

FYI – For Your Information

Colorado Source Capital Gain Subtraction

Qualified Colorado taxpayers may subtract certain net capital gain income earned from Colorado sources to the extent the gains are included in their federal taxable income. (§39-22-518 C.R.S.)

QUALIFYING NET CAPITAL GAINS

There are three different rules that determine which net capital gains qualify for the Colorado source capital gain subtraction. The first is a general rule that applies every year regardless of whether there is a budget surplus. This general rule is expanded in two circumstances, both of which depend on Colorado having a qualified budget surplus during the tax year.

General Rule

Under the general rule, this subtraction is available to taxpayers who have net capital gains that meet the following qualifications:

- Colorado sources — gains must be earned from the sale of either:
 - ✓ real or tangible personal property located in Colorado at the time of sale, or
 - ✓ stocks or ownership interest in Colorado company, limited liability company, or partnership,
- Acquisition date — taxpayer must have acquired the asset **on or after** May 9, 1994,
- Holding period — taxpayer must have owned the capital asset for at least five uninterrupted years prior to the sale,
- Included in the taxpayer's federal taxable income reported on taxpayer's Colorado income tax return.

Expanded Subtraction

Before May 9, 1994. Under the first expanded rule, for any tax year beginning on or after January 1, 1999 and during which the state's fiscal year ends with a qualified surplus, the general rule is expanded to include gains on assets acquired **before** May 9, 1994. Because there was a qualified surplus in 1999 and 2000, this expanded subtraction is available for those years. The other requirements of the general rule, such as the five-year holding period and gains earned from Colorado sources, still apply in this situation. (In order to claim the 1999 subtraction, an amended return must be filed because a late law change did not allow for a line for this subtraction to appear on the original 1999 forms.)

One-Year Holding Period. Under the second expanded rule, for any tax year beginning on or after January 1, 2001 and during which the state's fiscal year ends with a qualified surplus, the general rule for the subtraction is expanded to include gains on assets held for at least one year. The other requirements of the general rule apply, except for the May 9, 1994 acquisition date and the five-year holding period.



Colorado Department of Revenue
Taxpayer Service Division
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Sales Tax: (303) 232-2416
Withholding Tax: (303) 232-2416
Income Tax: (303) 232-2446
Severance Tax: (303) 232-2446
Fuel Tax: (303) 205-5602

Qualified Surplus

The expanded subtraction rules apply only to tax years during which the state's fiscal year ends in a sufficient surplus that must be refunded under the Taxpayer's Bill of Rights Amendment, section 20 of article X of the State Constitution. A surplus of at least \$260 million will activate the first expanded rule (assets acquired before May 9, 1994). The second expanded surplus (holding period of at least one year) requires a revenue surplus of at least \$430 million. These surplus requirements are adjusted annually to reflect the rate of growth of Colorado personal income. The amount of the surplus is determined in October or November of each tax year.

COLORADO SOURCES

The subtraction applies only to net capital gains earned from property located in Colorado. Thus, capital gain realized from the sale of real or personal property qualifies for this subtraction only if the property is located in Colorado at the time of the transaction that gave rise to the gain.

The gain from the sale of stock or ownership interest also qualifies if the stock or ownership interest is of a "Colorado company, limited liability company, or partnership." These are entities that have 50% or more of their property and 50% or more of their payroll assigned to Colorado under the Multistate Tax Compact (24-60-1301, C.R.S.) for the required holding period (e.g., one or five years). Taxpayers must report the property and payroll percentages on form DR 1316 (any such information provided the department may have is confidential and cannot be disclosed) and must keep appropriate records that demonstrate that the company meets the requirements of this subtraction.

Because the sale of a sole proprietorship is not considered a sale of an entity, but only of its assets, such a sale does not qualify as a sale of an "ownership interest." Therefore, gains earned from intangibles owned by a sole proprietorship do not qualify for the subtraction.

The Department will closely examine subtractions involving "pass-through" entities (entities that pass capital gains through to the partner/stockholder/member) that have only de minimis tangible property and payroll, and hold only stock, intangibles, or ownership interests in other entities. In such cases, the Department will require the intangible assets owned by the pass-through entity meet the requirements of the "Colorado source," holding period, and other requirements of this subtraction. *Example: A Colorado taxpayer owns stock in a pass-through entity that has de minimis tangible property and payroll and whose only significant asset is stock held in another company. The Department will apply the "Colorado source" and applicable holding period requirements to the underlying company to determine whether the pass-through of capital gain income from the sale of such stock qualifies for this subtraction.*

ACQUISITION DATE/HOLDING PERIOD

The acquisition date and holding period computations for the purposes of this subtraction are not necessarily the same as federal rules. The specific property must be directly and without interruption owned by the specific taxpayer for five years (or one year if the expanded rule applies to the tax year) to qualify for the subtraction. The Colorado holding period must be satisfied in addition to any holding period required by the federal Internal Revenue Code.

In order to qualify for the subtraction for gains on the sale of individual assets of a pass through entity, both the entity and the partner/Sub S stockholder/member of the pass-through entity must satisfy the applicable holding period for each asset.

Example 1: Partnership purchases an asset on May 10, 1994 and sells it on June 1, 1999. Partner A, who became a partner prior to May 10, 1994, satisfies the five-year holding period and qualifies for the subtraction. Partner B, who became a partner June 2, 1994, does not satisfy the five-year hold requirement and can not claim the capital gain subtraction.

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, then sold by the S corporation on July 30, 1999. What is the acquisition date and holding period for the purpose of the Colorado source capital gain subtraction?

The acquisition date of the asset by the S corporation is July 1, 1994. The holding period is July 1, 1994 through July 30, 1999. The Department will apply the holding requirement to the entity that sold the asset.

Example 3: If a taxpayer acquired a 25% interest in Colorado real property on May 20, 1994, and a 25% additional interest on November 1, 1994, and the whole property is sold on July 1, 1999, what gain may be subtracted?

Only the gain on the first 25% interest can be subtracted. The taxpayer did not hold the second 25% interest for the required five year holding period.

QUALIFIED TAXPAYER

A "qualified taxpayer" is any individual, firm, corporation, partnership, LLC, joint venture, estate, trust, or group or combination acting as a unit, with no overdue state tax liabilities and not in default on any contractual obligations owed to the state or to any local government within Colorado at the time the Colorado source capital gain subtraction is claimed.

DOCUMENTATION

If you claim the Colorado capital gain subtraction on a tax return, you must attach Form DR 1316 to the return. This form requests basic information regarding the capital gain, as well as an affidavit attesting that you qualified to claim the subtraction. List on the DR 1316 only the capital gains and losses that are used to compute the subtraction. This form is included in this FYI for your convenience.

LIMITATIONS TO THE SUBTRACTION

Capital gain income that qualifies for both the Colorado capital gain subtraction and the interest/dividend/capital gain subtraction (explained in FYI Income 40) may be deducted only once. You elect which subtraction you would like to use.

The Colorado capital gain subtraction is limited to the lesser of the amount of the federal net capital gain reported on Schedule D or the qualifying Colorado net capital gain.

Example 1: A taxpayer has a qualifying Colorado capital gain of \$4,000, a non-Colorado capital gain of \$500 and a non-Colorado 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 2: Same facts as in Example 1, 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).

INSTALLMENT SALES

If an asset is sold on an installment basis, the transaction must qualify for the subtraction in both the year the asset is sold and the year the gain is received.

Example 1: An asset is purchased on June 1, 1994 and sold on April 1, 1999, with deferred payments received monthly from July 1, 1999 to December 31, 2001. 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 2: An asset is purchased on June 1, 1992 and sold on July 1, 1999, with deferred payments received in 1999, 2000 and 2001. For this example, it is assumed there is no revenue surplus in 2001. The capital gain will qualify for the subtraction in 1999 and 2000, but the 2001 capital gain would not qualify because assets acquired prior to May 9, 1994 will not qualify for the subtraction in years where there is no state surplus.

Example 3: Same facts as in Example 2, except the asset was acquired on June 30, 1994. The capital gains from this transaction would qualify for the subtraction for 1999, 2000, and 2001 because the asset was acquired after May 9, 1994 and, under the general rule, a state surplus is not required.

Example 4: An asset is purchased on February 22, 1993 and sold on July 20, 1998, with deferred payments received in 1999 and 2000. The capital gains from this transaction do not qualify for the subtraction because the asset was sold in 1998. The Colorado capital gain subtraction was not available in 1998 so even the gains recognized in 1999 and 2000 do not qualify for the subtraction.

COMMON QUESTIONS

If Colorado property was acquired on May 10, 1994 by an individual, transferred on June 5, 1994 to a S corporation wholly owned by the individual, then sold on June 1, 1999 by the S corporation has the five-year holding requirement been satisfied?

No. The entity that sold the asset has not met the holding requirement.

Is the holding period for Colorado computations always the same as the federal holding period for the capital gain computation?

The holding requirement for the Colorado subtraction may be different than federal hold period requirements. The Colorado holding period must be satisfied in addition to any holding period required to qualify as net capital gains under section 1222 (11) of the Internal Revenue Code.

Does income reported as ordinary income after the sale of depreciated property qualify for the exclusion?

No. You can only subtract income which qualifies under Internal Revenue Code Section 1222 (11) as net capital gain. The qualifying gains receiving capital treatment are only federal net capital gains earned from Colorado property.

Does the sale of patents, goodwill, customer lists, or stock options qualify for the subtraction?

No. The subtraction only applies to tangible personal property. The only intangible property eligible is stock or ownership interests in Colorado companies.

If an entity is part of a group of companies that file combined or consolidated Colorado income tax returns, how will the Department determine whether the group is a Colorado company?

The Department will apply the property and payroll factors of the Multistate Tax Compact.

If a taxpayer owns stock in a Colorado corporation and the corporation liquidates, does the capital gain from the transaction qualify for the capital gain subtraction?

Yes, assuming the other requirements of the subtraction are met.

FURTHER INFORMATION

For more information on related topics, consult the following DOR publications:

- FYI General 1 "Department of Revenue Publications";
- FYI General 5 "General Information about Colorado Taxes";
- FYI General 8 "The FYI Program – Index and General Information."

Single FYIs are free from the Taxpayer Service Division. They may be obtained at any statewide taxpayer service center; by writing to the Colorado Department of Revenue, 1375 Sherman St., Denver, CO 80261; or by call the DOR Forms Hotline at (303) 232-2414. Please use the FYI number (General 1, Sales 9, etc.) when ordering FYI publications.

FYIs and commonly used forms are available on the Web at www.revenue.state.co.us

COLORADO SOURCE CAPITAL GAIN AFFIDAVIT

Taxpayer Name	Social Security Number or Colorado Account Number
Spouse Name (if applicable)	Social Security Number or Colorado Account Number

Provide the following information for each asset that qualifies under the requirements of the Colorado capital gain subtraction. Include any qualified assets that resulted in a capital loss. Under the description of property, include the location of the asset when sold or, if stock or an ownership interest in a Colorado company, include the property and payroll factors for the last five years.

If the capital gain is being passed through from a partnership or other pass-through entity, enter the asset involved. If the capital gain is being realized from the sale of an interest in a partnership or other pass-through entity that exists primarily as a holding company for intangible assets, you must look-through the ownership interest to the actual assets involved. List and describe only the assets involved that meet the definition of a qualifying capital gain for the Colorado capital gain subtraction.

Attach additional sheets if needed.

a) Description of Property	b) Date Acquired (mo., day, yr.)	c) Date Sold (mo., day, yr.)	d) Sale Price	e) Cost or other basis	f) Gain or loss
1.			.00	.00	.00
2.			.00	.00	.00
3.			.00	.00	.00
4.			.00	.00	.00
5.			.00	.00	.00
6. Total Gain or (Loss)					.00
7. Net Capital Gain from Federal Form 1040 or 1040A					.00
8. Colorado Source Capital Gain Subtraction, enter lesser of lines 6 or 7. Enter here and on Form 104.					.00

QUALIFYING COLORADO SOURCE CAPITAL GAINS AND LOSSES

I attest that the taxpayer(s) shown above has no overdue state tax liabilities and is not in default on any contractual obligations owed to the state or to any local government within Colorado at the time the attached income tax return is being filed.

Under penalties of perjury, I declare that to the best of my knowledge and belief, this affidavit is true, correct, and complete.

Signature, Taxpayer or Duly Authorized Individual	Date
Spouse Signature (if joint return, both must sign)	Date