Qualifying taxpayers can claim a subtraction on their Colorado income tax returns for certain qualifying capital gains included in their federal taxable income. The subtraction is allowed only for capital gains earned from qualifying property the taxpayer acquired on or after Mary 9, 1994 and owned for at least five uninterrupted years prior to the date of the sale.

This publication is designed to provide general guidance regarding the criteria the taxpayer, the capital asset, and the capital gain must meet in order to qualify for the subtraction and is intended to supplement guidance provided in the *Colorado Individual Income Tax Guide*. Nothing in this publication modifies or is intended to modify the requirements of Colorado's statutes and regulations. Taxpayers are encouraged to consult their tax advisors for guidance regarding specific situations.

Qualified taxpayers

The Colorado capital gain subtraction is allowed to eligible individuals, estates, trusts, and corporations. In order to be eligible to claim the 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.

A qualified taxpayer may claim the subtraction for qualifying capital gains the taxpayer recognizes from property the taxpayer owns either directly or through a pass-through entity, such as a partnership or S corporation, provided that all applicable requirements are met.

Qualifying capital gains

The subtraction is allowed only for capital gains that meet all applicable requirements. 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.

Capital gains must satisfy all of the following criteria to qualify for the subtraction:

1) the gain must be included in the qualified taxpayer's federal taxable income for the year of the subtraction;
2) the gain must be earned on either qualifying real property or qualifying tangible personal property, meeting the requirements described below;
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.

Qualifying real property

Capital gains from real property qualify for the subtraction only if both of the following conditions are met:

- the real property is located in Colorado; and
- the qualified taxpayer acquired the real property on or after May 9, 1994, but before June 4, 2009.

Real property located outside of Colorado and real property acquired on or after June 4, 2009 do not qualify for the subtraction.

Qualifying tangible personal property

Capital gains from tangible personal property acquired on or after May 9, 1994, but before June 4, 2009 qualify for the subtraction only if the property is located in Colorado. Capital gains from tangible personal property acquired on or after June 4, 2009 need not be located in Colorado to qualify for the subtraction.

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 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

"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.

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.

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 requirements, 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.

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 the transferring 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 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 that member would be the date they acquired their share of the entity.

Example #2: Qualifying 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: Qualifying property was acquired on October 1, 1999 by an LLC and distributed to its members on November 15, 2002. The acquisition date used for determining if the capital gain subtraction applies when a member sells the property is October 1, 1999.

Example #4: Qualifying 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: Qualifying 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 qualified taxpayer can claim is limited to the lesser of:

1) the total amount of the federal net capital gain reported on Schedule D of the taxpayer's return for all qualifying and non-qualifying property; or
2) the qualifying capital gain; or
3) $100,000.

The preceding limitations apply with respect to each qualified taxpayer, whether such qualifying taxpayer is an individual, estate, trust, or corporation. If a partnership, S corporation, or other pass-through entity sells qualifying property, resulting in qualifying capital gains, the preceding limitations apply to each partner, shareholder, or member who recognizes gain from the sale, but not to the pass-through entity as a whole.

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).

Example #10: A partnership consisting of two partners sells property resulting in qualifying capital gains of $50,000 for one partner and $150,000 in qualifying for another partner. Neither partner has any other capital gains or losses during the tax year. The first partner can claim a subtraction for the full $50,000 of qualifying capital gain they recognize. The subtraction the second partner can claim is limited to $100,000, rather than the full $150,000 of qualifying gain they recognize.

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 *Tax.Colorado.gov*. 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

The following is a list of statutes, regulations, forms, and guidance pertaining to Colorado capital gain subtraction. This list is not, and is not intended to be, an exhaustive list of authorities that govern the tax treatment of every situation. Individuals and businesses with specific questions should consult their tax advisors.

Statutes and regulations

- § 39-22-104, C.R.S. Income tax imposed on individuals, estates, trusts.
- § 39-22-301, C.R.S. Corporate tax imposed.
- § 39-22-304, C.R.S. Net income of corporation.
- § 39-22-518, C.R.S. Tax modification for net capital gains.
- Rule 39-22-518. Colorado Capital Gain Subtraction.

Forms and guidance

- *Tax.Colorado.gov*
- *Colorado Source Capital Gain Affidavit* (DR 1316)
- *Capital Gains and Losses* (IRS Schedule D)
- *Sales of Business Property* (IRS Form 4797)
- *Installment Sale Income* (IRS Form 6252)