Iowa Department of REVENUE

A Brief Overview of the Iowa Capital Gain Deduction

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Introduction

This paper provides an overview of the capital gain deduction reported by taxpayers in the state of Iowa. The Iowa capital gain deduction allows taxpayers to exclude from income net capital gains realized from the sale of all or substantially all of the tangible personal property or service of a business which has been held for at least ten years meeting the criteria of one of the six categories listed below. A capital gain is defined as a profit that results from a disposition of a capital asset where the amount realized on the disposition exceeds the purchase price. Taxpayers are also required to materially participate in the business or farm to qualify for the deduction. Overall, the intent of the capital gain deduction is to shield small business owners and farmers in Iowa from paying tax to the State on capital gains realized from the sale of their business or land or other related assets.

In order to qualify, a capital gain deduction requires that the income being deducted must be eligible for capital gain treatment on the federal tax return. Moreover, the capital gain from sales by an S corporation, partnership, LLC, estate, or trust may qualify for the deduction if the gain flows to an individual. Gains from a sale by a C corporation do not qualify for the deduction. In addition, the taxpayer, property, or property's owner may be located outside Iowa. Specifically, qualifying capital gain deductions result from the following:

a. The sale of real property used in a business in which the taxpayer materially participated for 10 years prior to the sale, and which has been held for a minimum of 10 years immediately prior to its sale.
b. The sale of a business in which the taxpayer materially participated for 10 years and which has been held for a minimum of 10 years immediately prior to its sale.
c. The sale of cattle and horses used for breeding, draft, dairy or sporting purposes and held for 24 months by the taxpayer who received in excess of 50% of his or her gross income from farming and ranching.
d. The sale of breeding livestock, other than cattle and horses, held for 12 months by the taxpayer who received in excess of 50% of his or her gross income from farming or ranching.
e. The sale of timber held for more than 12 months by the taxpayer who must treat the action as a sale or exchange for federal purposes.
f. 50% of the gain from the sale/exchange of employer securities of an Iowa corporation to a qualified Iowa ESOP who must own at least 30% of all outstanding employer securities issued by the Iowa corporation after completion of the transaction.

The capital gains deduction has a fairly brief history on the Iowa 1040 Individual Income Tax Form. For sales made on or after January 1, 1990, Iowa taxpayers could claim a 45% deduction on qualifying capital gains as specified in a. through e. above. Moreover, the deduction could not exceed $17,500 for the tax year. Although what qualifies for the deduction has mostly remained the same, legislators have managed to alter a few areas. In particular, legislators increased the amount of the deduction. For tax years beginning on or after January 1, 1998, qualified taxpayers could claim a 100% deduction of qualifying capital gains rather than a partial deduction with no limitation on the deduction. In addition, legislators specified that for some types of property, material participation or holding period lengths were not required if an individual sells to a lineal descendent; specifically, the term "lineal descendent" meant children of the taxpayer, including legally adopted children and biological children, stepchildren, grandchildren, great-grandchildren and any other lineal descendants of the taxpayer. Later, legislators amended the definition for the term "hold" and its determination for the 10-year holding period. In determining the 10-year holding period for eligibility for the Iowa capital gains deduction for sales prior to January 1, 2006, the asset being sold had to be owned by the taxpayer for the immediately preceding ten years to qualify for the deduction. For these years, the term "held" was defined as "owned." As for sales on January 1, 2006 and subsequent years, the federal holding period provisions set forth in section 1223 of the Internal Revenue Code and regulations adopted by the Internal Revenue Service are used in determining the 10-year holding period. Therefore, the time held requirement for the capital gains deduction is met as long as the holding period used to compute the capital gain according to the federal code is ten years or more. More recently, legislators modified the deduction with the inclusion of another eligible type of gain, category f. above. Particularly, legislators added a partial deduction for the sale of stock to an Employee Stock Ownership Plan (ESOP) as eligible for the deduction. Effective with tax year 2012, this addition is a 50% deduction on the gain from the sale of securities of an Iowa corporation to a qualified Iowa ESOP as noted in f. above. As a result, this provision expands the deduction's qualifications.

Data Analysis

The following analysis examines the capital gain deduction (CGD) from tax years 2004 to 2014. Initially, the analysis utilizes 2004 to 2013 tax year data in order to determine the number of taxpayers that claimed CGD and the total value of the deductions over those years. The first half of the analysis uses tax return data on all returns filed during those tax years including basic information on the deduction over an extended period. In particular, the data provide the number of tax returns that claimed the deduction, the total CGD claimed in each year, and the amount of times that taxpayers claimed the deduction over the ten years. Some key characteristics of those taxpayers are also presented. This information sets up the second half of the analysis. There, the analysis pays particular attention to 2013 and 2014 tax return information in order to understand which type of CGD taxpayers claim. The second half of the analysis uses electronic returns filed during these two years with more detailed information about the type of claimed deductions. In particular, the electronic returns reveal information about the sales that allow for a categorization of the type of claims that account for the majority of the deductions and specifically the type of CGD that taxpayers claim more than once over the years. In the end, this analysis will offer a better understanding of the CGD for future fiscal estimates of proposed legislative changes to the CGD.

The first half of this analysis incorporates information from tax years 2004 and 2013. Only those tax returns that claimed a CGD were included in the final analysis. This count includes tax returns that have one taxpayer who filed a CGD and tax returns that have two spouses filing separately under a married status claiming a CGD on the same return. In this second case, an Iowa return filing married separate on the same return where both spouses claim a CGD, the tax return is counted as one return. All these tax returns were combined to find the total amount of CGD claimed over the period. Overall, a total of 122,164 tax returns had total claims over $6.7 billion in CGD during these ten years.

Over the years, the number of tax returns with a claim to a CGD was fairly flat. The number of tax returns remained steady at 14,000 from 2004 to 2008, after which the number decreased by around 4,000 and stayed at this lower number for the next five years (see Figure 1). It remains unclear as to why recent numbers remain low. Although the recession likely impacted the number of claims in 2009 and 2010, with the recovery underway, it seems this number should have returned to previous highs. Consequently, there may be other reasons behind this decline including better scrutiny of claims by the Department. In tax year 2011, the Department introduced a worksheet to assist taxpayers in understanding their eligibility to claim the deduction noting that additional information is likely to be requested to substantiate any claim. This additional documentation might have led some taxpayers to realize they were not eligible for the deduction.

Despite the steady number of claims, the annual total of claimed CGD varied over time (see Figure 2). The amount of claimed CGD steadily increased during the first four years until 2007 reaching $900 million, after which the amount abruptly declined in 2008 and further in 2009 to just above $400 million. These lower amounts may be due in part to the recession since the economic slowdown may have altered expectations and behaviors. Since 2009, however, total CGD has fluctuated between $450 million and $550 million in most years. These lower amounts may be a consequence of the lower number of taxpayers who have claimed the CGD. One exception is 2012, where the total of claimed CGD was over $1.3 billion. Although 2012 is exceptionally large, it appears to be an outlier driven by the pending tax year 2013 federal tax increases to capital gains tax rates and all income tax rates, so taxpayers decided to sell assets and thus claim the deduction before the anticipated rate changes. In addition, agricultural land prices reached record highs in 2012, incentivizing taxpayers to sell land and capture those gains.[1] Furthermore, taxpayers who resided outside of Iowa claimed a significantly larger portion than usual in 2012 (see Figure 3). These taxpayers claimed between $50 million and $100 million in most years, but in 2012, they claimed over $340 million.

In addition, a closer look at the adjusted gross income (AGI) and the ages of taxpayers provides a better understanding of those taxpayers who claim the deduction (see Figures 4 and 5). Taxpayers who have an AGI of less than $25,000 and those who have an AGI of more than $250,000 altogether claimed over $4.5 billion of the deduction, or more than 67% of the total deduction during these ten years. Keep in mind that the measure of Iowa AGI used does not include the amount of capital gain as the deduction is one of the adjustments applied against gross income. Federal AGI for these same taxpayers would be higher, possibly significantly higher. Meanwhile, older taxpayers tend to claim larger amounts. Those taxpayers who were older than 64 years of age at the time of claim reported over $2.1 billion during this period as compared to those taxpayers who are younger than 35 years of age, who claimed about $50 million during this same period.

[1] Analysis of the types using electronic returns does show a big jump in farm gains in 2012 as compared to the 2013 and 2014 numbers presented later in the paper.

Another key aspect of understanding the CGD and those who claim it is by considering the number of times that taxpayers claimed the deduction during this ten-year period. A large number of taxpayers claimed the CGD more than once (see Table 1). In the ten years, there were 53,517 unique taxpayers, again considered on a return basis, making the 122,164 claims. Out of these taxpayers, 60% claimed the CGD only once during the ten-year period. These taxpayers accounted for 52% of the total CGD or $3.4 billion. Meanwhile, those who claimed the CGD all ten years account for 2% of taxpayers. Altogether, these taxpayers claimed 3% of the total CGD or $189.7 million over the ten years. Moreover, taxpayers who repeatedly claim the CGD tend to claim less per year than those who claimed only once with an average claim of $36,000 compared to $109,000. For taxpayers who claimed the deduction more than four times during this period, they on average claimed between $16,000 and $25,000 per year. These same taxpayers claimed less than $250 million in total CGD per year, which is much lower than the sums of those who claim the deduction once or a few times.

Although this data provides the number of taxpayers that claim the deduction and the sum of their CGD over those years, it does not provide information on the type of CGD that taxpayers claim. Rather, an analysis on electronic filings helps to obtain a better understanding of the type of claimed CGD. This second half of the analysis integrates information from tax years 2013 and 2014. The data was collected from the electronic tax returns which include all forms and data fields reported by the taxpayer to the Department of Revenue and the IRS. Thus the electronic filings contain descriptions of the types of CGD in addition to tax information on taxpayers. However, the electronic data contains fewer observations because around ten percent of taxpayers in these years filed a paper return. Although there were 9,815 tax returns that filed a CGD in 2013, only 8,852 of these were included in the detailed analysis. In addition, these tax returns account for slightly less in total CGD at over $433 million as opposed to over $456 million in 2013. Meanwhile, there were 8,787 electronic tax returns that claimed over $411 million in 2014. The analysis attempted to categorize each of the CGD into one of the six eligibility categories mentioned above. In some cases, taxpayers claimed the deduction on multiple asset sales, the report capital gains from multiple categories. This issue created some duplicates in the analysis; thus, the results presented below reflect 9,478 unique capital gains deductions in 2013 and 9,424 in 2014 after taking this issue into account. Furthermore, the claimed CGD amounts sometimes did not match the capital gains amounts reported on the various forms filed with the federal return. Consequently, the total sums ended up slightly larger than the original ones with over $444 million CGD in 2013 and over $417 million CGD in 2014. However, these are the numbers that are used in the following analysis because the goal is to provide a picture of how the CGD break down by specific category, not necessarily account for each dollar exactly. Note that manual review of paper returns that were among the top 200 claims in 2013 was also completed to formulate more accurate estimates of the distribution of CGD among the eligibility categories for that year. This handful of paper returns are included in the following tax year 2013 data.

In the review, CGD claims were divided into five eligibility categories based on a. through f. above, where c. and d. were combined into one category of *Livestock*.[2] The counts of claims by category and

[2] Property descriptions provided on the US 8949, US 4797, US 6252, and US 8824 were used to categorize the CGD. The US 8824 was used only for those within the top 200 claimers. Some taxpayers only indicated that the capital gain was reported

their sums stayed fairly similar over the two years (see Figures 6 and 7). Over 3,000 tax returns claimed the CGD for *Livestock* sales each year. Altogether, these tax returns claimed $54 million and $65 million in these years. Although only around 1,700 tax returns claimed *Business* sales and over 2,000 tax returns claimed *Farm* sales each year, these tax returns altogether reported over $300 million each year, far exceeding *Livestock* sales claims. Moreover, taxpayers claimed on average around $77,000 per year from a sale of a business and on average around $62,000 per year from a sale of a farm, while they claimed an average around $14,000 per year from a sale of livestock (see Figure 8). *Timber* sales counts and amounts are small but still significant. Around 300 claims on the electronic returns could be categorized in each of the years, but these tax returns report around $6 million each year, on average similar to the size of gains claimed by those in the *Livestock* group with an average around $17,000 per year. However, around 2,000 tax returns could not be associated with any of the categories for multiple reasons, with claims around $25 million of the CGD each year. These tax returns are categorized under the *Unknown* category. Furthermore, no *ESOP* numbers are provided because no claims could be found using the categorization methods. It is possible that some taxpayers did have qualifying sales to an ESOP but did not claim a deduction for it, or it is possible that taxpayers claimed a deduction under the ESOP category on paper returns which were not included in this portion of the analysis, or it is possible that the property description provided on the return resulted in a categorization of a business sale because the taxpayer did not include any indication that the sale was to an ESOP.

A closer look at the top 200 tax returns of 2013, in terms of the value of the total CGD claimed, provides a better understanding of the types of CGD claims of the top claimers. In 2013, the top 200 claimers claimed over $230 million of the total CGD, which accounts for more than half of the total CGD in that year, with claims ranging from $32 million to just over $359,000. Specifically, over $136 million of the CGD was reported by taxpayers who claimed a *Business* deduction, while over $83 million of the CGD was reported by taxpayers who claimed the deduction categorized as *Farm* (see Figure 9). Meanwhile, those taxpayers who claimed the deduction on *Livestock*, *Timber*, or who remain *Unknown* account for a small portion of the deduction.

Similarly, a closer look at those taxpayers who claimed the CGD during all ten years in the 2004 through 2013 panel offers a better understanding of those taxpayers who claim the deduction in successive years. Only 2013 data is considered, assuming that the most recent CGD claim represents those of the other nine years. There are 1,001 taxpayers who have claimed the deduction all ten years. However, there are 1,116 observations because some taxpayers claimed a deduction in multiple categories. In 2013, there were 591 tax returns that claimed the deduction for *Livestock* sales claiming over $14.1 million in CGD (see Figure 10). On the other hand, 310 tax returns claimed *Farm* sales reporting $7.1 million in gains while 141 tax returns claimed *Business* sales reporting $2.5 million in

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on a K-1 or on the Schedule D, and thus was passed through to them. To categorize these K-1 claims and some of the originally unknown claims, Schedule E was reviewed to identify the name of a partnership that was the original recipient of the capital gain passed through to the taxpayer in order to gain categorize the gain as either business or farm or information from the Schedule F was considered as an indicator that the taxpayer likely had a farm-related gain.

gains. These sales are predominantly installment sales which are smaller amounts because these taxpayers receive their installment sales payment and its deduction over many years.

These recent estimates suggest several conclusions. First, the sales of businesses and farmland account for most of the CGD each year. Although there are comparatively fewer taxpayers who claim business or farm CGD, these tax returns claim much larger amounts, but they usually do so only once. Second, tax returns that claim the deduction over several years tend to claim the deduction on livestock. Although these tax returns claim smaller annual amounts, these tax returns accrue relatively large numbers since they claim the deduction on a yearly basis. Third, although timber sales are low, their numbers remain significant because they account for around $6 million in CGD each year. Fourth, because ESOP is relatively new, its numbers are miniscule. Overtime, however, it is likely that the number of tax returns that will claim a deduction on a sale to an ESOP will increase because more taxpayers will become aware of this possibility. In addition, the 2014 data indicates that the number of tax returns and the total CGD will be around the same numbers as recent years. As a result of all these factors, the information suggests that the near future will continue the recent trends since 2009 rather than return to pre-recession levels.

Challenges

A few challenges occurred with the data. First, taxpayers claim the deduction using various fields, some of which lack a corresponding description that might describe the type of deduction. As a result, many claims remained in the *Unknown* category. Second, *Business* is the catch all category for deductions with a known description.[3] Consequently, some claims may belong in another, more accurate location but they are incorporated into the *Business* category because the description did not include the key words used in the categorization method. Third, the CGD sometimes does not match the capital gains amounts reported on the various forms filed with the federal return. This discrepancy made it more difficult to extract the categorization information because taxpayers would claim capital gains from various forms, and the numbers did not always match up. In some cases, the CGD numbers would be slightly more or less than the capital gains numbers. Finally, tax year 2014 data is still being processed. As a result, some of the tax year information was not used in this analysis. Moreover, the numbers needed daily alteration to match the most recent return information available.

In addition, two issues remain unanswered. First, it is uncertain as to why the number of tax returns claiming CGD per year never recovers to pre-recession highs. Second, it remains unclear as to the number of tax returns that claimed the deduction for a sale to an ESOP. Although the analysis did not report any ESOP figures, it is quite possible that those claims are miniscule and that they have filtered into another category, such as the *Business* or the *Unknown* categories. Moreover, it is possible that

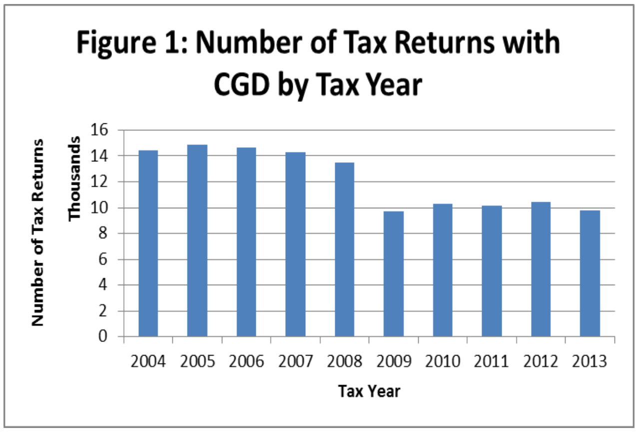
[3] Property descriptions were designated as *Farm* if they included any one of the terms: farm, land, or acre; *Livestock* terms: dairy, cow, feedlot, breed, raised, sow, hog, brdg, bull, or cattle; *Timber* terms: log, timber, or trees; and *ESOP* terms: ESOP or employee. Any identified description that did not include one of these terms was categorized as a *Business* sale.

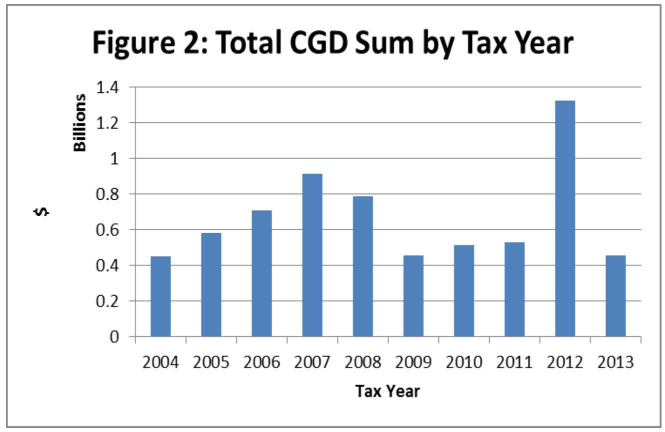
some taxpayers claimed the deduction for a sale to an ESOP on paper returns, and these returns were not included in that portion of the analysis.

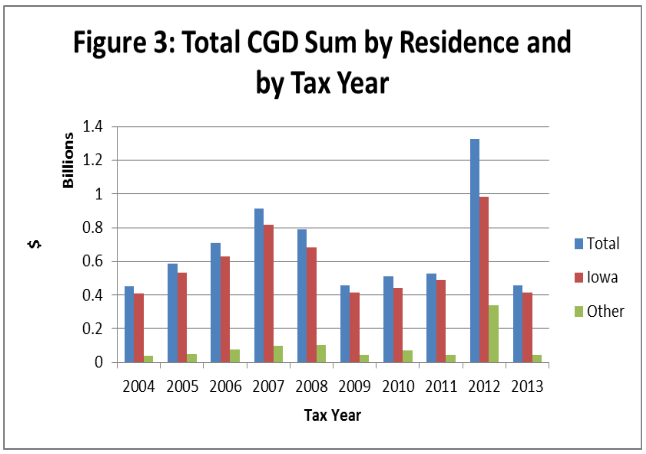
Conclusion

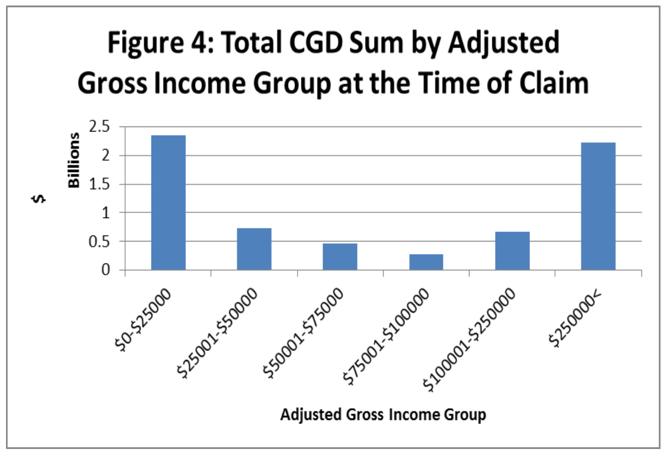
Taxpayers claim the Iowa capital gain deduction on various types of capital gains. Taxpayers understand, for the most part, which types of capital gains qualify for the deduction. However, taxpayers claim the deduction for capital gains reported across various federal fields. Although they are not necessarily right or wrong by incorporating various fields, it is more difficult to obtain all of the necessary information to categorize the deduction. In addition, further research should examine those taxpayers who claimed a capital gain without a deduction because these taxpayers could potentially claim deductions in the future if the Legislature were to expand the type of sales eligible for the deduction. Finally, tax year 2014 information suggests that recent trends will continue in future years since those numbers appear similar to numbers in recent years.

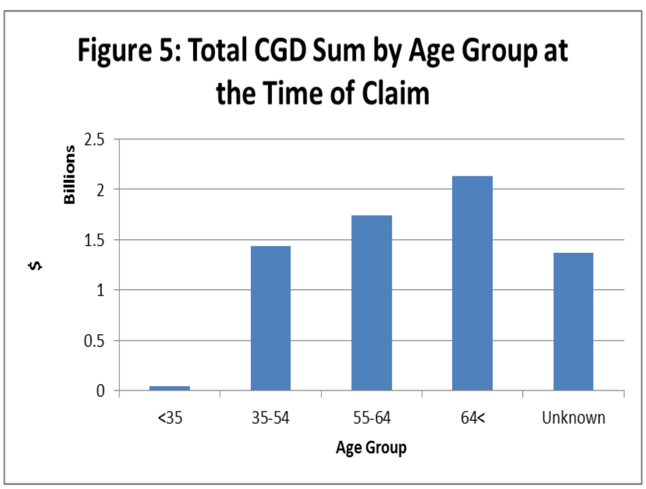
Tables and Figures

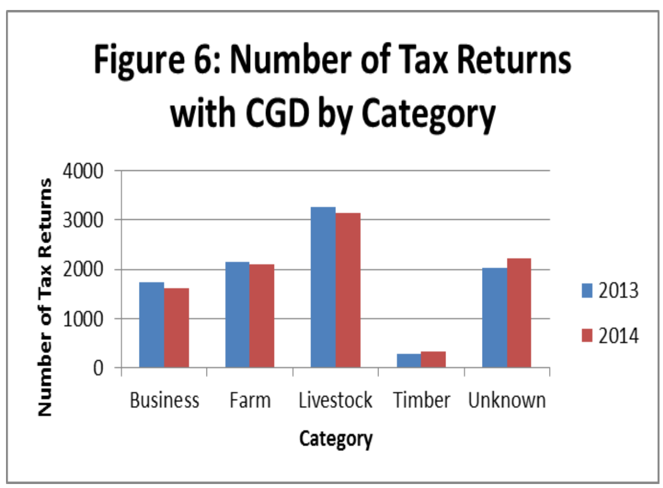


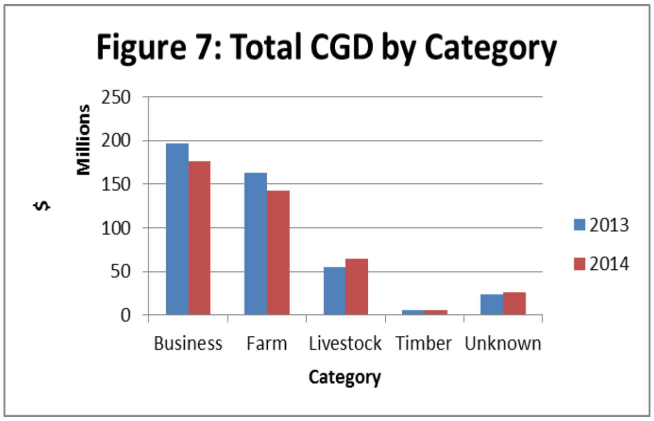


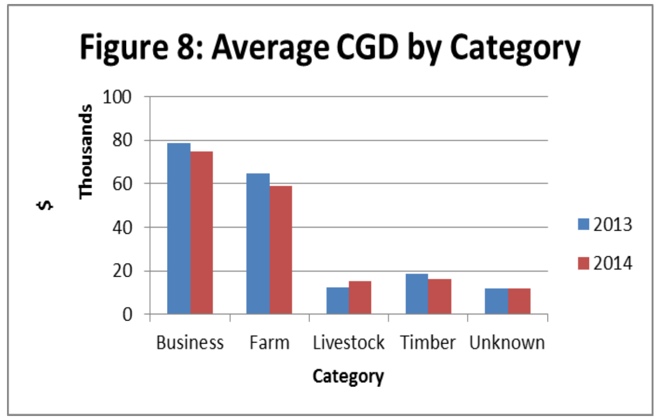


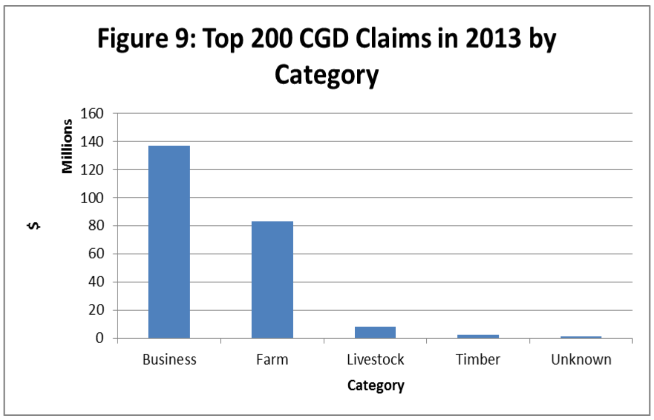












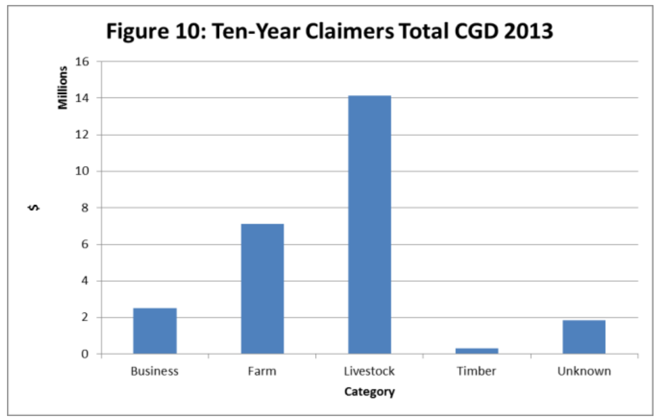


Table 1: Total CGD by Count*

Count	Number of Unique Tax Returns	% of Total Unique Taxpayers	Total CGD	% of Total CGD	Average Amount Received	Average by Year
1	31,923	60%	$ 3,481,425,130	52%	$ 109,057	$ 109,057
2	7,785	15%	$ 1,351,268,876	20%	$ 173,573	$ 86,787
3	3,777	7%	$ 483,602,488	7%	$ 128,039	$ 42,680
4	2,482	5%	$ 305,325,522	5%	$ 123,016	$ 30,754
5	1,943	4%	$ 242,775,307	4%	$ 124,949	$ 24,990
6	1,453	3%	$ 186,171,818	3%	$ 128,129	$ 21,355
7	1,203	2%	$ 171,789,814	3%	$ 142,801	$ 20,400
8	1,002	2%	$ 134,366,725	2%	$ 134,099	$ 16,762
9	948	2%	$ 181,773,780	3%	$ 191,744	$ 21,305
10	1,001	2%	$ 189,718,452	3%	$ 189,529	$ 18,953

*Number of Times that Taxpayers Claimed CGD over Ten Years