HAWAIʻI BUDGET
& POLICY CENTER

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CLOSING THE CAPITAL GAINS LOOPHOLE

The Hawai‘i Budget & Policy Center is a program of Hawai‘i Appleseed Center for Law & Economic Justice.

Our mission is to ensure that our state and local economic policies increase opportunity for all residents. We do this by analyzing and understanding the implications of tax and budget decisions and making sure that the public and policy-makers are informed through strategic communications, coalitions, and key partners.

HBPC's work is guided by the belief that government at all levels should play an active role in helping people reach their full potential.

ELIMINATING THE PREFERENTIAL TAX TREATMENT OF CAPITAL GAINS INCOME WILL INCREASE TAX FAIRNESS AND HELP FUND OUR FUTURE.

TO BUILD a better future for our keiki, our state needs to be able to invest resources into our schools, our hospitals and our parks; into the development of truly affordable housing; into climate change preparedness; and into programs to help working families handle the high cost of living, and drive the local economy.

Hawai‘i's tax system is a powerful tool policymakers can use to achieve the budget necessary to fund our collective future. But right now, some parts of our tax code actually stand in the way of that vision by perpetuating income and wealth inequality, reinforcing racial barriers to economic opportunity for people of color, and sapping the state of the revenue it needs to serve the people.

One change that would increase tax fairness while generating significant revenue would be to eliminate the preferential tax treatment of profits from the sale of capital assets—income that goes almost exclusively to the wealthiest 5 percent of households. By taxing these long-term capital gains at the same rate as regular income from work, Hawai‘i can make its tax code more fair while funding critical investments in education, housing, healthcare, and support for working families.

Income from wealth should be taxed like income from work. To maximize the economic impact of the additional revenue gained from closing the capital gains loophole, the state should consider reinvesting it into working families—especially those with children—in the form of targeted tax relief, such as through a state child tax credit.

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TAXATION OF CAPITAL GAINS VS. ORDINARY INCOME

Capital gains are income that comes from selling a capital asset, such as stocks, bonds, art, antiques or real estate at a profit. Tax law distinguishes between short-term capital gains—profits earned on assets held for a year or less—and long-term capital gains, which are profits from the sale of assets held for more than a year.

When we talk about "capital gains" in this brief, we are dealing exclusively with these long-term capital gains. That is because income from long-term capital gains is given preferential treatment by the federal government and by some states compared to ordinary income from wages, fees, interest, or other sources.[1] This favorable tax treatment includes allowing tax deductions for a portion of these profits, or by taxing long-term capital gains at a lower rate than short-term capital gains.

At the federal level, capital gains tax rates were initially taxed no differently than other income. However, in the early 1920s—an era, like now, marked by shifts in wealth toward the very rich—Congress set a different rate for capital gains income with a maximum level of just 12.5 percent. Then, Congress continued to increase the capital gains rate for both individuals and corporations during World War II. The rate for individuals peaked at 35 percent in the 1970s, although it has steadily descended since then.

Corporations that own capital assets are taxed at a different rate than individuals on their long-term capital gains. Historically, the highest rate for the corporate capital gains tax was 35 percent, in effect between 1993 and 2017. In 2018, Congress reduced the top corporate rate to 21 percent as part of the Tax Cuts & Jobs Act championed by the Trump Administration.

As of 2022, individuals pay a maximum 20 percent federal tax on their long-term capital gains, regardless of their tax bracket, while corporations still pay 21 percent.[2] **Figure 1** shows how rates have changed over the past century.

Figure 1. Federal capital gains tax rates, 1922–2022

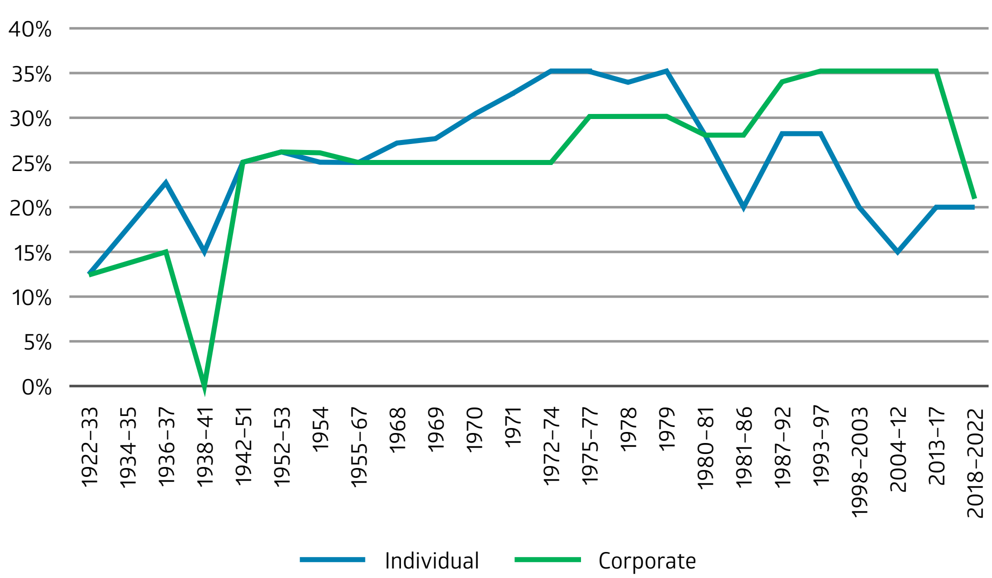


Figure 1. The federal long-term capital gains tax rates for individuals and corporations has fluctuated during different time periods since 1922. The rates for both individual and corporate long-term capital gains are now 40 percent less than the maximums charged in the 1970s (for individuals) and 1990s–2017 for corporations. Note that, between 1938 and 1941, corporations paid the same rate for long-term capital gains as for ordinary income.

WHY WE NEED CAPITAL GAINS TAX REFORM

Giving preferential tax treatment to capital gains income exacerbates economic inequality. Profits from capital gains overwhelmingly go to people who are already wealthy—those who have surplus income to invest in capital assets in the first place.

It is unfair that many struggling working families in Hawaiʻi must pay a higher tax rate on their wages than the rich pay on their income from capital gains. In order to make this tax system more equitable, capital gains income should be taxed at the same rates as regular income, with tax rates that progressively increase for wealthier taxpayers.[3]

Economic research points out that income and wealth inequality actually diminishes economic growth, in part because those with very high levels of wealth are not as likely to spend it in ways that support the economy. Even the richest person can only buy so many groceries, consumer goods, and services in a year, regardless of how much money they have sitting in their accounts.

In the end, working families power the economy, and increases to their income drive growth in the overall economy.[4] A capital gains tax would collect revenue from trapped wealth at the top that can then be used to invest in policies that boost the incomes of working families.

In addition, preferential tax rates on capital gains benefit those who are already rich, a group that is mostly white in the United States. Accordingly, this tax policy also supports and perpetuates racial inequities in the distribution of wealth and the harm they continue to do to communities and people of color.[5]

In Hawaiʻi, as shown in **Figure 2**, Native Hawaiians and Pacific Islanders are 24 percent of the tax units in the state, but receive only 17 percent of capital gains tax breaks.[6] As a result, the lower tax rate on capital gains concentrates wealth away from indigenous Pacific peoples. Since capital gains include profits from the sale of Hawaiʻi real estate, as well as art and antiques that may be *from the Pacific*, that wealth continues to be built on a legacy of colonialism.

Figure 2. Share of overall tax units and capital gains tax break in Hawaiʻi, by racial group

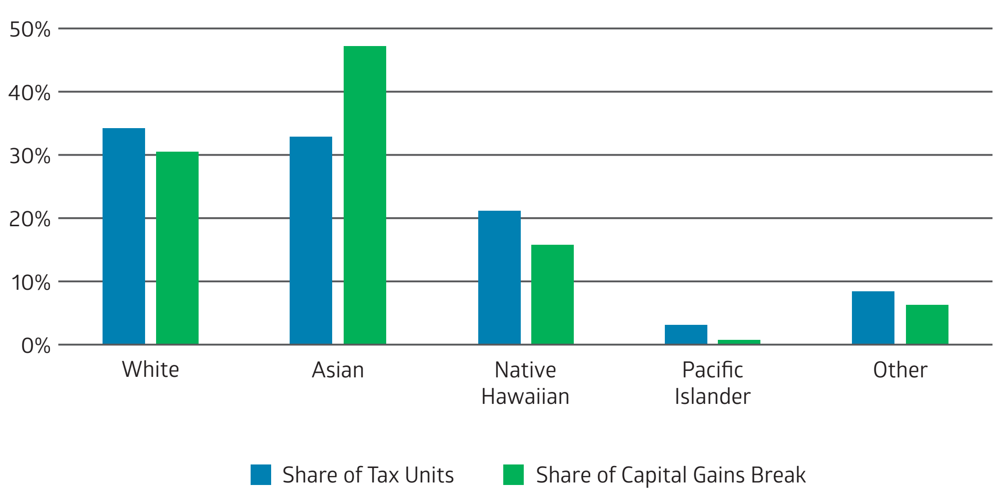


Figure 2. In Hawaiʻi, wealth from capital gains is concentrated away from Native Hawaiians and Pacific Islanders, furthering a harmful colonial legacy.

CAPITAL GAINS TAX RATES IN HAWAI‘I AND OTHER STATES

Nine states, including Hawai‘i, provide preferential tax rates or deductions for long-term capital gains over ordinary income. Besides Hawai‘i, these states are Arizona, Arkansas, Montana, New Mexico, North Dakota, South Carolina, Vermont and Wisconsin. Another 12 states offer capital gains tax breaks for in-state investments, and several others provide lower tax rates for capital gains investments in specific industries.[7]

In Hawai‘i, the tax rate for long-term capital gains is 7.25 percent, or the taxpayer's marginal income tax rate, whichever is lower. This maximum 7.25 percent rate is considerably less than the top marginal income tax rate of 11 percent imposed on high income taxpayers—the same group of taxpayers that earn about 77 percent of the long-term capital gains income across the state (including both residents and non-residents).[8]

The Hawai‘i Department of Taxation (DOTAX) writes, "...capital gains are heavily concentrated in the high end of the income distribution especially for nonresidents,"[9] and reports other information, including how capital gains are distributed among taxpayers by income. **Figures 3** and **4** highlight the disproportionate share of capital gains benefits enjoyed by the wealthiest taxpayers.

The department's 2020 Individual Income Tax Statistics publication reports that $3.9 billion—or 10 percent of income for all taxpayers—came from long-term capital gains. However, for taxpayers in the $400,000 or more income tax bracket, this proportion goes up to 35 percent for residents, and 34 percent for nonresidents, respectively.

In 2020, **resident** taxpayers:

- Reported $3.4 billion in long-term capital gains.
- 79 percent of that income went to households earning $400,000 or more, a group that makes up less than 8 percent of all resident taxpayers that had long-term capital gains.

In 2020, **non-resident** taxpayers:

- Reported $511 million in long-term capital gains.
- 65 percent of that income went to households earning $400,000 or more, a group that makes up about 14 percent of all nonresident taxpayers that had long-term capital gains.

Because of the low tax rate on long-term capital gains and the large share of income that capital gains make up for the wealthiest taxpayers, the average effective tax rate paid by the richest Hawai‘i residents was only 8 percent in 2020.

Eliminating the preferential treatment of taxes on long-term capital gains would generate significant tax revenues to support services and programs that help working families in Hawai‘i.

According to analysis by the Institute on Taxation and Economic Policy (ITEP), taxing long-term capital gains at the same rate as regular income would generate $88 million in additional revenue for the state.

A different estimate prepared by DOTAX for the 2022 legislature found that eliminating the preferential capital gains tax rate and applying the marginal tax rate to all income, regardless of source, would result in increased individual income tax revenue of $132.3 million in its first year of implementation, a sum that would increase annually thereafter.[10]

Along with an estimated cost for the increased capital gains tax, ITEP also modeled the financial impact that this tax would have on different income brackets, shown in **Table 1** & **Figure 5**.

Figure 3. Number of Hawai'i returns with long-term capital gains, 2020

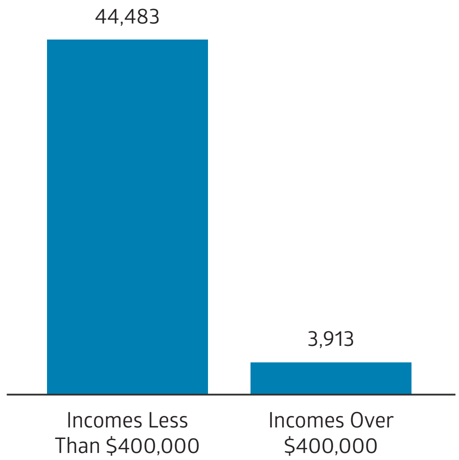
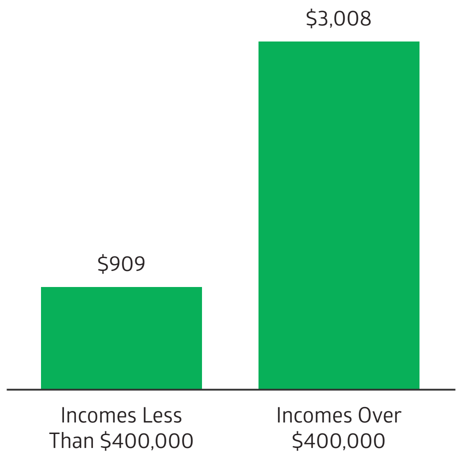


Figure 4. Dollar value of all long-term capital gains ($Millions), 2020



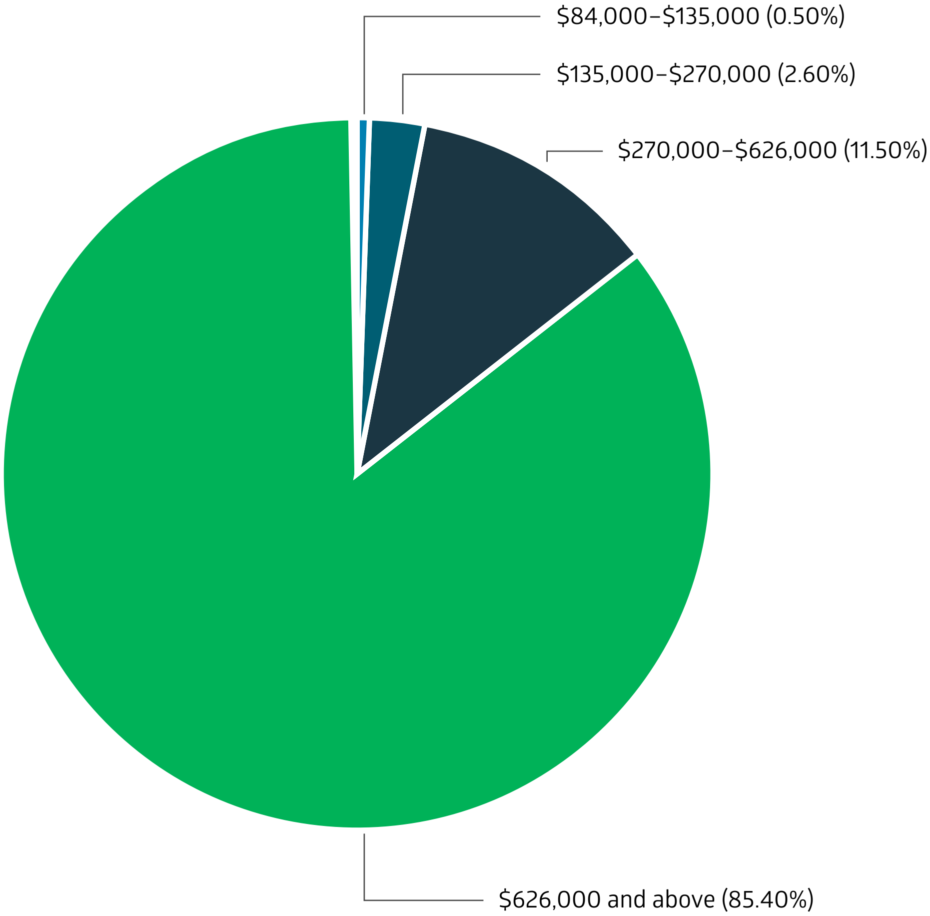
Figures 3 & 4. The distribution of returns with income from long-term capital gains and the amounts of income reported both disproportionately favor the wealthiest taxpayers. These figures include data for both resident and nonresident taxpayers in 2020.

Table 1. Average tax change from capital gains tax increase by income bracket, Hawai'i (2023)[11]

	Bottom 20%	20–40%	40–60%	60–80%	80–95%	95–99%	Top 1%
	$0–$25,000	$25,000–$52,000	$52,000–$84,000	$84,000–$135,000	$135,000–$270,000	$270,000–$626,000	$626,000 and Above
Average Tax Change	$0	$0	$1	$3	$20	$336	$9,913
Tax Change as a Percentage of Income	0.00%	0.00%	0.00%	0.00%	0.01%	0.09%	0.71%

Table 1. The proposed increase to the capital gains tax would have almost no impact on low- to middle-income Hawai'i residents

Figure 5. The share (percentage) of residents' long-term capital gains tax increase by income bracket, Hawaiʻi (2023)



Figures 5. The overwhelming majority of the tax burden would fall on the top 1 percent (earning $626,000 and above) of income earners in Hawaiʻi. This group would pay 85 percent of the tax increase, ensuring that the change in tax rates would be tailored to the highest-income earners. Even so, the total increase in the capital gains tax would equal just 0.71 percent of the income for residents belonging to this group, as shown in **Table 1**.

ENDNOTES

1. Guzman, Marco, “State Taxation of Capital Gains: The Folly of Tax Cuts & Case for Proactive Reforms,” Institute on Taxation and Economic Policy, September 25, 2020, https://itep.org/state-taxation-of-capital-gains-the-folly-of-tax-cuts-case-for-proactive-reforms

2. Luscombe, Mark, “Historical Capital Gains Rates,” Wolters Kluwer, March 9, 2022, https://www.wolterskluwer.com/en/expert-insights/whole-ball-of-tax-historical-capital-gains-rates

3. Hendricks, Galen and Seth Hanlon, “Capital Gains Tax Preference Should Be Ended, Not Expanded,” The Center for American Progress, September 28, 2020, https://www.americanprogress.org/article/capital-gains-tax-preference-ended-not-expanded

4. Bovino, Beth Ann, Gabriel J. Petek and John B Chambers, “Economic Research: How Increasing Income Inequality Is Dampening U.S. Economic Growth, And Possible Ways To Change The Tide,” McGraw Hill Financial, August 5, 2014, https://www.spglobal.com/_division_assets/images/special-editorial/how-the-advancement-of-black-women-will-build-a-better-economy-for-all/ratingsdirect__28714420_jun-07-2021.pdf

5. Guzman, 2020

6. Institute on Taxation and Economic Policy, 2022 analysis; for a description of a “tax unit” see also “ITEP's Approach to Modeling Taxes by Race and Ethnicity,” https://itep.org/itep-tax-model/iteps-approach-to-modeling-taxes-by-race-and-ethnicity

7. Guzman, 2020

8. Colby, Seth and Baybars Karacaovali, “Hawai Individual Income Tax Statistics Tax Year 2020,” Hawai‘i State Department of Taxation, September, 2022, https://files.hawaii.gov/tax/stats/stats/indinc/2020indinc.pdf

9. *ibid*

10. Hawai‘i State Department of Taxation, Analysis of Revenue Enhancements, 2022

11. Institute on Taxation and Economic Policy, 2023 analysis