FACTS AT A GLANCE

APRIL 2005

The SJC's Recent Ruling on the Taxation of Capital Gains

On April 26, 2005, the Massachusetts Supreme Judicial Court, in *Peterson vs. Commissioner of Revenue,* established January 1, 2002 as the effective date for the change in the personal income tax rate for capital gains originally adopted in conjunction with the FY 2003 budget.

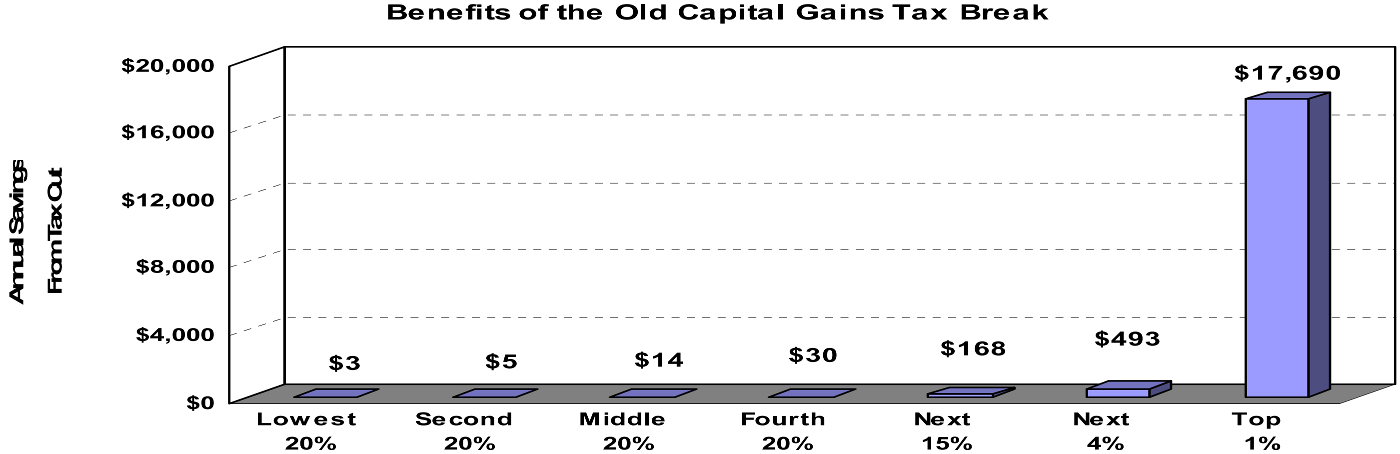
That was the effective date originally included in legislation that passed the House and Senate in 2002. Late in the legislative process that year, the conference committee preparing the final version of the bill changed the effective date from January 1, 2002 to May 1, 2002. A year ago the Supreme Judicial Court ruled that it is unconstitutional to have two different tax rates apply to capital gains income realized in one calendar year.

After last year's decision the Legislature enacted, and Governor Romney signed, a law creating a January 1, 2002 effective date, but also creating an "amnesty" provision that relieved taxpayers who had already filed their returns from the requirement that they pay the new tax rate on capital gains realized before May 1. The SJC's recent decision struck down the amnesty provision, saying that it essentially reestablished the May 1 cutoff date that the court had already invalidated. Because the new law contained a January 1, 2002 effective date and the legislative history indicated that the original bill had included that date until late in the legislative process, the court held that January 1, 2002 would be the effective date for the uniform capital gains tax rate.

This means that all taxpayers who realized capital gains in 2002 (not just those whose capital gains were realized on or after May 1 of that year) will have to pay the same tax rate on that income as ordinary taxpayers pay on wage and salary income. Before this tax change was enacted, capital gains income – the vast majority of which is earned by the very wealthiest taxpayers in the Commonwealth – was taxed at special, lower, rates – and was not taxed at all when it was derived from an asset held six years or longer.

In FY 2001 this tax break cost the Commonwealth an estimated $1.15 billion. The extension of that tax break to May 1, 2002 had cost the Commonwealth between $130 and $160 million. The SJC's ruling that it is unconstitutional to allow the tax break to apply to some taxpayers (those who sold their assets prior to May 1) and not others (those who sold their assets on or after May 1) will allow the Commonwealth to recoup that revenue.

The result of these decisions is that taxpayers who received capital gains in the first four months of 2002 will not be able to benefit from the capital gains tax break that was repealed that year. The chart below shows which taxpayers were the largest beneficiaries of the special low rates on capital gains income. These taxpayers will now be required to pay taxes on all of their 2002 capital gains at the same rates that taxpayers pay on their wage and salary income.



MASSACHUSETTS BUDGET AND POLICY CENTER
37 TEMPLE PLACE, 3RD FLOOR, BOSTON, MA 02111
TEL: 617.426.1228 • FAX: 617.695.1295 • www.massbudget.org