HOUSE RESEARCH | **Short Subjects**

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Capital Gains Taxation: Federal and State

What is capital gains income?

When a taxpayer sells a capital asset, such as stocks, a home, or business assets, the difference between the sale price and the asset's tax basis is either a capital gain or a loss. The "tax basis" is usually what the taxpayer invested in the asset, less any depreciation deductions claimed for business assets. Special basis rules apply to assets received as a gift or 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?

Four maximum federal income tax rates apply to most types of net long-term capital gains income in tax year 2016 (these rates include the additional 3.8 percent tax on net investment income or NII):

- 0 percent for taxpayers in the 10 percent or 15 percent bracket (under $75,300 of federal taxable income or FTI for married joint filers)
- 15 percent for taxpayers above the 15 percent bracket but below the threshold for the tax on NII (from $75,300 of FTI to $250,000 of modified adjusted gross income or MAGI for married joint filers)
- 18.8 percent for taxpayers subject to the tax on NII but not in the top bracket on ordinary income (from $250,000 of MAGI to $466,950 of FTI for married joint filers)
- 23.8 percent for taxpayers in the top 39.6 percent bracket ($466,950 of FTI or higher for married joint filers)

The net capital gain income that qualifies for the preferential rates is 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 or lower rates for certain kinds of income?

Three exceptions to the maximum federal rates apply:

- **Qualified small business stock.** 50 percent to 100 percent of the gain on sale of qualified small business stock is exempt, depending on when the stock was acquired; a 31.8 percent maximum rate applies to any remaining gain
- **Collectibles.** The net capital gain from selling collectibles (such as coins or art) is subject to a maximum 31.8 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 28.8 percent rate

How are gains from the sale of the taxpayer's main home taxed?

Taxpayers may exclude up to $250,000 of gain on the sale of the home ($500,000 for married joint filers), if they owned and used the homes as their principal residences for two out of the five years before the sales. There is no limit to the number of times a taxpayer may claim this exclusion.

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, 7.85, and 9.85 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 tax capital gains income in tax year 2015?

- Nine states (**Arkansas**, **Arizona, 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
- 31 states, including Minnesota, do not provide general preferential treatment for capital gains income; many provide special treatment for capital gains income from specific types of assets:
  - 19 states and the **District of Columbia** have preferential treatment of long-term gains on certain types of asset sales, usually involving in-state properties. A California court invalidated its in-state restrictions under the Commerce Clause of the U.S. Constitution, while the Oklahoma Supreme Court rejected a similar challenge.
  - 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
  - Three states have loss deduction rules that differ from the federal rules

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

In tax year 2014, about 19 percent of all returns filed by Minnesota residents reported some capital gain or loss. Married taxpayers filing joint returns reported 75 percent of capital gains income. Filers with incomes over $100,000 reported about 89 percent of capital gains income.

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	
Less than $50,000	$445	4.7%	20.1%	$2,681
$50,000 to $99,999	$630	6.6%	6.0%	$4,461
$100,000 to $500,000	$2,775	29.2%	7.5%	$13,779
Over $500,000	$5,666	59.5%	22.9%	$317,890
All incomes	$9,515	100.0%	12.8%	$18,078

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

Over 40 percent of taxpayers aged 65 and older reported some capital gains income in tax year 2014. 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	$137	1.4%	21.3%	$4,349
25 to 39	$512	5.4%	6.4%	$7,563
40 to 64	$5,526	58.1%	11.7%	$22,721
65 or older	$3,341	35.1%	17.9%	$18,155
All ages	$9,515	100.0%	12.8%	$18,078

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