduction in revenue to the state, has been provided by the Beacon Hill Institute at Suffolk University. They estimate that the complete elimination of the capital gains tax would reduce revenues to the state treasury by about $500 million in 2017, assuming the new rate of 5.499 percent will go into effect next year. As noted, this is a static estimate, which means that it is particularly conservative, and the loss to the state treasury could actually be less. It assumes that there are no positive economic growth effects that would feed back into the taxable income stream via other forms of income or additional spending and, therefore, greater sales tax collections.

If complete elimination is considered to be too big of a hit to the treasury all at once, a phase-in process could be put in place similar to the approach taken to reducing the corporate income tax, possibly using revenue triggers. This can be done by allowing for an exclusion of a certain percentage of gains that could be gradually increased over time. For example, a 25 percent exclusion would cost the treasury about $125 million annually, and a 50 percent exclusion would proportionately cost about $250 million.

The state could consider a plan that starts at 25 percent and then increases to 50 percent with complete elimination as the ultimate goal. The best way to make up for the revenue loss would be simultaneously to eliminate special industry subsidies and targeted business tax credit programs, which give rise to economic inefficiency and therefore reduce economic growth. Overall this would reinforce the positive economic impact of changing the tax treatment of capital gains, swapping inefficient targeted tax breaks for growth-enhancing, broad-based tax reduction. In other words, reducing capital gains taxes on the one hand, and eliminating corporate welfare programs on the other, would offer a complementary benefit to economic growth, enhancing economic efficiency and reducing inefficiency at the same time.

Conclusion

North Carolina has come a long way since we had a tax code that gave us the highest personal and corporate tax rates in the region. Furthermore, it was a system that attempted to centrally manipulate business investment and consumer choices with special breaks for businesses and industries that gained favor in the eyes of the "right" politicians. It was a tax system that was, at best, embarrassing and, at worse, detrimental to living standards for everyone except the privileged few.

The state now has the opportunity to continue down the road that was paved by the 2013 tax reform legislation. An important first step would be to begin a process that would lead to the ultimate elimination of capital gains from the tax base and the penalty on entrepreneurship and economic growth that our tax code currently imposes.

Endnotes

1 "NC has had the nation's fastest growing economy since 2013" Politifact North Carolina, April 28, 2016, http://www.politifact.com/north-carolina/statements/2016/apr/29/pat-mccrory/mccrory-north-carolina-has-had-countrys-fastest-gr/

2 Roy Cordato, "T*ax Reform 2013: Setting the Stage for Economic Growth" Spotlight No. 444*. The John Locke Foundation, September 24, 2013, http://www.johnlocke.org/acrobat/spotlights/Spotlight444TaxReform.pdf

3 It should be noted that there is also no adjustment-for-inflation so that an increase in an asset's value that is simply equal to or even less than the inflation rate would be taxed the same as an increase in the absence of inflation. This means that gains will, for tax purposes, be overstated even to the point of real adjusted for inflation losses showing up on tax statements as gains. This means that the actual tax rate on capital gains will be greater than the tax rate for ordinary income.

4 Roy Cordato, "*North Carolina's Capital Gains Tax: It's time to consider a Change" Spotlight No. 461*, The John Locke Foundation, September 15, 2015, http://www.johnlocke.org/acrobat/spotlights/Spotlight461StateCapitalGains.pdf.

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200 West Morgan St.
Raleigh, NC 27601

919-828-3876

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