



MEMORANDUM

Date: November 8, 2024
To: Tom Mikesell and Ben Noble, City Council Central Staff
From: Jan Duras, Office of Economic and Revenue Forecasts
Re: Capital Gains Tax Revenue Estimates Request

1. Introduction

In this memorandum, the Office of Economic and Revenue Forecasts (Forecast Office) provides a requested analysis of revenues likely to be raised by a 2% tax imposed on capital gains in Seattle city beginning in tax year 2026 with first collection occurring in 2027. The data used for this analysis and the results can be found in the “Seattle capital gains tax estimates 2024-11-08.xlsx” spreadsheet file.

2. Washington State capital gains tax forecast

The proposed tax on capital gains in Seattle city would be similar in structure to the 7% capital gains tax that Washington State started collecting in FY 2023 for tax year 2022. Because of this and the general limited data availability, this analysis of the potential revenues for Seattle city capital gains tax is largely based on the actual collection and forecasts for Washington State. Recent forecasts for state’s capital gains tax can be found in the “DOR WA forecasts and actuals” sheet.

Washington State started collecting tax revenues only recently, in 2023. After collecting almost \$600 million more than expected in FY 2023, collection dropped by 57.4% in FY 2024, bringing in about \$300 million less than forecasted. As a result, the **state’s forecast for FY 2025 through FY 2027 was reduced by about half between February 2024 and September 2024**. Initiative 2019 that aimed to repeal the tax likely contributed to this drop, as some taxpayers likely delayed trades in hope that the Initiative is successful. The effect is however hard to estimate, state’s forecast from September 2024 assumes 13% growth in FY 2025, followed by approximately 4.5% growth in FY 2026 and FY 2027. This results in a \$445 million forecast for FY 2027.

3. Assessing volatility of capital gains tax revenues – Washington State tax data

Capital gain tax collection data in Washington State provides only very limited information when it comes to assessing the likely volatility of revenues in the longer run. Collection only started in 2023 and was likely affected by legal challenges and changes in taxpayer behavior as this new tax was introduced.

Nevertheless, tax collection data provides relevant information regarding the number of taxpayers and the concentration of capital gains tax payments received by Washington State in 2023. This information can be found in the “DOR Seattle and King County” sheet.

1. **In 2023, of the total 3,354 taxpayers in Washington State, the top 20% (374 taxpayers) accounted for about 92% of the total capital gains tax revenue collected.**
2. **The top 10% (333 taxpayers) accounted for about 87% of the total revenue.**
3. **Top 10 taxpayers in Washington State accounted for 56% of the total revenue.**

Forecast Office has also obtained some information regarding the distribution of state’s capital gain tax paid by taxpayers in Seattle city. This information is not for the whole 2023 calendar year, but only as of May 31, 2023.

4. **Of the 816 taxpayers in Seattle city that paid as of May 31, 2023, the top 20% (163 taxpayers) accounted for 85.7% of the revenues collected from Seattle city taxpayers.**

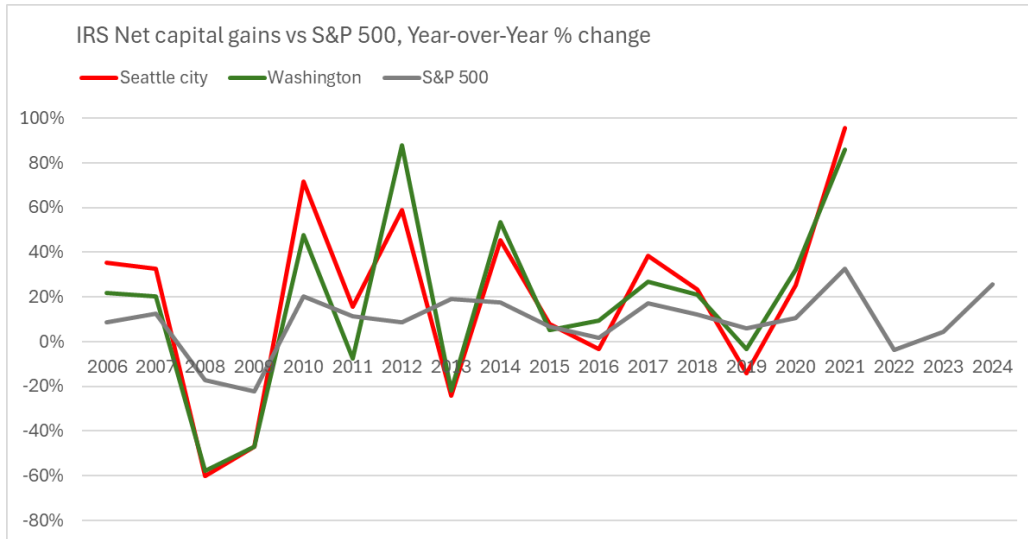
These findings highlight the fact that the capital gains tax is extremely heavily concentrated and strongly affected by the decisions of a very limited number of taxpayers.

4. Assessing volatility of capital gains tax revenues – IRS data

To obtain some additional useful insights regarding the behavior of capital gains over longer time, the Forecast Office analyzed public IRS data from federal income tax returns. In particular, the IRS Individual income tax statistics ZIP code data for the 2005-2021 period was used to calculate the total net capital gain amounts, as reported on line 7 of 1040 federal tax return form, for Washington State and Seattle city. This data on total capital gains does not account for the \$250,000 deduction, but likely shares some of the properties of the tax base for the Washington State capital gains tax. This information can be found in the “IRS” sheet in the “Seattle capital gains tax estimates 2024-11-08.xlsx” spreadsheet file.

The chart below shows the year-over-year changes in the total net capital gain amounts and compares them to the year-over-year changes in the S&P 500 Index. The following observations can be made:

1. **Changes in reported total capital gains are correlated with change in the S&P 500 Index**, they tend to move in the same direction
2. **Changes in reported capital gains are more than twice as volatile as changes in S&P 500 index.** This is due to an amplification since the decision to sell some stock held depends itself on the change in the stock prices - an individual holding stocks is more likely to sell it and realize the gain in a year when stock prices increase significantly, vice versa, in a year when stock prices decline fewer individuals will sell them, preferring to hold and wait for prices to recover.



In addition, inspecting the underlying data reveals the following facts:

3. Reported total capital gains grew 11 years out of 16 and declined in remaining 5 (only 2 of those were years when a recession took place).
4. Reported **total capital gains grew on average 17% in Washington State, in the years when the change was positive they grew on average 40%, in the those when the change was negative they declined on average 21%.**
5. The change in the reported capital gains flipped sign in 8 out of 16 years - **a year with positive growth in total capital gains is often followed by a year when total capital gains decline.**

5. Seattle city capital gains tax estimate

Forecast Office has requested data from the Washington State's Department of Revenue that would help to estimate the share of the revenue collected in Seattle city. This information tax can be found in the "DOR Seattle and King County" sheet, which also provides total revenue collected from taxpayers in King County.

Based on the initial 2023 returns for state's capital gains tax collected as of May 2023, taxpayers located in Seattle city accounted for about 15.8% of total revenues. This estimate is quite lower than the roughly 22.5% estimate based on capital gains reported on IRS federal income tax returns discussed above. The low share is also particularly striking since based on the Department of Revenue data, revenue collected from taxpayers in King County in 2023 constitutes 83.6% of total state's capital gains tax revenues.

Given the 15.8% Seattle share and the September 2024 state's tax forecast of \$445 million in capital gains tax revenues in FY 2027, a 2% tax imposed in Seattle city would generate approximately \$20 million in 2027. Assuming stronger growth in FY 2025 through FY 2027, (as a result of a 55% bounce back in FY 2025 due to a delay caused by Initiative 2019, followed by 18% growth in FY 2026-FY 2027, consistent with average growth in IRS capital gains data discussed below), combined with a larger 22.5% Seattle share would imply about \$51 million raised by a 2% Seattle city tax in 2027.

Overall tax collection will also depend on the extent of outreach, enforcement and auditing efforts. **State estimates assume that compliance is 85% in the first year, 90% in the second year, and 95% thereafter.** In any case, taxpayers can take various steps to reduce their tax obligations. **A 2% Seattle city tax on top of the Washington State 7% tax and the progressive federal tax with rates of 15%/20%/28% would imply a 6.5% to 9% increase in tax burden** (depending on the capital gains amount and thus the federal tax rate). **Studies of the elasticity of capital gains tax revenues have estimated the long run elasticity to be on average about -0.5. This would imply a 3% to 5% reduction in revenues due to changes in taxpayers' behavior.** Short run elasticity can be however notably larger (state's revenue estimates assume it's about twice larger in the first year), and a local tax is likely to have a higher elasticity than state or federal tax. Some taxpayers may be motivated to move and relocation is easier between local jurisdictions than moving out of state or to a different country. The long term effect of the tax on economic activity in city will likely be negative, but it's hard to quantify.

Given the inherent dependence on the performance of financial markets, amplified by the taxpayers' timing decisions, the high possibility of steps taken to reduce taxable gains, and the extreme concentration of the tax base, revenues from capital gains tax imposed in Seattle city are very likely to fluctuate significantly for year to year and from forecast to forecast. The large uncertainty regarding the revenue collection is also reflected in the estimates for a 2% Seattle city tax imposed starting in tax year 2026. **With 90% compliance and an additional reduction based on a -0.5 short run elasticity as taxpayers take various legal steps to reduce their tax obligations, the above estimate of a \$20 million to \$51 million collection in 2027 would be reduced to about \$17.5 million to \$44.5 million. Under the assumption of 85% compliance and an additional reduction based on -1 short run elasticity as taxpayers take further steps to reduce their tax obligations, the estimate would be reduced to about \$16 million to \$40.5 million.**