Vermont Department of Taxes
TECHNICAL BULLETIN

TAX: Individual Income Tax **TB-60**

SUBJECT: Taxation of gain on the sale of capital assets **ISSUED: January 6, 2011**

STATUTORY REFERENCE: 32 V.S.A. §5811(21)

INTRODUCTION

Effective for income received in 2011[1] and after, the Vermont tax treatment of adjusted net capital gain income has changed. 2010, No. 160, sec. 60 (amending 32 V.S.A. § 5811(21)). Tax treatment varies depending upon the type of capital asset sold. This bulletin provides guidance with respect to how the income tax applies to various types of capital gain income.

THE NEW LAW

For capital gain income received in 2011 and after, individuals may reduce taxable income by either:

(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:

- Any real estate or portion of real estate used by the taxpayer as a primary or non primary residence
- Depreciable personal property other than farm property and standing timber
- Stocks or bonds publicly traded or traded on an exchange or any other financial instruments.

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[1] Adjusted net capital gain income earned or received by a taxpayer on or after July 1, 2009 and before January 1, 2011was taxed under a different scheme: a 40 percent exclusion applied if the taxpayer was age 70 or older as of the last day of the tax year or the adjusted net capital gain income was from the sale of a farm or standing timber. In all other cases (and when elected by a taxpayer 70 or older), the first $2,500 of adjusted net capital gain income was excludable from taxable income. 2009, No. 1 (Sp. Sess.), §H.47; No. 2 (Sp. Sess.), §§16a, 16b, 17,18; No. 3 (Sp. Sess.), §22b. Prior to the 2009 changes, all taxpayers could exclude 40 percent of adjusted net capital gain income to arrive at taxable income. 32 V.S.A. § 5811(21). Under all 3 tax schemes the exclusion was limited to 40 percent of federal taxable income. This limitation was added in 2008. 2007 No. 190 (Adj. Sess.), §102(6).

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 exclusions 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 and the length of time the asset has been owned.

Note that the new law affects only *adjusted net capital gain income* as defined in Section 1(h) of the Internal Revenue Code. Capital gain income that does not fall within that federal definition is not (and has not been under prior law) accorded favorable treatment. Adjusted net capital gain does not include unrecaptured section 1250 gain or 28 percent rate gain. IRC § 1(h)(3). In general, unrecaptured 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 rate is the sum of collectibles gain and section 1202 gain (gain on the sale of small business stock) over the sum of collectibles loss, the net short-term capital loss and the amount of long-term capital loss carried under section 1212(b)(1)(B) the taxable year.

TREATMENT OF ASSETS TYPES UNDER THE NEW LAW

A. Real Estate

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

- real estate used to operate a business, such as a store, office, factory, or warehouse, including the parcel of land on which the structure is located
- real estate held for investment purposes, such as an apartment building or raw land
- real estate used for farming, whether or not the owner is a farmer, including farm buildings
- real estate which is logged

Examples of real estate gains that do not qualify for the 40 percent exclusion include gains from the sale of:

- a taxpayer's primary residence, second residence, camp, cottage, ski condominium or vacation property unless the dwelling is *not* used as a home under federal law.
- a taxpayer's timeshare in a ski condominium
- land that was part of the residential parcel[2] at the time of sale, even if it was subdivided prior to sale

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 the Internal Revenue Code a person is considered to use a dwelling unit as a home if the person uses it for personal purposes[3] 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.

Allocation 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 the residence of an owner of the farm if the seller is an 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 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.

Another situation in which gain may be allocated is 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

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[2] The term parcel is used herein as it is defined in Vermont property law to refer to all contiguous property in the same ownership. *See* 32 V.S.A. § 4152(a)(3).

[3] 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 home 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 home 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 fair rental price.

http://www.irs.gov/taxtopics/tc415.html

taxpayer's federal income tax returns, including Form 8829, and any property tax adjustment claims filed with respect to the property.

Conversion 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 could 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 tax 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 the property was actually converted to nonresidential use.

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 2008 and sold in 2010 under an installment contract would not be eligible for the 40 percent exclusion even if payments were received in 2011.

B. Depreciable Personal Property

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.[4] 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 a 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. Regardless of its proper tax classification or who sells it, standing timber specifically qualifies for the 40 percent exclusion.

Adjusted net capital gain on the sale of most depreciable personal property is ineligible 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:

- Trade fixtures or business equipment such as restaurant equipment or office furniture

[4] The new law does not define "farm property". "Sale of a farm" is defined in 32 V.S.A. §5811(27)(A), but that phrase was used in the law applicable to gain received prior to 2011, not the new (2011) law.

- Construction, road building and logging equipment
- Motorized vehicles, boats, airplanes

C. Stocks or Bonds Publicly Traded on an Exchange; Financial Instruments

Adjusted net capital gain on the sale of stocks and bonds that are publicly traded and all other financial instruments does not qualify for the 40 percent exclusion. Other “financial instruments” include but are not limited to debt instruments, futures contracts, securities, stock options, demutualization of life insurance policies, real estate mortgage investment conduits, financial asset securitization investment trusts and collateral debt obligations.

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 that the 40 percent exclusion in lieu of the flat exclusion up to a maximum of $5000. All taxpayers claiming an exclusion of adjusted net capital gain are required to complete Schedule IN-153. Taxpayers claiming the 40 percent exclusion for some or all of their adjusted net capital gain income must provide details regarding the source of the gain as requested.

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.

USE OF TECHNICAL BULLETINS

A technical bulletin provides general information to the public and does not replace the need for competent legal or accounting advice. This technical bulletin supersedes all prior department pronouncements on this subject.

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