

## Capital Gains Taxation: Federal and State

*What is capital gains income?*

When a taxpayer sells a capital asset, such as stock holdings, a home, or longer-lived business assets, the difference between the amount realized on the sale and the taxpayer's basis is either a capital gain or a loss. The taxpayer's "basis" is usually what the taxpayer paid for and invested in the asset, less any depreciation deductions claimed for business assets. Special rules apply to assets received as a gift or through inheritance.

*What are short-term and long-term gains and losses?*

The gain or loss on an asset held for more than one year is considered "long term." If the taxpayer disposes of an asset after holding it for a year or less, the gain or loss is "short term."

*How does the federal government tax capital gains income?*

The maximum federal income tax rate for most net long-term capital gains income is 15 percent in tax year 2012. There is no tax on capital gains income in 2012 for taxpayers in the 10 percent or 15 percent bracket for ordinary income—in tax year 2012, the 0 percent rate applies for married joint filers with taxable income under \$70,700. The amount of net capital gains income that qualifies for the maximum 15 percent or 0 percent rate is the long-term capital gain after subtracting both long-term capital losses and net short-term capital losses (i.e., in excess of short-term capital gains). Short-term capital gains do not qualify for the preferential federal rates but are taxed as ordinary income.

*Are there higher rates for certain kinds of income?*

Three exceptions to the maximum 15 percent and 0 percent federal rates apply:

- **Qualified small business stock.** Between 50 percent and 100 percent of the gain on sale of qualified small business stock is excluded from taxable income, depending on when the stock was acquired; any remaining gain is subject to a maximum rate of 28 percent
- **Collectibles.** The net capital gain from selling collectibles (such as coins or art) is subject to a maximum 28 percent rate
- **Section 1250 real property.** The part of any net capital gain on property for which the taxpayer claimed "additional depreciation" (Section 1250 real property) is taxed at a maximum 25 percent rate

*Is there special tax treatment for gains realized through the sale of the taxpayer's home?*

Yes. Taxpayers who meet "use" and "ownership" tests may exclude up to \$250,000 of gain on the sale of the home (\$500,000 for married joint taxpayers). Under the "use" test, the taxpayer must have used the home as his or her principal residence for two of the five years preceding the sale. Under the "ownership" test, the taxpayer must have owned the home for at least two years. There is no limit to the number of times a taxpayer may claim this exclusion. Beginning in January 2009, the exclusion is apportioned based on the amount of time in which the home was used as the principal residence, from January 2009 to the time of sale.

***Can capital losses reduce ordinary income?***

Yes, up to \$3,000 per year of capital losses can be deducted from ordinary income. Losses over \$3,000 are carried forward to future tax years. Losses on personal use items, such as a home or car, are not deductible.

***How does Minnesota tax capital gains income?***

Minnesota includes all net capital gains income in taxable income and subjects it to the same tax rates as apply to other income: 5.35, 7.05, and 7.85 percent. Minnesota recognizes the federal exclusions on the sale of the taxpayer's home and all or part of the gain on qualified small business stock.

***How do other states that impose an individual income tax treat capital gains income in tax year 2011?***

- Eight states (**Arkansas, Hawaii, Montana, New Mexico, North Dakota, South Carolina, Vermont, and Wisconsin**) exclude a portion of long-term capital gains income, provide a lower rate, or allow a credit
- 32 states, including Minnesota, do not provide general preferential treatment for capital gains income; many provide limited special treatment for capital gains income
  - 16 states and the **District of Columbia** have preferential treatment of long-term gains on a certain investments, such as in new business, property located in state, or low-income housing. Nearly all limit the preferential treatment to in-state investments.
  - Seven states exclude gains on some or all federal, state and local bonds
  - Three states allow exclusion of all or part of certain capital gains income under a more general exclusion for retirement income

***What are the income levels and filing types of people who have capital gains income?***

In tax year 2009, about 17 percent of all returns filed by Minnesota residents reported some capital gain or loss. Married taxpayers filing joint returns received 80 percent of capital gain income. Filers with incomes over \$100,000 received over 85 percent of capital gain income, and capital gain income made up over 6 percent of total income for those returns reporting capital gains.

Federal adjusted gross income	\$ of capital gains reported (millions)	% of all gains reported	% of income consisting of gains	Average gains per return
			returns with capital gains only	
Less than \$50,000	\$223	7.9%	4.1%	\$971
\$50,000 to \$99,999	\$187	6.6%	2.1%	\$2,043
\$100,000 to \$500,000	\$768	27.1%	4.2%	\$8,805
Over \$500,000	\$1,656	58.4%	13.2%	\$168,247
All incomes	\$2,834	100.0%	6.3%	\$6,775

***What are the ages of taxpayers who have capital gains income?***

Almost 35 percent of taxpayers aged 65 and older reported some capital gains income in tax year 2009. The table shows the percent of gains by age of taxpayer.

Taxpayer age	\$ of capital gains reported (millions)	% of all gains reported	% of income consisting of gains	Average gains per return
			returns with capital gains	
Less than 25	\$3	0.1%	1.1%	\$100
25 to 39	\$131	4.6%	2.6%	\$2,523
40 to 64	\$1,825	64.4%	6.1%	\$8,946
65 or older	\$875	30.9%	8.8%	\$6,461
All ages	\$2,834	100.0%	6.3%	\$6,775

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