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North Carolina's Capital Gains Tax

It's time to consider a change

KEY FACTS:

- **In 2013 North Carolina instituted sweeping tax reform and began the process of making its tax system more efficient and more consistent with liberty.**
- **There are important areas of the tax code that still need to be reformed, and the treatment of capital gains is one of those areas.**
- **Capital gains taxes penalize saving, investment, and therefore entrepreneurship.**
- **They do this by imposing a second layer of taxation on equity investment.**
- **The most straightforward way to end this bias is to eliminate the tax on capital gains completely.**
- **If abolition of the capital gains tax is considered to be too difficult a task politically, then North Carolina could take the same approach as the federal government and tax capital gains at a lower rate than ordinary income.**
- **Another approach would be to follow the lead of some other states. For example, South Carolina allows taxpayers to reduce their capital gains by 44 percent before applying the tax, while Wisconsin allows for an exclusion of 30 percent.**

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In 2013 North Carolina instituted sweeping tax reform and began the process of making its tax system more efficient and more consistent with liberty. It created a single rate system, bringing both the top rate of 7.75 percent and the bottom rate of 6 percent down to a flat rate of 5.75 percent. In addition, the base was broadened, eliminating many special privileges in the code, and the corporate income tax was reduced. Furthermore, the tax reform process was used to reduce the overall tax burden on NC citizens, allowing average citizens from all income groups to keep more of their incomes.[1]

All of these reforms are good for the economy.[2] In addition to transferring more revenues from political control to private sector allocation -- i.e. from less efficient to more efficient uses -- the changes in the rates and the base have reduced the tax system's bias against saving, investment, and entrepreneurship.

There's more to be done

But there are important areas of the tax code that still need to be reformed. The treatment of capital gains is one of those areas. A logical next step in North Carolina's movement toward a truly efficient tax system would be to reduce the tax on capital gains with an eye toward eventually repealing it. The current system, even after the 2013 reforms, still contains special penalties for investment and entrepreneurship, and the capital gains tax is one of them. Others include taxes on interest and dividends.

Double Taxing Saving, Investment, and Entrepreneurship

Income taxes at both the state and federal levels, by their very nature, penalize economic growth, creating a bias against saving and investment. This happens when income that is saved or invested is taxed while also taxing the returns. If the government taxes a given amount of income, say by 10 percent, it not only reduces the amount of income available for consumption by 10 percent but also the amount available for saving and investment. In doing so, the income stream that could be generated from that saving or investment is also reduced by 10 percent. So when the returns to that investment are also taxed as ordinary income it amounts to double taxation. The way to eliminate this double taxation is to either leave the principle investment untaxed or refrain from taxing the returns on the investment. Examples of these two approaches would be regular IRAs and Roth IRAs respectively.

Capital gains are a return on equity investment. Consequently capital gains taxes, as in the analysis above, impose a second layer of taxation on equity investments and therefore entrepreneurship, when after tax income is used to make the investment. This kind of investment includes anything from stocks and bonds to a plot of land or one's home or business. If a person invests in stock that costs him $5,000, and 10 years later he sells that stock for $10,000, his capital gain would be $5,000. Under current law in North Carolina, the $5,000 gain would be taxed at the same rate as regular income. Let's assume that in our example the $5,000 used to invest in stocks began as $5,555 in pre-tax income, and the way the investor ended up with $5,000 to invest is that the $5,555 was taxed at a rate of 10 percent.

So in the absence of the tax, the person could have made a $5,555 investment. After the tax, however, the investment had to be reduced to $5,000. The value of the stock that could be purchased was reduced by 10 percent. In doing so the return that could be generated from that investment, in this case the capital gain, was also reduced by 10 percent.

To tax the capital gain is to reduce it a second time and therefore is a form of double taxation.

How to eliminate this bias

The most straightforward way to end this bias is to eliminate the tax on capital gains completely. While there are no U.S. states that do this, there is a number of other places that do, including Belgium, New Zealand, and not surprisingly, Hong Kong.[3]

If abolition of the capital gains tax is considered too difficult a task politically, then there are ways to at least ameliorate the problem. North Carolina could take the same approach as the federal government and tax capital gains at a lower rate than ordinary income. The Federal government taxes capital gains at about half the rate of regular income. Using the federal system as a model, North Carolina could have a differential rate for capital gains of about 2.9 percent.

Another approach that is used by some states (see table below) is to exempt a certain amount of capital gains from taxation. For example, South Carolina allows taxpayers to reduce their capital gains by 44 percent before applying the tax, while Wisconsin allows for an exclusion of 30 percent. Other states take different approaches with different exclusion amounts. By exempting part of the capital gains you are in effect creating a differential in the rate. For example, assume you have $100 in capital gains and 50 percent of that gain is exempt from taxation. If the regular income tax rate is 10 percent by excluding half the gain you are effectively creating a 50 percent differential in the rate. The 10 percent rate on half the gain is in effect a 5 percent rate on the full gain.

Capital Gains in the States	
Arkansas	excludes 30 percent net gains
Hawaii	taxes all capital gains income, regardless of wage income, at 7.3 percent (top income tax rate in Hawaii is 11 percent)
Montana	gives taxpayers a tax credit of up to 2 percent of net capital gains
New Mexico	allows for a partial deduction for net capital gains against ordinary income
North Dakota	excludes 30 percent of net capital gains
South Carolina	excludes 44 percent of long term gains
Wisconsin	excludes 30 percent net gains
Source: Tax Foundation	

What the state should not do is create a distinction between long term and short term capital gains with a lower rate for the former and a higher rate for the latter. This would be nothing more that an attempt to use the state's tax code to centrally plan investment decisions. There is nothing inherently "better" about long term gains—gains that are realized further into the future—than short term gains. Investment decisions can only be made efficiently if based on the investor's entrepreneurial insights and actual market conditions. A tax code that tries to influence investment decisions in one direction or the other cannot improve upon this process. The fact that North Carolina's code already has biases of this nature built into its structure is the reason for reform in in the first place.

Conclusion

Whatever the North Carolina legislature does about the capital gains tax, it has to decide to do something. The current approach is a relic from our old tax system and is inconsistent with our state's new and economically more sensible approach to tax policy. Surely reform or even repeal of North Carolina's tax on capital gains is something that should be considered in the next legislative session.

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Endnotes

1. Roy Cordato, "Tax Cuts for All: Tax Reform Means Savings to All North Carolina Income Groups," John Locke Foundation *Spotlight*, June 16, 2014. johnlocke.org/research/show/spotlights/300.
2. Roy Cordato, "Tax Reform: Setting the Stage for Economic Growth" John Locke Foundation *Spotlight*, September 14, 2013. johnlocke.org/research/show/spotlights/295.
3. Andres Henderson, "Top 5: Ex-pat friendly countries with no capital gains taxes," Nomad Capitalist.com, April 6, 2014. nomadcapitalist.com/2014/04/06/top-5-expat-friendly-countries-with-no-capital-gains-taxes.