Income 15: Colorado Capital Gain Subtraction

Qualifying taxpayers can claim a subtraction on their Colorado income tax returns for certain qualifying capital gain income included in their federal taxable income. This FYI provides information regarding the criteria the taxpayer, the capital asset, and the capital gain must meet in order to qualify for the subtraction.

QUALIFIED TAXPayers

Taxpayers that may claim the Colorado capital gain subtraction include any individual, firm, corporation, partnership, LLC, joint venture, estate, trust or group or combination acting as a unit. In order to be eligible to claim the Colorado capital gain subtraction, the taxpayer must not, at the time of the claim, either

- have any overdue state tax liabilities, including any uncollectible tax liabilities resulting from bankruptcy or
- be in default on any contractual obligations owed to the state or to any local government within Colorado.

QUALIFYING CAPITAL GAINS

The Colorado capital gain subtraction is allowed for capital gains that satisfy all of the following criteria:

1. the capital gain must be included in the taxpayer’s federal taxable income for the year of the subtraction;
2. the capital gain must be earned on either real or tangible personal property;
3. the qualified taxpayer must have acquired the property on or after May 9, 1994;
4. the taxpayer must have owned the property for at least five uninterrupted years prior to the sale; and
5. the property must meet the following criteria related to the property type (real or tangible), location (inside or outside of Colorado), and date of acquisition:

<table>
<thead>
<tr>
<th>Additional qualifying criteria</th>
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<td>Acquisition date</td>
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<td>On or after May 9, 1994, but before June 4, 2009</td>
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<td>On or after June 4, 2009</td>
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Taxpayers cannot claim a subtraction for any income that is treated as ordinary income on their federal income tax return, including any recapture of depreciation. The subtraction is only allowed for income which qualifies as net capital gain for federal income tax purposes.

ACQUISITION DATE AND HOLDING PERIOD

In order to qualify for the subtraction, the specific real or tangible personal property for which the subtraction is claimed must be owned by the taxpayer directly and without interruption for a minimum of five years preceding the sale. This minimum holding period for the subtraction is in addition to any holding period provisions of the Internal Revenue Code applicable to capital gain. The following sections provide information regarding determination of acquisition date and holding periods under various circumstances.

Grantor trusts

Due to the unique attributes of a grantor trust, the transfer of an asset to a grantor trust does not interrupt the holding period. Therefore, to determine if the sale of an asset meets the holding period requirements of the subtraction, the acquisition date of the asset will be considered to be the date when the individual originally acquired title to the asset. This is only the case when property is re-titled between a grantor trust and the creator of the trust who is also the owner of the property.

"Grantor Trust" refers only to those trusts that qualify for the definitions, and treatment for income tax, found in sections 671 through 677 of the federal Internal Revenue Code.
Divorce settlements

When calculating the holding period, the acquisition date of property held by an individual after a divorce will be determined by the status of that property during the marriage. The acquisition date of property that is not jointly titled and controlled during the marriage will be the date the asset is transferred to the spouse during the divorce.

Pass-through entities and their members

A taxpayer who realizes qualifying capital gains as a partner, shareholder, or member in a partnership, S corporation, or other pass-through entity may be able to claim the subtraction, provided the gain satisfies all applicable criteria, including those regarding the acquisition date and holding period. In general, all four of the following conditions must be met for the partner, shareholder, or member to be able to claim the subtraction.

1. The gain from the sale of the asset by the pass-through entity must satisfy the criteria for qualifying capital gains, detailed on page 1 of this publication;
2. The pass-through entity must have acquired the asset on or after May 9, 1994;
3. The pass-through entity must have owned the asset for at least five uninterrupted years immediately preceding the sale that gave rise to the capital gain; and
4. The partner, shareholder, or member must have held a consistent ownership interest in the pass-through entity for at least five uninterrupted years immediately preceding the sale that gave rise to the capital gain.

Example #1: A partnership purchases an asset on May 10, 2000 and sells it on June 1, 2005. The partnership acquired the asset on or after May 9, 1994 and held the asset for a period of at least five uninterrupted years immediately preceding the sale. One partner, who became a partner prior to May 10, 2000, satisfies the five-year holding period and qualifies for the subtraction. A different partner, who became a partner June 2, 2000, does not satisfy the five-year holding requirement and therefore cannot claim the capital gain subtraction.

Property transfers between pass-through entities and members

In the case of property that has been transferred between a pass-through entity and its members, special rules apply when determining whether a member may claim a subtraction.

The acquisition date for determining the members’ holding period of property that is transferred by a pass-through entity to its members is the date the pass-through entity acquired the property. This assumes the members owned their share of the entity for the entire period that the property was owned by the pass-through entity. If any member acquired their share of the pass-through entity after the entity already owned the property, then the acquisition date of the property in the hands of the member would be the date they acquired their share of the entity.

The acquisition date for determining the members’ holding period of property that is transferred by one member to a pass-through entity is, for the transferor, the date that member acquired the property, and, for all other members, the date of the transfer to the pass-through entity. This assumes the members owned their share of the entity for the entire period that property was owned by the pass-through entity. If any member acquired their share of the pass-through entity after the entity already owned the property, then the acquisition date of the property in the hands of the member would be the date they acquired their share of the entity.

Example #2: Colorado property was acquired on May 1, 1994, by an individual, transferred to an S corporation on July 1, 1994, that is wholly owned by the individual, and then sold by the S corporation on July 30, 1999. Therefore, the acquisition date of the asset is May 1, 1994. The holding period is May 1, 1994, through July 30, 1999. In this example, the gain does not qualify as the property was acquired before May 9, 1994.

Example #3: Colorado property was acquired on October 1, 1999 by an LLC and distributed to its members on November 15, 2002. The acquisition date to be used for determining if the capital gain subtraction applies when a member sells the property is October 1, 1999.

Example #4: Colorado property was acquired on June 1, 2002 by an individual. The property was transferred to a partnership in which the individual was a 40% partner on July 1, 2003. The property is sold on June 15, 2008 by the partnership. The individual’s holding period for the property was from June 1, 2002 through June 15, 2008, which qualifies for the capital gain subtraction. However, the other partners’ holding period for the property was from July 1, 2003 through June 15, 2008, which does not meet the five-year holding period for the subtraction.

Example #5: Colorado property was acquired on June 1, 1992 by an individual. The property was transferred to a partnership in which the individual was a 40% partner on July 1, 2000. The property is sold on June 15, 2008 by the partnership. The individual’s acquisition date for the property was June 1, 1992, which does not qualify for the capital gain subtraction. However, the other partners’ acquisition date for the property was July 1, 2000, which does qualify for the subtraction.
Installment sales

In order for capital gains recognized through installment sales to qualify for the subtraction, the asset must be held for five uninterrupted years immediately preceding the sale transaction date. If this requirement is not met, no gain derived from any installment payment qualifies for the subtraction, even if five years elapse between the initial acquisition of the payment and the date of the installment payment.

Example #6: An asset is purchased June 1, 2000, and sold on April 1, 2005, with deferred payments received monthly from July 1, 2005, to December 31, 2008. The capital gains from this transaction do not qualify for the subtraction because the five year holding period was not met when the asset was sold.

Example #7: Same facts as Example #6, above, except the asset was acquired January 1, 2000. The capital gains from this transaction would qualify for the subtraction because the asset was held for the required five uninterrupted years preceding the sale.

LIMITATIONS

The Colorado capital gain subtraction a taxpayer can claim is limited to the lesser of:

1. the amount of the federal net capital gain reported on Schedule D of the taxpayer’s return; or
2. the qualifying capital gain; or
3. $100,000.

Example #8: A taxpayer has a qualifying capital gain of $4,000, a non-qualifying capital gain of $500 and a non-qualifying capital loss of $1,000, for a federal net capital gain of $3,500. The subtraction allowed on the Colorado return will be $3,500 (the lesser of $3,500 and $4,000).

Example #9: Same facts as Example #8, above, except the $1,000 loss is a qualifying Colorado capital loss. The subtraction allowed in this example would be $3,000 (the lesser of $3,500 and $3,000).

DOCUMENTATION

In order to claim the Colorado capital gain subtraction, a taxpayer must complete and submit a Colorado Source Capital Gain Affidavit (DR 1316) with the Colorado return upon which the subtraction is claimed. Forms and instructions are available online at Colorado.gov/tax. Taxpayers must also submit with their Colorado return copies of the federal Schedule D and/or Form 4797 used in determining the amount of federal net capital gain. The Department may request additional documentation if necessary to determine the validity of any subtraction claimed.

ADDITIONAL RESOURCES

- Colorado statutes and regulations
  - 1 CCR 201-2, Regulation 39-22-518. Colorado capital gain subtraction
  - House Bill 09-1366
- Colorado forms, publications, and guidance
  - DR 1316 - Colorado Source Capital Gain Affidavit
- Federal laws
- IRS forms, publications, and guidance
  - Schedule D - Capital Gains and Losses
  - Form 4797 - Sales of Business Property
  - Form 6252 - Installment Sale Income

FYIs represent a good faith effort to provide general information concerning a variety of Colorado tax topics in simple and straightforward language. By their nature, however, FYIs cannot and do not address all taxpayer situations nor do they provide a comprehensive overview of Colorado’s tax laws. For this reason, FYIs are not binding on the Colorado Department of Revenue, nor do they replace, alter, or supersede Colorado law and regulations.

A taxpayer seeking additional guidance regarding the tax consequences of a particular transaction or factual scenario can request a Private Letter Ruling (PLR) or General Information Letter (GIL). Requests for PLRs and GILs must comply with certain requirements, which are currently set forth at 1 Code of Colorado Regulations 201-1, Regulation 24-35-103.5. PLRs are binding upon the Department only with respect to the specific taxpayer that requested the PLR. GILs are for informational purposes only and are not binding on the Department.