



State of Oklahoma

Incentive Evaluation Commission

Draft Capital Gain Deduction Evaluation

October 1, 2021

PFM Group Consulting LLC
BNY Mellon Center
1735 Market Street
43rd Floor
Philadelphia, PA 19103



Contents

Key Findings and Recommendations 3

Introduction 6

Incentive Usage and Administration 9

Economic and Fiscal Impact 16

Incentive Benchmarking 19

Appendices 23

 Appendix A: Incentive Statute 24

 Appendix B: Comparable State Programs 27

 Appendix C: IMPLAN Economic Impact Methodology 29



Key Findings and Recommendations



Incentive Overview

The incentive provides a deduction from taxable income for gains from the sale of qualified Oklahoma-based property. Qualified gains include the sale of real and tangible personal property based in Oklahoma and stock or ownership interest in a business entity with a primary headquarters in Oklahoma.

Recommendation: Repeal

Key Findings

- **The deduction resulted in an estimated \$716.3 million in foregone revenue in tax years 2014 through 2018.** Foregone revenue averaged \$143.3 per year during this period and peaked at \$193.0 million in 2015.

Table 1: Use of the Deduction¹

Tax Year	Returns Claiming the Deduction	Total Amount Deducted	Estimated Foregone Tax Revenue
2005	10,828	\$1,539,922,016	\$87,005,594
2006	18,379	\$2,582,859,065	\$145,931,537
2007	18,223	\$3,325,139,828	\$182,882,691
2008	14,785	\$2,203,512,997	\$121,193,215
2009	12,369	\$905,343,747	\$49,793,906
2010	14,584	\$1,561,014,955	\$85,855,823
2011	17,106	\$1,420,260,932	\$74,563,699
2012	16,962	\$3,009,138,923	\$157,979,793
2013	15,649	\$1,520,093,410	\$79,804,904
2014	17,274	\$2,047,103,649	\$107,472,942
2015	17,446	\$3,675,894,222	\$192,984,447
2016	16,330	\$2,606,876,225	\$130,343,811
2017	19,078	\$2,624,369,667	\$131,218,483
2018	19,935	\$3,086,488,916	\$154,324,446

Source: Oklahoma Tax Commission

- **The return on investment for the capital gains deduction is negative.** Over the five-year period from 2014-2018, the total economic impact of the capital gains deduction is \$403.3 million, compared with \$716.3 million in foregone revenue to the State. Economic impacts of the deduction are far less (56 percent) than the deduction itself.
- **The foregone revenue would generate substantially greater employment and economic impacts statewide if these revenues were spent as part of the Oklahoma budget.**
- **Claimants of the deduction represent one percent of Oklahoma taxpayers.** An average of 18,000 individual income tax deductions were claimed each year from 2014 through 2018.
- **From 2015 to 2018, taxpayers with Federal Adjusted Gross Income (AGI) of less than \$100,000 were the most frequent claimants of the deduction but accounted for just 6.1 percent of the total amount deducted.**
 - Over the same period, claimants with AGI greater than \$1,000,000 accounted for 5.4 percent of claimants but claimed about two-thirds (66.3 percent) of the total amount deducted.

¹ Foregone tax revenue estimated using the top income tax rate in each year.



- Claimants with AGI greater than \$25 million accounted for 0.1 percent of claimants but about a quarter (24.8 percent) of the total amount deducted over this period.
- **Most claimants deduct amounts of \$100,000 or less.** From 2015 through 2018, 81.8 percent of returns deducted amounts of \$100,000 or less and about 80 percent of those returns were filed by taxpayers with AGI of \$200,000 or less.
- **There are no cost controls in place.** This is especially important because of the amount of foregone revenue associated with the program and the volatile nature of capital gains tax revenue.
- **The deduction is available for both individual and corporate income tax, but the Tax Commission is unable to aggregate data on the usage of the deduction for corporate income tax.** It is likely that most usage of the deduction is for individual income tax and the State's total corporate income tax revenue is low, equal to about 6.6 percent of income tax revenue in FY 2020. The data presented represent individual income tax deductions only.

Recommendations, if the program is retained

- **Reconfigure the program with specific legislative intent and economic development goals.** Oklahoma's capital gains deduction is the most broad among comparable incentives. Real or intangible property, and stock or ownership interest can all qualify for the deduction and gains generated by investments in any industry are eligible. Due to the breadth of Oklahoma's program, it is not clear exactly what it intends to accomplish, thus its benefits are difficult to quantify.

Most states target similar incentives toward a specific industry or small businesses, and many limit the deduction to certain types of property. The benefits of a more targeted approach include lower costs to the State and more measurable outcomes. If, for example, Oklahoma's deduction was narrowed to only apply to gains from investments in certain industries, or if the gains were required to be re-invested in certain industries in the State, data on the use of the deduction could be compared to the performance of target industries in the State for some indication of the program's impact.

- **Require qualified gains to be reinvested in Oklahoma.** Doing this would improve the economic impact of the program. Currently, there is no indication of where or how the gains associated with deductions are or are not spent. Utah places requirements on how gains are spent and targets this spending toward an economic development goal. It requires that at least 70 percent of gains are reinvested in a Utah small business within a year. Oklahoma could adopt a similar requirement and target reinvestment to an industry that aligns with the State's economic development goals.
- **Cap the deduction.** Other states cap comparable deductions to control costs. For example, Colorado limits its deduction to \$100,000 per taxpayer while Vermont caps its deduction \$350,000. A cap limiting the amount of income deducted in Oklahoma to \$100,000 would have had no impact on 81.8 percent of claimants from 2015 to 2018 who deducted less than that amount, while still providing some benefit to claimants above that amount. A cap matching Vermont's would have had no impact on over 90 percent of claimants from 2015 to 2018.²

² Tax Commission data show 89.5 percent of claimants over this period deducted gains of \$200,000 or less, and 5.5 percent of claimants in the next deduction range of \$200,001 to \$500,000.



Introduction



Oklahoma Incentive Evaluation Commission Overview

The Oklahoma Incentive Evaluation Commission (Commission) was created by HB 2182 of 2015 to produce objective evaluations of the State of Oklahoma’s wide array of economic incentives. The Commission is made up of five members appointed by the Governor, President Pro Tempore of the Senate and Speaker of the House of Representatives, along with representatives of the Department of Commerce, Office of Management and Enterprise Services and Tax Commission.

Under the enabling legislation, each of the State’s economic incentives must be evaluated once every four years according to a formal set of general criteria, including (but not limited to) economic output, fiscal impact, return on incentive and effectiveness of administration, as well as criteria specific to each incentive.

Since the Commission’s inception, it has contracted with PFM Group Consulting LLC (PFM) to serve as the independent evaluator of each incentive scheduled for review in a given year. PFM issues a final report on each incentive with recommendations as to how Oklahoma can most effectively achieve the incentive’s goals, including recommendations on whether the incentive should be retained, reconfigured or repealed; as well as recommendations for any changes to State policy, rules or statutes that would allow the incentive to be more easily or conclusively evaluated in the future.

The Commission is charged with considering the independent evaluator’s facts and findings – as well as all public comments – before voting to retain, repeal or modify each incentive under review. It then submits a final report to the Governor and Legislature.

Summary of 2017 Evaluation Findings and Recommendations

Based on the preceding framework, significant findings from the 2017 evaluation of the Capital Gains Deduction are summarized in the following table.

Table 2: Summary of 2017 Evaluation Findings and Recommendations

Evaluation Category	Significant Finding(s)
Overall Findings	- The deduction was found to be a significant net cost to the state with a total of \$465 million in foregone tax revenue while creating an estimated \$9 million in additional tax revenue. Most benefits of the program were received by individuals with reported income of \$200,000 or more. Due to lack of legislative intent and broad eligibility, it is unclear exactly what the program intends to accomplish.
Fiscal and Economic Impact	- Based on economic and fiscal impact analysis, foregone revenue far exceeded estimated tax revenue generated.
Future Fiscal Impact Protections	- The incentive does not provide a cap or any other limit to future costs.
Administrative Effectiveness	- The Tax Commission was unable to provide information on the use of the deductions by corporations. The evaluation focused only on its use for individual income tax.
Achievement of Goals	- Due to lack of legislative intent and broad eligibility, it is unclear exactly what the program intends to accomplish. Data showed that the share of tax returns reporting any net capital gain or loss decreased since the program was established.
Retain, Reconfigure or Repeal	- Based on its analysis of available data, the project team recommended in 2017 the deduction be repealed.
Other Recommendations	<ul style="list-style-type: none"> - If program is retained, target the incentive to a specific industry. - Require gains to be reinvested in Oklahoma. - Improve data collection for future evaluation.



The Commission voted 3-1 to disapprove PFM's recommendation to repeal the incentive. In 2017, HB 1279, which would have ended the deduction for individual income tax, was introduced but did not advance. Another bill intending to repeal the deduction, HB 2590 introduced in 2018, also failed. In 2019, HB 1455 attempted to modify the program by limiting its use by income level, but the bill did not pass. No statutory or programmatic changes have been made since the program was last evaluated in 2017.

2021 Criteria for Evaluation

The provisions of HB 2182 require that criteria specific to each incentive be used for the evaluation. A key factor in evaluating the effectiveness of incentive programs is to determine whether they are meeting the stated goals as established in state statute or legislation.

To assist in a determination of program effectiveness, the Incentive Evaluation Commission has adopted the following criteria:

- Number of realized capital gains
- Employment/capital/payroll associated with realized capital gains
- Change in realized capital gains before/after the deduction
- State return on investment

2021 Evaluation Approach

To conduct its 2021 review of the Capital Gains Deduction, the project team conducted the following activities:

- Submitted a data request to the Oklahoma Tax Commission (OTC);
- Reviewed and analyzed OTC-provided data;
- Completed subject matter expert/internal stakeholder interviews with representatives from OTC;
- Conducted external stakeholder interviews with industry representatives;
- Benchmarked Oklahoma to other states.



Incentive Usage and Administration



Incentive Characteristics

The incentive provides a deduction from taxable income for gains from the sale of qualified Oklahoma-based property. Qualified gains include the sale of real and tangible personal property based in Oklahoma and stock or ownership interest in a business entity with a primary headquarters in Oklahoma.

The statute that established the deduction does not include legislative intent, so it is not clear what the legislature intended the deduction to accomplish. However, the design of this incentive suggests it intends to encourage investments in Oklahoma-based property and businesses. By not taxing profits generated from the sale of Oklahoma-based assets, the State is increasing the potential return on those investments, making them more attractive compared to a similar investment made outside the State.

Capital Gains Taxation Background

A capital gain is profit from the sale of an asset. Although assets may appreciate in value over many years, that value is taxed only when an asset is sold and profit is “realized” by a taxpayer.

At the federal level, capital gains are taxed at a lower rate than ordinary income. This rate varies, depending on a taxpayer’s income and filing status. As shown in table 2, in 2020, capital gains for single filers were not taxed if taxable income was less than \$40,000, taxed at 15 percent if taxable income was between \$40,000 and \$441,450, and 20 percent if taxable income was greater than \$441,450. Most states, including Oklahoma, tax capital gains at the same rate as ordinary income. In Oklahoma, the top individual income tax rate is 5 percent.

Table 3: 2020 Federal Tax Rate on Long-Term Capital Gains, by Filing Status and Taxable Income

Tax Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately
Zero	Below \$40,000	Below \$80,000	Below \$53,600	Below \$40,000
15%	\$40,000 to \$441,450	\$80,000 to \$496,600	\$53,600 to \$469,050	\$40,000 to \$248,300
20%	Greater than \$441,450	Greater than \$496,600	Greater than \$496,050	Greater than \$248,300

Source: Tax Policy Center

The federal tax rate on capital gains has generated significant debate over the last several decades. Discussions relating to the federal tax rate on capital gains focus on what tax rate is optimal rather than the impact of a deduction of capital gains income. However, discussion of the tax rate’s impact on investor behavior and economic growth can provide helpful context for understanding Oklahoma’s deduction.

Proponents of a low capital gains tax rate argue that high tax rates discourage savings and investment, which ultimately decreases long-term economic growth. One way that a high tax rate may dampen economic growth is through the “lock-in” effect. A high tax rate may decrease the after-tax return on an investment enough to discourage the realization of gains, causing taxpayers to keep gains “locked” in their assets rather than realizing and possibly reinvesting or spending them.³ It has been argued that this effect is especially important for start-up companies, which often rely on funding from wealth angel investors who reinvest gains.⁴ Evidence of the lock-in effect can be seen in years following a federal capital gains tax reduction when tax revenue increases despite the decreased tax rate, as more gains are realized. However, these increases in revenue have historically been transitory, with revenue decreasing in subsequent years. Furthermore, a Congressional

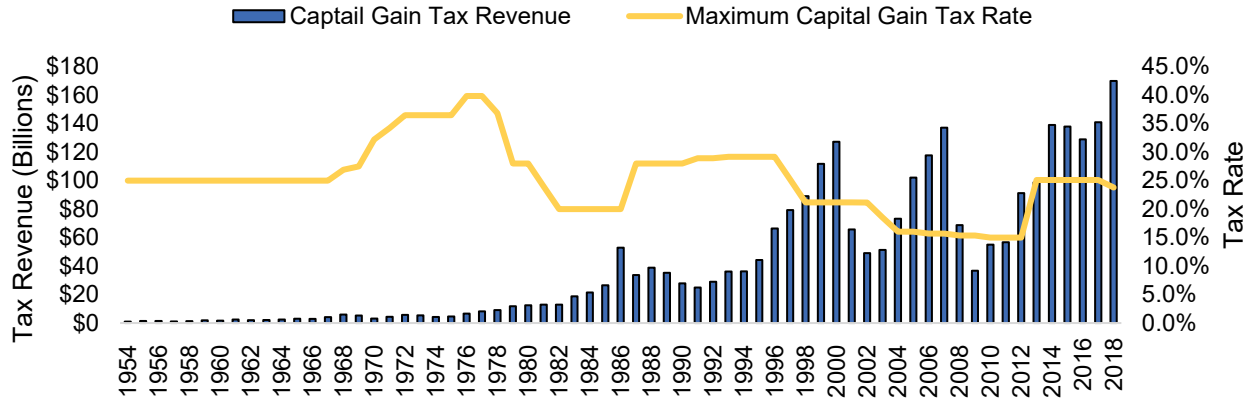
³ “Should we Ax the Capital Gains Tax?” Federal Reserve Bank of St. Louis, July 1, 1995. Accessed electronically at: <https://www.stlouisfed.org/publications/regional-economist/july-1995/should-we-ax-the-capital-gains-tax>

⁴ “Six Reasons to Keep Capital Gains Tax Rates Low,” Cato Institute, December 28, 2012. Accessed electronically at: <https://www.cato.org/commentary/six-reasons-keep-capital-gains-tax-rates-low>



Research Service report in 2018 found little historical evidence that the capital gains tax rate has had a meaningful impact on economic growth.⁵

Figure 1: Federal Capital Gain Tax Rate and Revenue, 1954 to 2018



Source: Tax Foundation

Proponents of maintaining or increasing the federal capital gains tax rate question the fairness of taxing capital gains at a lower rate than ordinary income and argue that decreasing the tax rate would disproportionately benefit wealthy taxpayers. An analysis of IRS data by the Center for American Progress found that in 2018, capital gains accounted for more than half of income for taxpayers with a federal adjusted gross income (AGI) of \$10,000,000 or more compared to just 2 percent for taxpayers with AGI of less than \$100,000, and 8 percent for taxpayers with an AGI of between \$100,000 to \$1,000,000, respectively.⁶ Consequently, more than half of income for taxpayers with an AGI of \$10,000,000 or more is taxed at the lower capital gains tax rate. Reducing the rate further would primarily benefit the wealthiest taxpayers.

The relevance of the debate around the federal tax rate to the evaluation of Oklahoma's deduction is limited. For example, the argument that decreased revenue due to a lower capital gains tax rate will be offset by an increase in the tax base due to increased gain realizations does not apply to Oklahoma's full deduction of qualifying gains. Because it is a full deduction, rather than a reduced rate or partial deduction, an increase in the tax base cannot offset foregone revenue. The benefit Oklahoma may receive from allowing the deduction is entirely determined by any indirect benefits it generates. Indirect benefits of the deduction may include greater reinvestment of capital gains by investors and business owners, which may create jobs and economic activity that would lead to increases in other State revenue streams. These benefits are difficult to quantify, as there is no assurance that gains deducted from Oklahoma taxable income are reinvested in the State.

However, the discussion of who benefits from reduced capital gains taxes is applicable to Oklahoma's deduction. Oklahoma's deduction is used by a small portion of taxpayers and many of the claimants who benefit most report high incomes.

Historic Use of the Deduction

The number of Oklahoma state income tax returns claiming the capital gains deduction nearly doubled from 10,828 in 2005, the first year it was available, to 19,935 in 2018. Part of this sharp increase may have been due to taxpayers not being aware of the deduction in its first year, as returns claiming it increased from 10,828 in

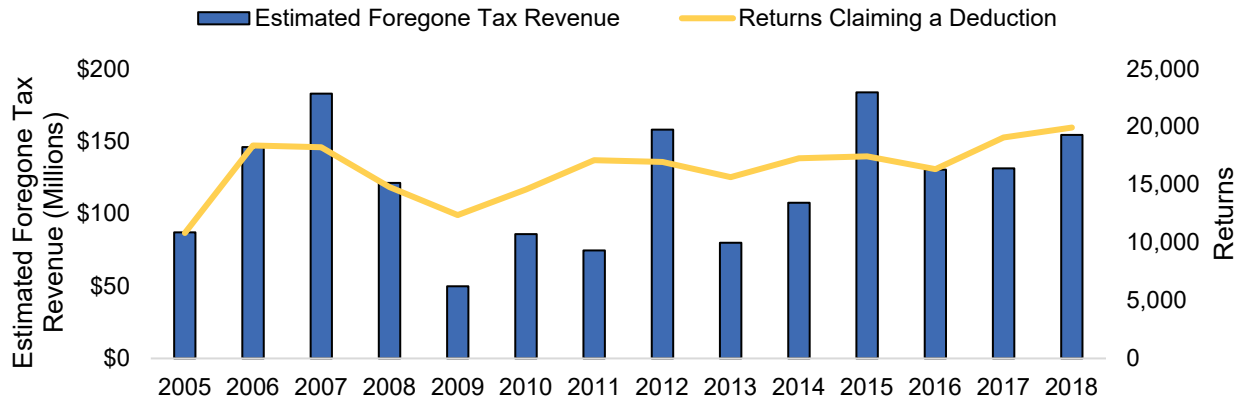
⁵ "Capital Gains Taxes: An Overview," Congressional Research Service, March 16, 2018. Accessed electronically at: <https://crsreports.congress.gov/product/pdf/RS/96-769>

⁶ "Capital Gains Tax Preference Should Be Ended, Not Expanded," Center for American Progress, September 28, 2020. Accessed electronically at: <https://www.americanprogress.org/issues/economy/reports/2020/09/28/490816/capital-gains-tax-preference-ended-not-expanded/>



2005 to 18,379 in 2006. The amount of income deducted also more than doubled over this period, from \$1.5 trillion to \$3.1 trillion. The following chart shows the estimated foregone tax revenue due to deducted gains and the number of returns claiming them over time.⁷

Figure 2: Estimated Foregone Tax Revenue and Number of Claims, Tax Years 2005 to 2018



Tax Year	Returns Claiming the Deduction	Total Amount Deducted	Estimated Foregone Tax Revenue
2005	10,828	\$1,539,922,016	\$87,005,594
2006	18,379	\$2,582,859,065	\$145,931,537
2007	18,223	\$3,325,139,828	\$182,882,691
2008	14,785	\$2,203,512,997	\$121,193,215
2009	12,369	\$905,343,747	\$49,793,906
2010	14,584	\$1,561,014,955	\$85,855,823
2011	17,106	\$1,420,260,932	\$78,114,351
2012	16,962	\$3,009,138,923	\$157,979,793
2013	15,649	\$1,520,093,410	\$79,804,904
2014	17,274	\$2,047,103,649	\$107,472,942
2015	17,446	\$3,675,894,222	\$192,984,447
2016	16,330	\$2,606,876,225	\$130,343,811
2017	19,078	\$2,624,369,667	\$131,218,483
2018	19,935	\$3,086,488,916	\$154,324,446

Source: Oklahoma Tax Commission

Capital gains are not commonly reported by taxpayers in Oklahoma, and the share of total federal returns filed in Oklahoma that report gains has lagged the national rate and declined over time. The percentage of total Oklahoma Federal income tax returns reporting a net capital gain or loss has decreased from 15.3 percent when the deduction was first made available in tax year 2005, to 12.8 percent in 2018. This decrease is consistent with trends seen nationally. The percent of total federal income tax returns reporting a net capital gain or loss also decreased from 19.3 percent in 2005 to 16.6 percent in 2018.

Taxpayers claiming the Oklahoma Capital Gains Deduction account for an even smaller share of the total. From 2005 to 2018, the number of returns claiming the deduction as a share of all federal income tax returns in Oklahoma averaged 1.0 percent. As a share of total Oklahoma federal returns reporting a capital gain or loss, they averaged 7.9 percent.

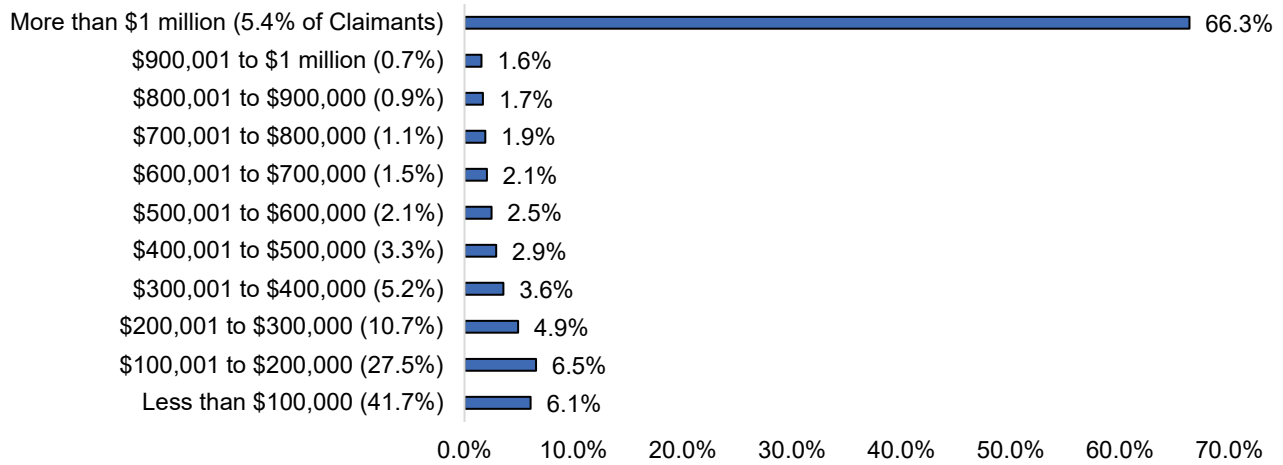
⁷ Foregone tax revenue estimated using the top income tax rate in each year.



The Tax Commission was able to provide detailed data for tax years 2015 through 2018, showing aggregate count and amount of deductions by federal adjusted gross income (AGI) level, with the number of returns in each income category broken down by the amount of deduction claimed.

This data shows that, in aggregate from 2015 through 2018, claimants with federal AGI greater than \$1,000,000, who accounted for 5.4 percent of total returns claiming a deduction, claimed about two-thirds (66.3 percent) of the total amount deducted. Filers with AGI less than \$100,000 were the most frequent claimants of the deduction but accounted for just 6.1 percent of the total amount deducted.

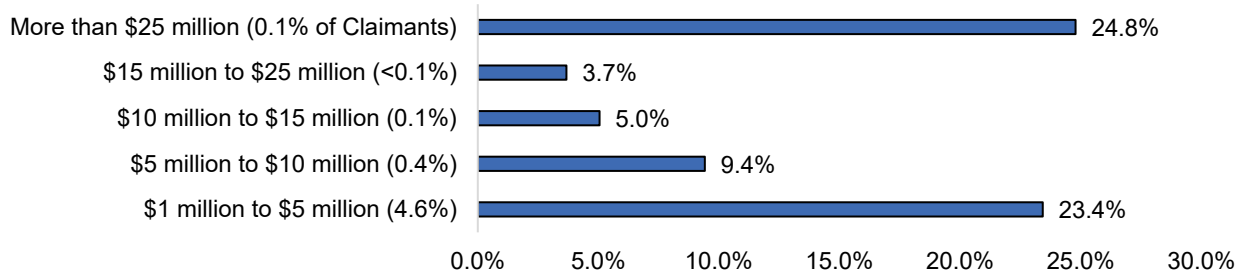
Figure 3: Share of Total Amount Deducted, by Federal AGI, 2015 through 2018



Source: Oklahoma Tax Commission

A further breakdown of claimants with AGI greater than \$1,000,000 shows that claimants with AGI greater than \$25,000,000 accounted for 0.1 percent of total claimants but about a quarter (24.8 percent) of the total amount deducted over this period.

Figure 4: Share of Total Amount Deducted, by Federal AGI, 2015 through 2018



Source: Oklahoma Tax Commission

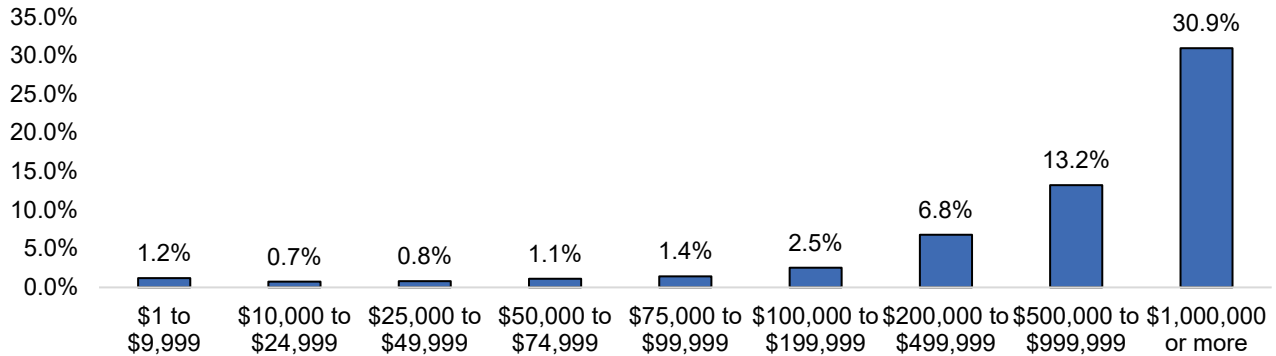
Most claimants deduct amounts of \$100,000 or less. From 2015 through 2018, more than four-fifths (81.8 percent) of returns deducted amounts of \$100,000 or less and four-fifths of those returns were filed by taxpayers with AGI of \$200,000 or less.

Claimants with high AGI claim most of the benefits of the deduction not only because higher income generates greater tax liability, but because capital gains account for a greater share of income as income increases. The following chart shows net capital gains as a share of total income for Oklahoma Federal income tax filers in tax



year 2018. At AGI between \$25,000 to \$50,000, net capital gains account for just 0.8 percent of total income, but this share grows to 30.9 percent at AGI levels above \$1,000,000.

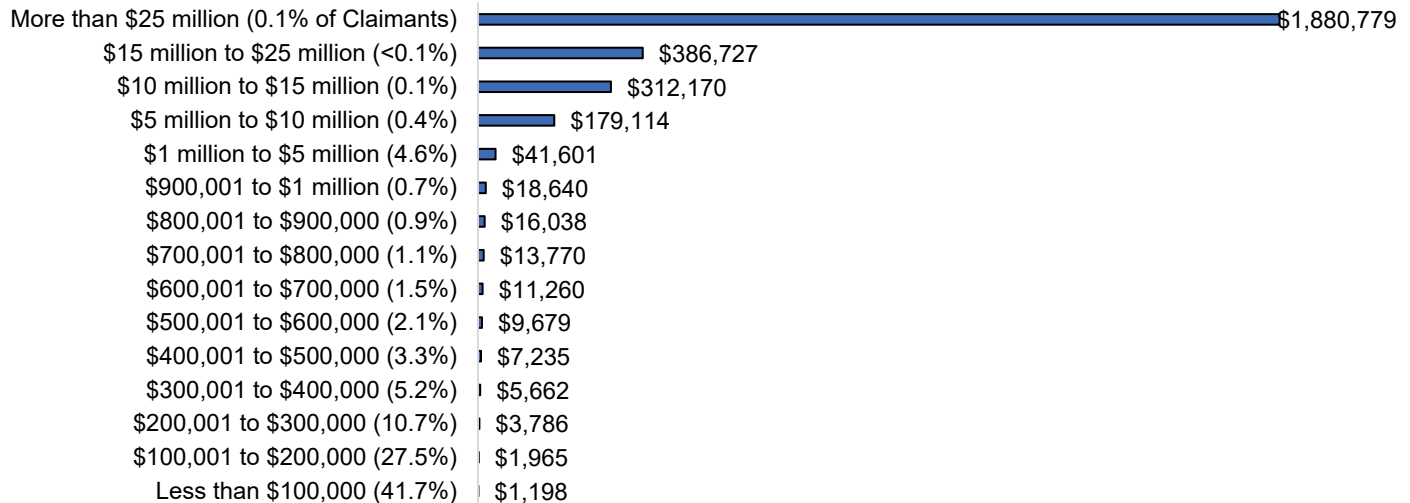
Figure 5: Oklahoma Federal Income Taxpayer Net Capital Gain as a Share of Total Income, by Federal AGI, Tax Year 2018



Source: US Internal Revenue Service, Statistics of Income

The average tax benefit received by deduction claimants, estimated using the top personal income tax rate of 5 percent, at different levels of AGI provides another illustration of this trend. Tax benefit received by claimants did not grow proportionally with income. From AGI of \$100,000 or less to AGI between \$900,001 and \$1,000,000, income levels are 10 times greater, but the average tax benefit is more than 34 times greater, increasing from \$1,198 to \$18,640. The following chart shows the growth in average tax benefit received at different AGI levels.

Figure 6: Average Tax Benefit by AGI Level, 2015 through 2018



Source: Oklahoma Tax Commission

Information regarding the type of property sold to generate deducted capital gains is not aggregated by the Tax Commission for analysis. There is also no information collected regarding the use, including possible reinvestment, of qualifying capital gains received and no guarantee that the capital gains received subsequently spent or reinvested in Oklahoma. As a result, it is not clear in what ways the State may be benefiting from the use of this deduction. Complicating this issue is the fact that non-residents are eligible to claim the deduction. From 2015 through 2018, a total of 6,129 non-resident income tax filers claimed total deductions of \$1.5 trillion,



generating foregone revenue of \$76.5 million. Non-residents accounted for 8.4 percent of total claimants over this period and 12.8 percent of the total amount deducted.

Incentive Administration

The OTC administers the deduction. Taxpayers claiming the deduction submit a form along with other income tax forms. The following summarizes the essential components of this process:

Eligibility

Net gain from the sale of Oklahoma-based real or tangible property, or stock or ownership interest in an Oklahoma-based business entity is eligible to be deducted from income for state income tax purposes for individuals, estates, trusts, and corporations. Real or tangible property must be owned for at least five years prior to the sale. Stock or ownership interests must be in a business entity that has had a primary headquarters in Oklahoma for at least three years prior to the sale. Estates, trusts, and corporations must have owned the stock or ownership interest for three years prior to the sale. For individuals, this requirement is reduced to two years. If the gain results from the sale of all or substantially all of the assets of an Oklahoma-based company, the holding period is two years for individuals and three years for estates, trusts, and corporations.

Deduction Claims

Taxpayers may claim the deduction by completing Tax Form 561. Taxpayers report qualifying gains by location or address for tangible property or Federal ID number for stock or ownership interests. Other information reported on the form includes acquisition date, sale date, and associated gain.

Reporting

Estimates of the cost of the capital gain deduction are reported in the Tax Expenditure report published bi-annually by the OTC. Due to difficulties in aggregating the data associated with corporate tax deductions, estimates are only made for cost of personal income tax deductions.

The OTC does not aggregate information collected on Form 561 such as the holding period of capital, the industry that corporations benefiting from the deduction operate in, or data identifying deduction amounts for real property versus stock or ownership interests.



Economic and Fiscal Impact



The economic gains resulting from a capital gains tax deduction flow directly to the income of the claimant. Claimants may be individuals, estates, trusts or corporations. Approximately 66 percent of deductions are attributable to claimants with incomes in excess of \$1 million. These include businesses and high income individuals.

Economists use a number of statistics to describe regional economic activity. Four common measures are **Output**, which describes total economic activity and is generally equivalent to a firm's gross sales; **Value Added**, which equals gross output of an industry or a sector less its intermediate inputs; **Labor Income**, which corresponds to wages and benefits; and **Employment**, which refers to jobs that have been created in the local economy.

In an input-output analysis of new economic activity, it is useful to distinguish three types of effects: **direct**, **indirect**, and **induced**.

Direct effects are production changes associated with the immediate effects or final demand changes. The payment made by an out-of-town visitor to a hotel operator or the taxi fare paid for transportation while in town are examples of direct effects.

Indirect effects are production changes in backward-linked industries caused by the changing input needs of directly affected industries – typically, additional purchases to produce additional output. Satisfying the demand for an overnight stay will require the hotel operator to purchase additional cleaning supplies and services. The taxi driver will have to replace the gasoline consumed during the trip from the airport. These downstream purchases affect the economic output of other local merchants.

Induced effects are the changes in regional household spending patterns caused by changes in household income generated from the direct and indirect effects. Both the hotel operator and taxi driver experience increased income from the visitor's stay, as do the cleaning supplies outlet and the gas station proprietor. Induced effects capture the way in which increased income is spent in the local economy.

A multiplier reflects the interaction between different sectors of the economy. An output multiplier of 1.4, for example, means that for every \$1,000 injected into the economy, all other sectors produce an additional \$400 in output. The larger the multiplier, the greater the impact will be in the regional economy.

Figure : The Flow of Economic Impacts



For the capital gains tax deduction, the foregone tax amounts were allocated to claimant incomes according to spending characteristics of differing household income profiles, developed by IMPLAN.⁸ Income profiles take into account differing saving, spending, investment and tax rates applicable as incomes change. Analysis of household income impacts differ from industry income impacts as household incomes are not a function of production and payroll. As a result, the economic impacts of household income changes result only in induced economic effects and have no direct or indirect economic impact.

⁸ IMPLAN is one of several well-known input-output models that represents the interdependencies between different sectors of a national, state or regional economy. The State of Oklahoma also uses the IMPLAN model.



The table below describes the induced economic impacts of foregone tax revenue to the State, which results in income and spending increases among claimants. The spending of the foregone state tax revenue by those benefitting claimants is portrayed as if the benefits received were additional income and spent in the year claimed. It should be noted there are no requirements to collect data as part of the capital gains deduction application or qualification forms regarding whether, where or when the capital gains tax credit income may be spent. As a result, the impact data represent an estimated approach to identify economic impacts of the incentive.

Tax Year	Estimated Foregone Tax Revenue	Economic Impact	Employment	State Tax Revenue
2014	\$107,472,942	\$60,505,127	411	\$1,782,355
2015	\$192,984,447	\$106,041,834	722	\$3,117,905
2016	\$130,343,811	\$73,535,369	499	\$2,166,869
2017	\$131,218,483	\$74,639,096	506	\$2,201,042
2018	\$154,324,446	\$88,566,057	600	\$2,611,839
2014-2018	\$716,344,129	\$403,287,484	548	\$11,880,009

Source: IMPLAN, PFM

Over the five-year period from 2014-2018, the total economic impact of the capital gains deduction is \$403.3 million, compared with \$716.3 million in foregone revenue to the State. Economic impacts of the deduction are far less (56 percent) than the deduction itself.

By comparison, if the State were to spend the \$716.3 million as part of its budgeted operations the resulting economic impacts would reach \$1.0 billion, exceeding the value of the revenue through the multiplier effects. This activity would create substantially more employment, 1,757 jobs on an average annual basis, compared with 548 jobs annually when spent through claimant spending over the course of the five-year period.

Government spending is estimated using IMPLAN's Institutional Spending Profile for general state and local government. This profile is used to measure the effects of tax and policy changes on government budgets and the local economy, as compared with either private production and industry output or household spending.

The return on investment for the capital gains deduction is negative. The foregone revenue would generate substantially greater employment and economic impacts statewide if these revenues were spent as part of the Oklahoma budget.



Incentive Benchmarking



Benchmarking

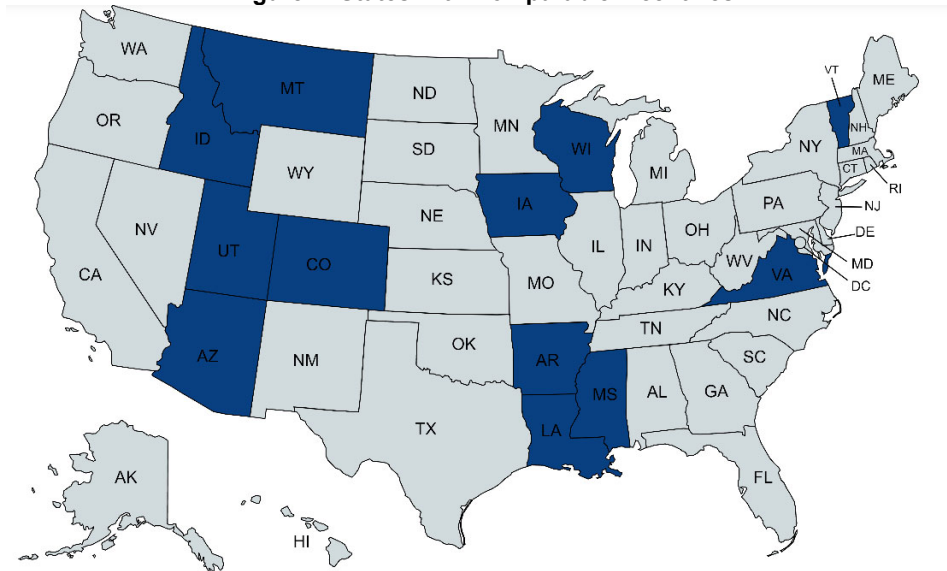
A detailed description of comparable state programs can be found in **Appendix B**.

For evaluation purposes, benchmarking provides information related to how peer states use and evaluate similar incentives. At the outset, it should be understood that no states are ‘perfect peers’ – there will be multiple differences in economic, demographic and political factors that will have to be considered in any analysis; likewise, it is exceedingly rare that any two state incentive programs will be exactly the same.⁹ These benchmarking realities must be taken into consideration when making comparisons – and, for the sake of brevity, the report will not continually re-make this point throughout the discussion.

The process of creating a comparison group for incentives typically begins with bordering states. This is generally the starting point, because proximity often leads states to compete for the same regional businesses or business/industry investments. Second, neighboring states often (but not always) have similar economic, demographic or political structures that lend themselves to comparison.

For Oklahoma’s Capital Gains Deduction, the comparison group consists of 12 states, including two neighboring states – Arkansas and Colorado. The comparison group was created with a focus on states that use a capital gain deduction as a targeted incentive. Several states outside the comparison group allow for a standard percentage of capital gains to be deducted from taxable income. These deductions function more as features of the tax code than incentives. For example, New Mexico and South Carolina allow 40 and 44 percent of capital gains to be deducted from taxable income, respectively, with no special requirements as to the type of property or location of property, effectively creating a lower tax rate for all income from capital gains. The deductions offered by Oklahoma and the chosen comparators are different because they limit the deduction to certain types of property, held for a certain period.

Figure 7: States with Comparable Incentives



⁹ The primary instances of exactly alike state incentive programs occur when states choose to ‘piggyback’ onto federal programs.



Incentive Targets

Oklahoma's deduction is uniquely broad relative to comparable state incentives. The key requirements for Oklahoma's deduction are the location requirement and the holding period requirement. There are no other requirements that involve specific industries or revenue-generating activities and all types of property – real, personal, intangible, may qualify. All other comparable state incentives target a specific industry or type of property.

- Four states – Arizona, Montana, Utah and Virginia – target gains from small business investment. Among those states, Virginia further specifies that the small businesses must be technology-based businesses.
- Colorado's incentive is geographically broad in that the property which generated the gains can be located anywhere, but must be tangible personal property.
- Idaho limits its deduction to real property and revenue-generating tangible personal property.
- Iowa limits its deduction to gains from the sale of a business, real property used in a business, cattle, horses, breeding livestock, and timber.
- Louisiana limits its deduction to gains from the sale of investments in non-publicly traded businesses domiciled in Louisiana.
- Mississippi limits its deduction to gains from the sale of ownership interests in businesses domiciled in the state.
- Vermont limits its deduction to the sale of Vermont-based business assets.

Location Requirement

Nearly all states in the comparison group require qualifying capital gains to be sourced from in-state property or businesses. Colorado, which has no location restriction, is the only exception among the group. Some states have flexible requirements.

Benefit Amount

Oklahoma's deduction is similar to most comparable state incentives in that it offers a full deduction of qualified gains. Seven comparable state incentives also provide a full deduction of qualified gains.¹⁰ One-third of comparable state incentives limit the deduction to a percentage of the total gain, while Utah's incentive is in the form of a tax credit that effectively reduces the tax rate on qualified capital gains.

Benefit Caps

Only two comparable state incentives feature a cap. Colorado limits the amount of capital gain income a taxpayer can deduct to \$100,000. Vermont caps its deduction at \$350,000 per taxpayer.

Holding Period

Oklahoma's holding period requirement of three to five years is one of the longest among comparable incentives. Iowa has the longest holding period requirement among comparable incentives, requiring businesses and real property used in a business to be held for 10 years prior to its sale in order to qualify. Three state incentives require a holding period of five years, Vermont requires three years, Idaho requires one to two years depending on the type of property sold, and four states require a one-year holding period. Montana and Utah have no holding period requirement associated with their incentives.

¹⁰ Colorado provides a full deduction, up to \$100,000



Deduction Applicability

Oklahoma's deduction is available for both individual and corporate income tax. Only three other states allow their incentive for both individual and corporate income. The remaining three-quarters of comparable state incentives provide a deduction only for individual income.



Appendices



Appendix A: Incentive Statute

68 O.S. § 2358D

- D. 1. For taxable years beginning after December 31, 2005, the taxable income of any corporation, estate or trust, shall be further adjusted for qualifying gains receiving capital treatment. Such corporations, estates or trusts shall be allowed a deduction from Oklahoma taxable income for the amount of qualifying gains receiving capital treatment earned by the corporation, estate or trust during the taxable year and included in the federal taxable income of such corporation, estate or trust.
2. As used in this subsection:
- a. "qualifying gains receiving capital treatment" means the amount of net capital gains, as defined in Section 1222(11) of the Internal Revenue Code, included in the federal income tax return of the corporation, estate or trust that result from:
- (1) the sale of real property or tangible personal property located within Oklahoma that has been directly or indirectly owned by the corporation, estate or trust for a holding period of at least five (5) years prior to the date of the transaction from which such net capital gains arise,
 - (2) the sale of stock or on the sale of an ownership interest in an Oklahoma company, limited liability company, or partnership where such stock or ownership interest has been directly or indirectly owned by the corporation, estate or trust for a holding period of at least three (3) years prior to the date of the transaction from which the net capital gains arise, or
 - (3) the sale of real property, tangible personal property or intangible personal property located within Oklahoma as part of the sale of all or substantially all of the assets of an Oklahoma company, limited liability company, or partnership where such property has been directly or indirectly owned by such entity owned by the owners of such entity, and used in or derived from such entity for a period of at least three (3) years prior to the date of the transaction from which the net capital gains arise,
- b. "holding period" means an uninterrupted period of time. The holding period shall include any additional period when the property was held by another individual or entity, if such additional period is included in the taxpayer's holding period for the asset pursuant to the Internal Revenue Code,
- c. "Oklahoma company", "limited liability company", or "partnership" means an entity whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise,
- d. "direct" means the taxpayer directly owns the asset, and
- e. "indirect" means the taxpayer owns an interest in a pass-through entity (or chain of pass-through entities) that sells the asset that gives rise to the qualifying gains receiving capital treatment.
- (1) With respect to sales of real property or tangible personal property located within Oklahoma, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the property for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a



member, partner, or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than five (5) years.

(2) With respect to sales of stock or ownership interest in or sales of all or substantially all of the assets of an Oklahoma company, limited liability company, or partnership, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the stock or ownership interest or the assets for not less than three (3) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than three (3) years.

68 O.S. § 2358F

F. 1. For taxable years beginning after December 31, 2004, a deduction from the Oklahoma adjusted gross income of any individual taxpayer shall be allowed for qualifying gains receiving capital treatment that are included in the federal adjusted gross income of such individual taxpayer during the taxable year.

2. As used in this subsection:

a. "qualifying gains receiving capital treatment" means the amount of net capital gains, as defined in Section 1222(11) of the Internal Revenue Code, included in an individual taxpayer's federal income tax return that result from:

(1) the sale of real property or tangible personal property located within Oklahoma that has been directly or indirectly owned by the individual taxpayer for a holding period of at least five (5) years prior to the date of the transaction from which such net capital gains arise,

(2) the sale of stock or the sale of a direct or indirect ownership interest in an Oklahoma company, limited liability company, or partnership where such stock or ownership interest has been directly or indirectly owned by the individual taxpayer for a holding period of at least two (2) years prior to the date of the transaction from which the net capital gains arise, or

(3) the sale of real property, tangible personal property or intangible personal property located within Oklahoma as part of the sale of all or substantially all of the assets of an Oklahoma company, limited liability company, or partnership or an Oklahoma proprietorship business enterprise where such property has been directly or indirectly owned by such entity or business enterprise or owned by the owners of such entity or business enterprise for a period of at least two (2) years prior to the date of the transaction from which the net capital gains arise,

b. "holding period" means an uninterrupted period of time. The holding period shall include any additional period when the property was held by another individual or entity, if such additional period is included in the taxpayer's holding period for the asset pursuant to the Internal Revenue Code,

c. "Oklahoma company," "limited liability company," or "partnership" means an entity whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise,

d. "direct" means the individual taxpayer directly owns the asset,



e. "indirect" means the individual taxpayer owns an interest in a pass-through entity (or chain of pass-through entities) that sells the asset that gives rise to the qualifying gains receiving capital treatment.

(1) With respect to sales of real property or tangible personal property located within Oklahoma, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the property for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner, or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than five (5) years.

(2) With respect to sales of stock or ownership interest in or sales of all or substantially all of the assets of an Oklahoma company, limited liability company, partnership or Oklahoma proprietorship business enterprise, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the stock or ownership interest for not less than two (2) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than two (2) years. For purposes of this division, uninterrupted ownership prior to July 1, 2007, shall be included in the determination of the required holding period prescribed by this division, and

f. "Oklahoma proprietorship business enterprise" means a business enterprise whose income and expenses have been reported on Schedule C or F of an individual taxpayer's federal income tax return, or any similar successor schedule published by the Internal Revenue Service and whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise.



Appendix B: Comparable State Programs

Capital Gains Deduction Benchmarking						
State	Description	Benefit Amount	Cap	Holding Period Requirement	Deduction applied to	Location Requirement
Oklahoma	Gains from the sale of Oklahoma-based property are fully deductible	Full Deduction	None	Three to five years	Individual and Corporate income tax	Companies must be headquartered in Oklahoma for three consecutive years prior to sale. Property sold must be located in Oklahoma.
Arizona	Gains from qualified small business investment are fully deductible	Full Deduction	None	One year	Individual income tax	Business must have a portion of its operations in Arizona
Arkansas	Gains from the sale of in-state venture capital investments are fully deductible	Full Deduction	None	Five years	Individual income tax	Qualified businesses are certified by the Arkansas Economic Development Commission
Colorado	Gains from the sale of tangible personal property, regardless of location, are fully deductible up to \$100,000	Full Deduction	Up to \$100,000 of qualified gains can be deducted	Five years	Individual and Corporate income tax	None
Idaho	Gains from the sale of revenue-generating tangible personal property located in Idaho, or any real property located in Idaho is eligible for 60% deduction	60 percent deduction	None	One year for real or tangible personal property, two years for timber, cattle, and horses	Individual income tax	Must be located in Idaho
Iowa	Gains from the sale of a business or real property used in a business, cattle, horses, breeding livestock, and timber are fully deductible	Full Deduction	None	One to two years for cattle, horses, breeding livestock and timber. 10 years for businesses and business property.	Individual income tax	Must be located in Iowa



Capital Gains Deduction Benchmarking (continued)

State	Description	Benefit Amount	Cap	Holding Period Requirement	Deduction applied to	Location Requirement
Louisiana	Gains from investment in non-publicly traded businesses domiciled in Louisiana may be deducted. The amount of gain eligible for deduction varies from 50% to 100%, based on the holding period.	50% to 100%	None	Five years	Individual income tax	Must be domiciled in Louisiana
Mississippi	Gains from the sale of ownership interests in domestic businesses may be fully deducted	Full Deduction	None	One year	Individual income tax	Must be located in Mississippi
Montana	Gains from investments in Small Business Investment Companies benefiting Montana are fully deductible	Full Deduction	None	None	Individual income tax	Small Business Investment Company must benefit Montana businesses
Utah	A credit equal to 5% of a taxpayer's capital gain is available if 70% of gains are reinvested in certain Utah small businesses within 12 months	5 percent of qualified gain (Tax Credit)	None	None	Individual income tax	Business receiving reinvestment must be located in Utah
Vermont	Gains from the sale of Vermont-based Business assets may be excluded from income. Real estate, stocks, bonds and financial instruments, and depreciable property other than farm property and standing timber do not qualify.	40% Deduction	Deduction limited to \$350,000 per taxpayer	Three years	Individual income tax	Must be located in Vermont
Virginia	Gains from investment in small technology businesses based in Virginia are fully deductible. Investments made after June 30, 2020 do not qualify	Full deduction	None	One year	Individual and Corporate income tax	Must be located in Virginia
Wisconsin	Gains from the sale of farm assets are 60% deductible	60% Deduction	None	One year	Individual income tax	Must be located in Wisconsin



Appendix C: IMPLAN Economic Impact Methodology

The economic impact methodology utilized to determine the multiplier effects is IMPLAN (Impact Analysis for PLANning), a proprietary model; PFM has obtained a license for use of the IMPLAN model for these evaluations.

IMPLAN's Social Accounting Matrices (SAMs) capture the actual dollar amounts of all business transactions taking place in a regional economy as reported each year by businesses and governmental agencies. SAM accounts are a better measure of economic flow than traditional input-output accounts because they include "non-market" transactions. Examples of these transactions would be taxes and unemployment benefits.

Multipliers

SAMs can be constructed to show the effects of a given change on the economy of interest. These are called Multiplier Models. Multiplier Models study the impacts of a user-specified change in the chosen economy for 440 different industries. Because the Multiplier Models are built directly from the region-specific SAMs, they will reflect the region's unique structure and trade situation.

Multiplier Models are the framework for building impact analysis questions. Derived mathematically, these models estimate the magnitude and distribution of economic impacts, and measure three types of effects which are displayed in the final report. These are the direct, indirect, and induced changes within the economy. Direct effects are determined by the Event as defined by the user (i.e. a \$10 million order is a \$10 million direct effect). The indirect effects are determined by the amount of the direct effect spent within the study region on supplies, services, labor, and taxes. Finally, the induced effect measures the money that is re-spent in the study area as a result of spending from the indirect effect. Each of these steps recognizes an important leakage from the economic study region spent on purchases outside of the defined area. Eventually, these leakages will stop the cycle.