Reg. §1.5811(21)(B)(ii) Capital Gains Exclusion (Effective Date / /)

Reg. §1.5811(21)(B)(ii) - 1 Statutory Framework

Vermont individual income tax is imposed on the taxable income earned or received in the tax year by every individual, estate, and trust, subject to income taxation under the laws of the United States. Taxable income is defined in 32 V.S.A. § 5811(21) as federal taxable income with certain additions and subtractions. Federal taxable income is decreased by the following capital gain income to arrive at Vermont taxable income:

(1) The first $5000 of adjusted net capital gain income or

(2) 40 percent of adjusted net capital gain income from the sale of assets held by the taxpayer for more than 3 years except from the sale of the following:

  (a) Any real estate or portion of real estate used by the taxpayer as a primary or non-primary residence,

  (b) Depreciable personal property other than farm property and standing timber, and

  (c) Stocks and bonds publicly traded or traded on an exchange or any other financial instruments.

The total amount of decrease due to capital gains exclusions cannot exceed 40 percent of federal taxable income.

A taxpayer may choose the exclusion that results in the greater tax reduction, but may not take both the $5000 and 40 percent exclusion in one tax year. The $5000 exclusion may be applied against all types of adjusted net capital gain income. In no case may the exclusion exceed the taxpayer's adjusted net capital gain. The 40 percent exclusion is limited both as to the type of asset generating the gain and the length of time the asset was held.

Reg. §1.5811(21)(B)(ii) - 2 Exclusion Limited to Adjusted Net Capital Gain Income

Only capital gain income that is *adjusted net capital gain income* as that term is defined in Section 1(h) of the Internal Revenue Code is eligible for the Vermont exclusion. Adjusted net capital gain does not include income short term gain but includes most long term capital gain.

Adjusted net capital gain income does not include section 1250 gain or 28 percent gain. IRC §1(h)(3).

Section 1250 gain is realized on the sale of depreciable real estate and is taxed at a 25 percent maximum federal capital gains rate (or less in some cases). Unrecaptured 1250 gains are only realized when there is a net Section 1231 gain that is not subject to recapture as ordinary income.

The 28 percent gain is the sum of collectibles gain and Section 1202 gain (gain on the sale of small business stock)[1] over the sum of collectibles loss, the net short-term capital loss and the amount of the long-term loss carried to the succeeding tax year under Section 1212(b)(1)(B).

In addition to the limitations of the Section 1(h) definition, qualified dividends are not treated as adjusted net capital gain income for purposes of applying the 40 percent exclusion. 32 V.S.A. § 5811(21)(B).

Reg. §1.5811(21)(B)(ii) - 3 Real Estate Exclusion

(A) The 40 percent exclusion extends to all real estate that is owned more than 3 years except primary or non-primary residences. Examples of real estate the gain from the sale of which qualifies for the 40 percent exclusion include the following:

(1) Real estate in which a business is operated, such as a retail store, office, factory or warehouse and the parcel[2] of land on which the structure is located,

(2) Real estate held for investment purposes, such as an apartment building or raw land,

(3) Real estate used for farming, whether or not the owner is a farmer, including farm buildings,

(4) Real estate that is logged.

(B) Examples of real estate the gain from the sale of which does not qualify the 40 percent exclusion include the following:

(1) A taxpayer's primary residence, second home, camp, cottage, ski condominium or vacation property unless, under federal law, the property is not considered to be used as a home,

(2) A taxpayer's timeshare in a ski condominium,

(3) Land that was part of a residential parcel at the time of sale even if it was subdivided prior to sale.

(C) Part-time Rental Gain from a sale of a primary or non primary residence does not qualify for the 40 percent exclusion even if the property is rented for a significant portion of the year. Under

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[1] The general rule in the case of a non-corporate taxpayer is that gross income does not include 50 percent of any gain from the sale or exchange of qualified small business stock. 26 U.S.C. §1202. Special rules for 2009 through 2013 provided for even more favorable treatment – the exclusion of 75 or 100 percent of the gain from gross income – depending on the date of acquisition. For purposes of the Vermont exclusion, since this gain is not part of adjusted net capital gain it is not eligible for the 40 percent exclusion.

[2] For purposes of this regulation, "parcel" has the same meaning as in 32 V.S.A. §4152(a)(3) where it is defined as "all contiguous land in the same ownership, together with all improvements thereon."

the Internal Revenue Code a person is considered to use a dwelling unit as a home if the person uses it for personal purposes during the tax year for more than the greater of: 14 days or 10 percent of the total days it is rented to others at a fair rental price. However, if the property is a second home that is rented at fair market rent for all but 14 days each year and is otherwise treated as an investment property (e.g., it is depreciated, expenses are deducted and the rental income is reported), it is not considered residential. Likewise, a seasonal camp may be used by the owner for 14 days before it is considered residential.

A day of personal use of a dwelling unit is any day that it is used by:

(1) You or any other person who has an interest in it, unless you rent your interest to another owner as his or her main house under a shared equity financing agreement;

(2) A member of your family or of a family of any other person who has an interest in it, unless the family member uses it as his or her main house and pays a fair rental price;

(3) Anyone under an agreement that lets you use some other dwelling unit; or

(4) Anyone at less than a fair rental price.

(D) Allocation of Gain If a parcel includes both qualifying real estate and residential real estate, the gain must be allocated between the two classes of real estate. For example, if a farm consisting of 200 acres, a farmhouse (the seller's residence or, if the farm is owned by an entity, the residence of an owner of the entity) and a barn is sold and the seller realizes a gain, the adjusted net capital gain should be allocated in the same way as the property value is allocated to the qualifying and non-qualifying real estate. Thus, if 30 percent of the assessed value is on the housesite, 30 percent of the gain should be allocated to the housesite. The remaining 70 percent of the gain is eligible for the 40 percent exclusion. If the taxpayer takes the 40 percent exclusion on the eligible gain, the $5,000 exclusion is not available for any part of the adjusted net capital gain.

(E) Home Office or Business Gain Gain may also be allocated when a taxpayer has a home office or business in the residence. The burden of demonstrating that a portion of the property is not residential is on the taxpayer. Relevant facts may include how the property is treated on the taxpayer's federal income tax returns, including form 8829, and any property tax adjustment claims filed with respect to the property.

(F) Conv ersion A residential property that is converted to a nonresidential use prior to sale may qualify for the exclusion depending upon the facts and circumstances surrounding the conversion. If the property is converted to nonresidential use within 3 years of the sale it is presumed that the asset is residential, but the presumption may be rebutted by the taxpayer. Relevant facts include how long the residence was rented and to whom (e.g. whether the lease is arms' length), when efforts to sell the residence commenced, treatment of the rental income

for state and federal purposes and how the real estate is classified on the grand list. A taxpayer claiming the 40 percent exclusion with respect to real estate that was a residence has the burden of demonstrating that he property was actually converted to nonresidential use.

(G) Installment sales Whether the requirement that the asset be held 3 years is satisfied in an installment sale depends upon when title to the asset passes to the buyer. Thus, property purchased in 2010 and sold in 2012 under an installment contract would not be eligible for the 40 percent exclusion even if payments were received in 2013 and after.

Reg. §1.5811(21)(B)(ii) - 4 Depreciable Personal Property

(A) Adjusted net capital gain income from the sale of depreciable personal property does not qualify for the 40 percent exclusion unless the property sold is farm property. Standing timber also qualifies for the 40 percent exclusion.

(B) Farm property includes any tangible personal property used to generate income from an agricultural activity. For example, a baler used to bale hay for sale qualifies, but a baler used to bale hay to feed a pet horse does not. A tractor used to mow down vegetation between Christmas trees grown for sale qualifies, but tractor used by a landscaping business does not. Livestock used in a business for draft, breeding or dairy purposes qualifies for the 40 percent exclusion.

(C) Adjusted net capital gain on the sale of most depreciable personal property is not eligible for the 40 percent exclusion. Examples of depreciable personal property the gain on which does not qualify for the 40 percent exclusion include the following:

(1) Trade fixtures or business equipment such as restaurant equipment or office furniture;

(2) Equipment used for construction, road building and logging;

(3) Boats, airplanes and motorized vehicles.

(D) Property is "depreciable" if it is a type of property that can be depreciated under the Internal Revenue Code for federal tax purposes. It is irrelevant that such property has not yet been placed in service or that no depreciation expense has yet been taken.

Reg. §1.5811(21)(B)(ii) - 5 Stocks or Bonds Publicly Traded on an Exchange and Financial Instruments

(A) Adjusted net capital gain on the sale of stocks and bonds that are publicly traded does not qualify for the 40 percent exclusion. Other financial instruments that are publicly traded, such as futures, options, swaps and other derivative instruments also do not qualify.

(B) The sale of stock of a closely held corporation that is not publicly traded qualifies for the 40 percent exclusion. Similarly, adjusted net capital gain from the sale of a membership interest in

an LLC or partnership interest in a partnership – provided those entities are not publicly traded – is eligible for the exclusion.

(C) Examples:

(1) Taxpayer sells IBM stock and realizes adjusted net capital gain. This gain is not eligible for the 40 percent exclusion.

(2) Taxpayer sells his stock in a closely-held S-corporation that owns real property, machinery and equipment and good will. The stock is not traded on a public exchange. The adjusted net capital gain realized on the sale is eligible for the 40 percent exclusion even though the machinery and equipment would not be eligible if sold separately as assets.

Reg. §1.5811(21)(B)(ii) - 6 Business Asset Sales

(A) If the sale of a business is structured as an asset sale rather than sale of an ownership interest in the entity, the availability of the exclusion will depend upon the nature of the asset. This is also the case where the membership or ownership interest in a single-member pass-through entity (e.g., limited liability company) is sold, because these entities are disregarded for federal income tax purposes and the assets are treated as assets of the owner.[3] The sale is treated as the sale of the assets under federal law. Vermont follows the federal tax treatment of income in these cases. 32 V.S.A. § 5820.

(B) Examples:

(1) Taxpayer is selling the membership interest in single member LLC. For federal tax purposes, and therefore for Vermont income tax purposes, this is treated as the sale of assets. All of the assets that are used in the LLC's trade or business, consisting of real estate, tangible personal property, intangible rights and licenses, and goodwill, are being sold. The business real estate and intangibles, including good will, are eligible for the 40 percent exclusion. To the extent that the tangible personal property is depreciable, it is not eligible for the exclusion. Taxpayer must be able to produce a reasonable allocation schedule.

(2) Taxpayer owns a convenience market that is going out of business. He sells the coolers and remaining inventory to another market and sells his leasehold interest in the real estate to a third party for a clothing store. Gain related to the coolers, which have been depreciated over several years, and gain from the sale of the inventory is not eligible for the 40 percent exclusion; gain from the sale of the leasehold interest is eligible.

Reg. §1.5811(21)(B)(ii) – 7 Pass-through Entities

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[3] *Proc. & Admin. Regs.* §301.7701-3. Other disregarded entities under federal law are "qualified subchapter S subsidiaries" and "qualified REIT subsidiaries"

The 40 percent exclusion is available only with respect to assets "held by the taxpayer for more than three years" prior to the sale giving rise to adjusted net capital gain. If the seller is a pass-through entity, such as an S-Corporation, partnership or limited liability company, the exclusion is available to the shareholder, partner or member who reported adjusted net capital gain with respect to the sale provided the entity held the asset for more than three years.

Reg. §1.5811(21)(B)(ii) – 8 Basis

The 40 percent exclusion applies only to gain that is included in "adjusted net capital gain" (see subdivision 2 above) which is an amount determined under federal law. Any basis adjustment permitted under federal law to arrive at adjusted net capital gain is therefore reflected in the amount which is eligible for the Vermont exclusion. For example, to the extent that expenses associated with one asset are capitalized to another asset under federal law, that reallocation is recognized for purposes of determining the adjusted net capital gain eligible for the 40 percent exclusion.

Reg. §1.5811(21)(B)(ii) –9 Holding Period

When stock or another form of ownership interest in a business is sold, the three-year holding period is measured from acquisition of the stock or interest. In the case of an asset sale, the Department will follow federal rules in determining holding period of the asset the sale of which gives rise to adjusted net capital gain.

Reg. §1.5811(21)(B)(ii) – 10 Filing Requirements

In order to exclude capital gains income from Vermont income tax, taxpayers will need to identify income that qualifies as adjusted net capital gain income under Section 1(h) of the Internal Revenue Code. Vermont taxable income may be reduced by the first $5000 of such income. Alternatively, taxpayers with eligible assets held more than 3 years may claim the 40 percent exclusion in lieu of the flat exclusion. All taxpayers claiming the 40 percent exclusion should retain records detailing the source of the gain that can be produced upon request by the Department.

If there is a loss with respect to the sale of an asset that would qualify for the 40 percent exclusion if the transaction had resulted in a gain, the loss must be netted against gains that qualify for the 40 percent exclusion. "Adjusted net capital gain" for purposes of calculating the exclusion under 32 V.S.A. § 5811(21)(B)(ii) may not exceed the amount of capital gain reported on line 13 of Federal Form 1040.