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MEMORANDUM

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May 1, 2009

TO: Interested Persons

FROM: Kate Watkins, Ron Kirk, Economics Section, 303-866-3521

SUBJECT: Colorado's Capital Gains Deduction

This memorandum provides information on Colorado's capital gains tax laws in response to questions about the repeal of these laws by **House Bill 09-1366**. The first section of this memorandum provides a history of the capital gains deduction from its inception in 1937 to changes in federal tax policy in 1986. The second section summarizes current law allowing for capital gains deductions, and the General Fund revenue impacts resulting from these deductions. The third section provides information on a memo from the Office of Legislative Legal Services addressing the constitutionality of Colorado's capital gains deduction.

Summary

Capital gains were used to calculate Colorado taxable income for individuals when the state income tax was enacted in 1937. By 1957, state law excluded from the tax base 50 percent of capital gains derived from the sale of assets held by taxpayers for six months or longer.

Current law allows taxpayers to deduct capital gains if qualifying assets are purchased on or after May 9, 1994 and certain conditions are met. The annual General Fund revenue impact for capital gains ranged from $5.6 million in 1999 to $32.9 million in 2005. Current law also allows for two TABOR refund mechanisms that expand the annual capital gains deduction. One mechanism allows a capital gains deduction on assets purchased *prior* to May 9, 1994. The second reduces the five-year holding period to one year. General Fund impacts from these mechanisms totaled $111.5 million and $156.8 million in 2000 and 2001 respectively, the only years the mechanisms were in place.

A recent analysis by the Office of Legislative Legal Services finds that Colorado's current state income tax deduction for capital gains "appears to violate the U.S. Commerce Clause based on *Fulton Corp. v. Faulkner*."[1] The deduction has not been challenged in a legal action in Colorado.

History of Colorado's Capital Gains Modification

Capital gains were included in the Colorado taxable income calculation for individuals when the state income tax was enacted in 1937. The modification to income was calculated using a *percentage* of the gain that was realized by the taxpayer and was based upon the length of time that the capital asset was held. As the capital asset was held for a greater period of time, the percentage applied to the gain declined. By 1957, state law excluded from the tax base 50 percent of capital gains derived from the sale of assets held by taxpayers for six months or longer. At this time, Colorado taxpayers used a long-form to deduct capital gains. The deduction was eliminated in 1987 when the state individual income tax rate was changed from a graduated rate structure to a flat 5 percent rate in response to federal tax reform. From 1987 to 1994, no capital gains deductions were specified by the Colorado statutes.

Capital Gains Deduction

Capital gains deduction under the general rule. Qualified Colorado-source capital gains can be deducted annually pursuant to House Bill 94-1053. This bill reduced state income taxes on qualifying capital gains and became effective May 9, 1994. State law allows taxpayers to deduct certain capital gains if qualifying assets were purchased **on or after May 9, 1994, and held for five uninterrupted years prior to the sale**. The deduction first became available to taxpayers in 1999 and is available to taxpayers when:

- net gains are earned from the sale of either real or tangible personal property *located in Colorado* at the time of sale;
- net gains are earned from the sale of stocks or ownership interests in a *Colorado* company, limited liability company, or partnership; and
- net gains are included in the taxpayer's federal taxable income reported on the taxpayer's Colorado income tax return.

Revenue impacts. Capital gains deductions under the general rule became available to taxpayers for the 1999 tax year and ranged from $119.0 million in the first year to $706.1 million in the 2005 tax year.[2] When applying the 4.63 percent tax rate, the General Fund revenue impact ranged from a low of $5.7 million to $32.7 million over this same period. Figure 1 summarizes historical capital gains impacts and a forecast over the period from FY 2006-07 through FY 2011-12.

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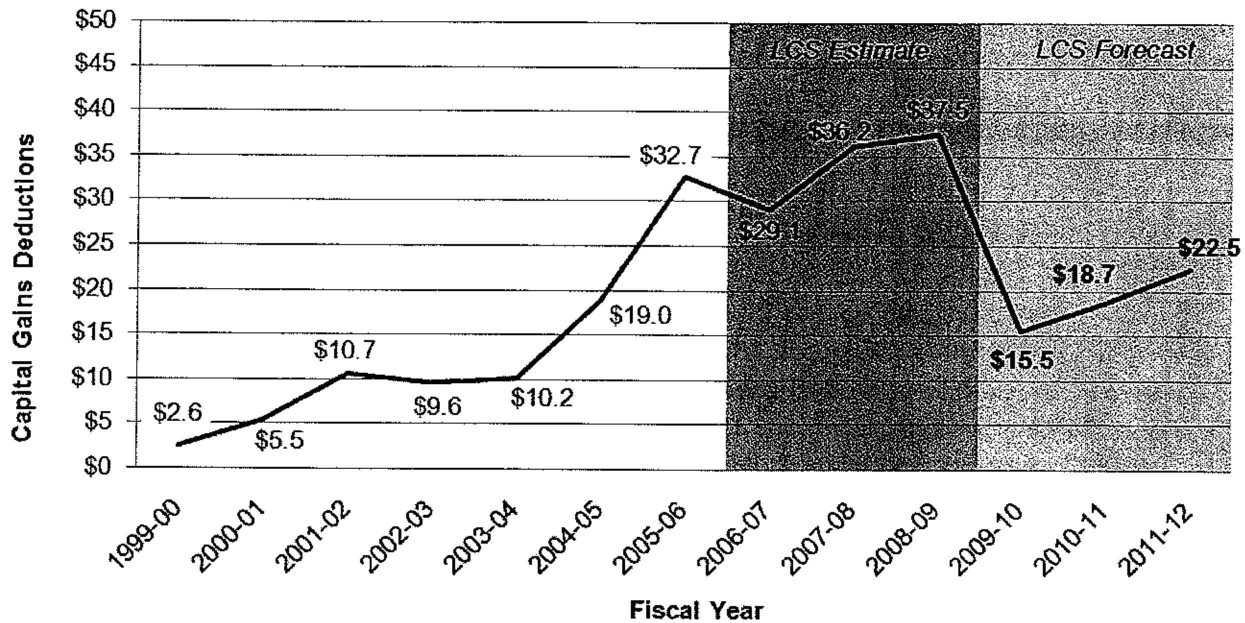
[1] 116 S. CT. 848 (1996).

[2] Tax data is only available through tax year 2005.

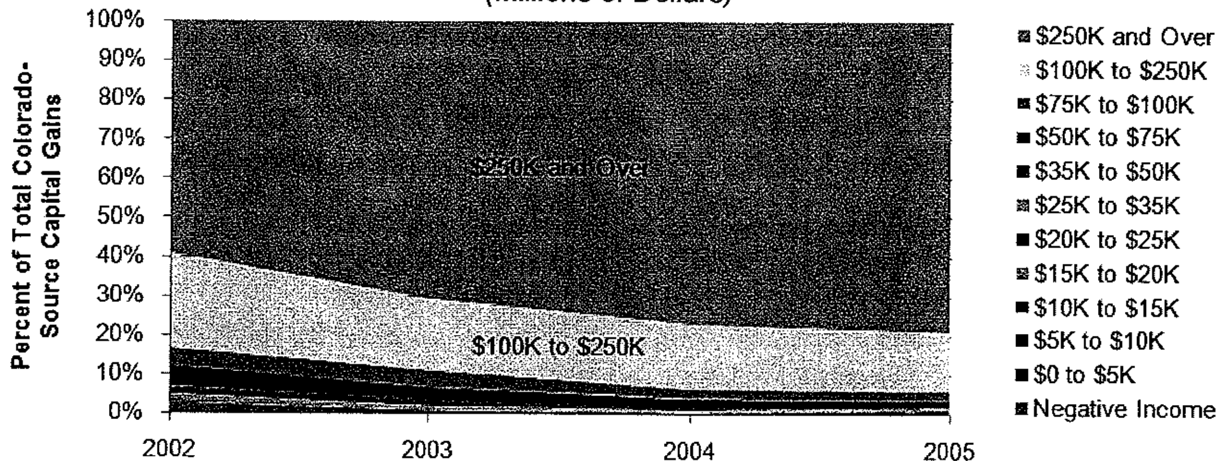
Figure 1: General Fund Impact of Deductions Under General Rule (FY 1999-00 to FY 2011-12)
(Millions of Dollars)



Source: Colorado Department of Revenue and Legislative Council Staff.

Income tiers and capital gains under the general rule. When looking at Colorado's taxpayers, the majority of capital gains claimed for federal income tax purposes are claimed by taxpayers whose federal adjusted gross income is greater than $100,000. Figure 2 shows the percent distribution of Colorado-source capital gains under the general rule by income tier. In tax year 2005, 93.9 percent of Colorado-source capital gains came from taxpayers with incomes greater than $100,000. Appendix A provides data by income tier for Colorado-source capital gains and the estimated fiscal impact of these capital gains for tax year 2005.

Figure 2: Percent of Colorado-Source Capital Gains Under the General Rule by Income Tier (Tax Years 2002 to 2005)
(Millions of Dollars)

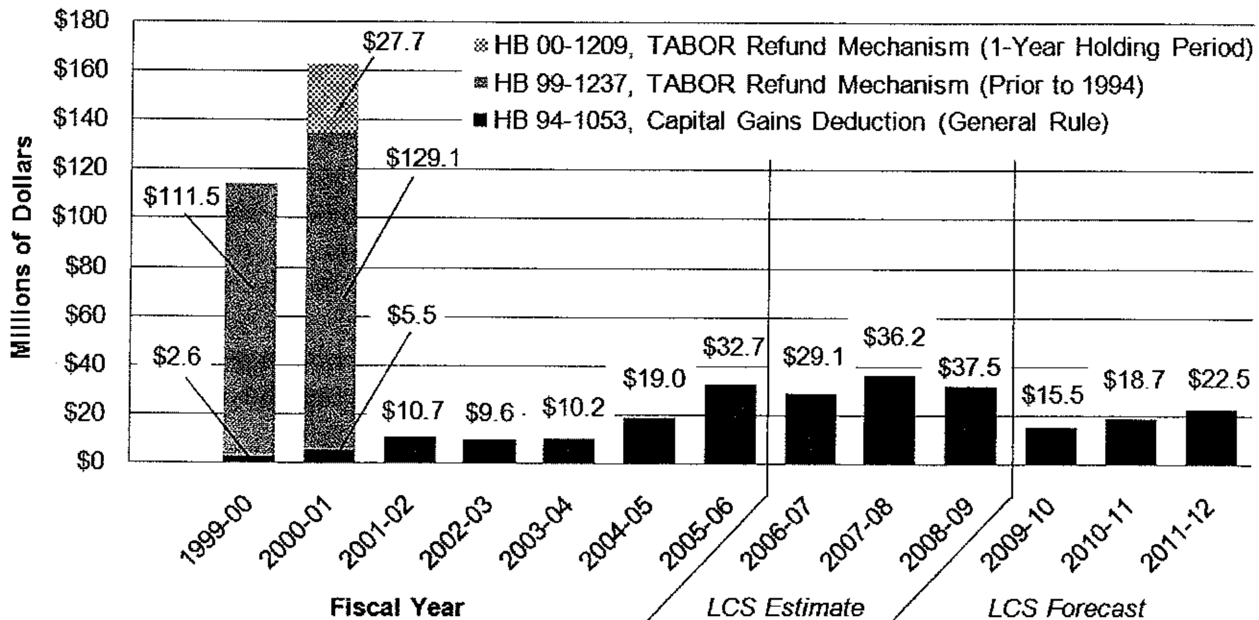


Source: Colorado Department of Revenue.

Capital gains deductions as TABOR refund methods. In addition to the general rule, the state created two TABOR refund mechanisms that expand the state capital gains deduction when the state has a large enough TABOR surplus to trigger either of these two mechanisms.[3] **House Bill 99-1237** became one of five TABOR refund mechanisms enacted by the General Assembly during the 1999 legislative session. It expanded the deduction in House Bill 94-1023 to apply to qualifying assets acquired *before* May 9, 1994. This refund mechanism was in place for two years when the state had large enough surpluses to trigger the mechanism, refunding $111.5 million in FY 1999-00 and $129.1 million in FY 2000-01. Legislative Council Staff does not expect a TABOR surplus large enough to trigger the expanded deduction for capital gains in the next five fiscal years through 2013.

During the 2000 legislative session, the General Assembly enacted **House Bill 00-1209**, which created a second capital gains TABOR refund mechanism. The bill reduced the five-year holding period to one year. To date, the refund mechanism under the bill was only available in FY 2001-02, when the TABOR surplus was large enough to trigger the expanded deduction. Figure 3 combines the revenue impacts from deductions under the general rule and two TABOR refund mechanisms. The total revenue impact from the state capital gains deduction for FY 2000-01 was $162.3 million.

Figure 3: General Fund Impact of Colorado-Source Deductions Under General Rule and TABOR Refund Methods (FY 1999-00 to FY 2011-12)
(Millions of Dollars)



Source: Colorado Department of Revenue and Legislative Council Staff.

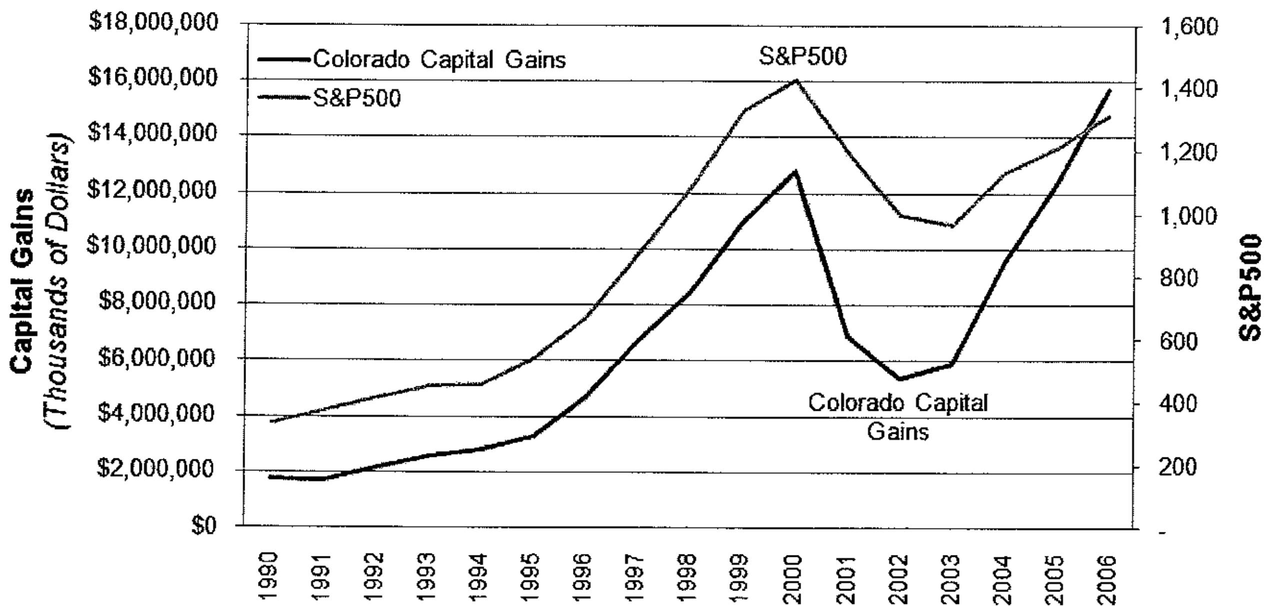
Economic factors affecting capital gains deductions. General Fund revenue impacts can differ significantly from year-to-year based on a number of economic factors, including magnitudes

[3] TABOR limits the amount of revenue that the state may collect each year. Revenue collected above this limit is commonly referred to as the TABOR surplus. The surplus must be returned to taxpayers in the form of refunds or credits unless voters allow the state to keep the surplus.

of capital gains, timing, and general market conditions. A single asset of high value (such as a large Colorado business or highly valuable property) can significantly impact General Fund revenue in a single year. Secondly, for TABOR surplus years, there may be a considerable difference in the General Fund revenue impact for capital gains that are realized on assets purchased before 1994 because assets that are held longer generally yield larger capital gains. It is interesting to note that when Colorado's initial income tax legislation was enacted in 1937, a declining percentage was applied to capital assets as they were held for longer periods of time. For example, assets that were held longer than ten years were adjusted to 30 percent of the gain for purposes of calculating Colorado taxable income.

General market conditions also impact capital gains through the appreciation or depreciation of asset values. For example, when real estate values rise, capital gains will be higher than when real estate values fall. Similarly, capital gains are impacted by increases and decreases in stock market values. Figure 4 illustrates total capital gains for all Colorado taxpayers (including Colorado-source capital gains) and the average annual S&P 500 index, which serves as an indicator of the stock market. As the figure illustrates, capital gains generally move with the fluctuation in the stock market.

Figure 4: Capital Gains and S&P 500 Index (1990 to 2006)



Source: Colorado Department of Colorado and Standards & Poor's: Security Price Record.

Colorado Source Capital Gains Subtractions and the U.S. Commerce Clause

A recent analysis by the Office of Legislative Legal Services concludes that Colorado's capital gains deduction (Section 39-22-518, C.R.S.), "appears to violate the U.S. Commerce Clause based on *Fulton Corp. v. Faulkner*."[4] This North Carolina case involved the state's intangibles taxes scheme and found that the tax scheme gave preferential treatment to North Carolina corporations. It is important to note that Colorado's state income tax deduction has not been challenged in a court action in Colorado.

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[4] 116 S. CT. 848 (1996).

Appendix A: 2005 Tax Year Colorado Source Capital Gains and Estimated Fiscal Impacts from Capital Gains Subtractions

	Colorado Source Capital Gains				Estimated Fiscal Impact	
Adjusted Gross Income	Capital Gains	Number of Returns	Percent of Total Capital Gains	Average Capital Gains per Return	Fiscal Impact (General Fund Reduction)	Average Impact per Return
Negative Income	$4,306,080	52	0.6%	$82,809	($199,372)	($3,834)
$0 to $5K	$1,361,200	34	0.2%	$40,035	($63,024)	($1,854)
$5K to $10K	$1,187,820	64	0.2%	$18,560	($54,996)	($859)
$10K to $15K	$254,270	69	0.0%	$3,685	($11,773)	($171)
$15K to $20K	$566,520	113	0.1%	$5,013	($26,230)	($232)
$20K to $25K	$1,374,470	121	0.2%	$11,359	($63,638)	($526)
$25K to $35K	$3,152,370	254	0.4%	$12,411	($145,955)	($575)
$35K to $50K	$4,309,420	398	0.6%	$10,828	($199,526)	($501)
$50K to $75K	$10,937,740	761	1.5%	$14,373	($506,417)	($665)
$75K to $100K	$15,551,900	761	2.2%	$20,436	($720,053)	($946)
$100K to $250K	$103,855,60	1,983	14.7%	$52,373	($4,808,514)	($2,425)
$250K and Over	$559,272,93	1,400	79.2%	$399,481	($25,894,337)	($18,496)
Total	**$706,130,32**	**6,010**	**100.0%**	**$117,493**	**($32,693,834)**	**($5,440)**

Source: Colorado Department of Revenue.