Iowa Department of REVENUE

An Overview of the Iowa Capital Gain Deduction and An Analysis of the IA 100 Form for Tax Year 2015

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September 2016

Introduction

This paper provides an overview of the Iowa capital gain deduction claimed by taxpayers on Iowa individual income tax returns during tax years 2004 through 2015, building on the paper released in 2015 (see *Review of Capital Gain Deduction*). However, taking advantage of the IA 100 Iowa Capital Gain Deduction form developed after the release of that paper, a detailed analysis of eligibility information reported by taxpayers during tax year 2015 is also included.

Iowa Capital Gain Deduction

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. The Iowa Capital Gain Deduction (CGD) is the exclusion from taxable income of the net capital gains realized from the sale of all or substantially all of the tangible personal property, service of a business, a farm, or other eligible property. The intent of the capital gain deduction is to shield certain business owners and farmers in Iowa from paying tax to the State on capital gains realized from the sale of their business, land, or other related assets.

For the capital gain to be eligible for the deductions, it has to be classified as one of the six categories listed below:

1) Sale of Employer Securities to a Qualified Iowa Employee Stock Ownership Plan (ESOP)
2) Sale of Timber
3) Sale of Cattle, Horses, or Breeding Livestock
4) Sale of Real Property used in a Farm Business
5) Sale of a Business
6) Sale of Real Property Used in a Nonfarm Business

Taxpayers are also required to materially participate in the business or farm to qualify for the deduction related to the last three categories.

Iowa Capital Gain Deduction History

The Iowa Capital Gain Deduction was first introduced in 1990 as a 45% deduction of Iowa capital gains up to $17,500 per tax year. Starting January 1, 1998, qualified taxpayers could claim a 100% deduction of qualifying capital gains rather than a partial deduction, with no limitation on the value of 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” means children of the taxpayer, including legally adopted children, biological children, stepchildren, grandchildren, and any other lineal descendants of the taxpayer. In 2006, the legislators altered the term “held.” Originally, the term “held” was defined as “owned.” After 2006, the time held requirement for the capital gains deduction is met as long as the holding period used to compute the capital gain as according to the federal tax code is ten years or more. More recently, in 2012, legislators added the sale of employer securities to a qualified Iowa Employee Stock Ownership Plan (ESOP) as one of the eligibility categories.

Overview of Tax Years 2004 through 2015

During tax years 2004 through 2015, over $7.7 billion of capital gain deductions were claimed on a total of 139,019 Iowa individual income tax returns. These claims are as reported by the taxpayer at the time of filing and do not reflect outcomes of subsequent audit by the Department.

The number of tax returns with claims remained steady at 14,000 from tax years 2004 to 2008 (see Figure 1). In tax year 2009, the number of returns with claims decreased by around 4,000 but stayed around 10,000 through tax year 2014. The Department of Revenue increased auditing of claims during those years. Preliminary data for tax year 2015 shows the number of tax returns with claims dropped again by about 4,000. However, the tax return data for tax year 2015 includes only returns reviewed as of July 2016. Since taxpayers can file returns through the end of October, tax year 2014 claims by review date were assessed to estimate how many more 2015 returns will likely have claims. For 2014, 9,692 tax returns with CGD claims were through review, 94.8% of total returns with CGD claims for the entire tax year. For 2015, there were only 6,608 claims through review by the end of June. If the timing of 2015 returns filing and Department review is the same as 2014, this suggests only 6,973 claims will be filed, an abrupt drop from prior tax years. The decrease in tax returns in 2015 might reflect that the detailed questions in the IA 100 to substantiate eligibility may have informed taxpayers that they are not eligible for the CGD before making a claim.

Despite the relatively steady number of tax returns with CGD claims, the dollar amount of CGD claimed varies over time (see Figure 2). From tax year 2004 to tax year 2007, the dollar amount of CGD claimed steadily increased from $0.45 billion to $0.92 billion. In tax year 2008, the amount of CGD claimed declined moderately to $0.79 billion and then abruptly dropped to $0.46 billion in 2009 because of the financial crisis and national recession. Since 2009, the amount of claimed CGD has remained in the range of $0.46 billion to $0.60 billion through tax year 2015. One exception is tax year 2012, where the total CGD claimed exceeded $1.33 billion. The exceptionally large number appears to be an outlier driven by the pending tax year 2013 federal tax increase to capital gains tax rates and all income tax rates along with record high farmland prices incentivizing taxpayers to sell assets.

Despite the drop in the number of claims in tax year 2015 through review in June, the average CGD claimed per tax return in 2015 to-date is $63,116, which is slightly larger than $58,376 per tax return in 2014 (see Figure 3). This suggests that the 4,000 taxpayers who chose not to claim the CGD in 2015 had smaller claims on average than other taxpayers who did claim the CGD in 2015.

A closer look at the resident status, adjusted gross income (AGI), and ages of taxpayers making CGD claims provides a better understanding of those taxpayers who claimed the deduction and whether those characteristics changed in 2015 compared to the prior decade. In tax year 2015, the share of CGD claimed by nonresidents was just 5.3%, down from an average of 13.3% in the prior 11 years (see Figure 4). This suggests that the details required to complete the IA 100 may have dissuaded nonresidents from making a claim.

AGI is a measure of income that includes a comprehensive list of cash income received by a taxpayer minus a set of adjustments defined in federal and Iowa tax codes. During tax years 2004 to 2014, taxpayers reporting Iowa AGI of $25,000 or less and more than $250,000 together claimed $4.6 billion in CGD, which is 68.0% of the total deductions (see Figure 5). In tax year 2015, taxpayers with an AGI of less than $25,000 and more than $250,000 together still claimed the largest share of the total deductions that year (64.4%). The deductions claimed by taxpayers with AGI of less than $25,000 increased to 41.3% in 2015, while the deductions by those with AGI of at least $250,000 decreased from 33.1% to 23.2%in 2015. This shift toward the lowest income group may reflect the sharp drop in farm income reported in tax year 2015. Indeed, in 2015, among the group with AGI less than $25,000, taxpayers who reported non-zero farm income accounted for 93.9% of the deductions and these taxpayers all reported negative farm income.

Taxpayers age 65 or older claimed the largest share of the total deductions in both tax years 2004 to 2014 and tax year 2015 (see Figure 6). During tax years 2004 to 2014, this group claimed a total of $2.1 billion CGD, which is 31.7% of the total; in tax year 2015, this group claimed a total of $0.2 billion CGD, which is 41.9% of the total deductions claimed in that year. The jump could largely reflect the drop in the share of taxpayers with an unknown age (age is calculated based on birth dates matched from federal returns, the match rate improves over time). Taxpayers making CGD claims who were younger than 35 years old accounted for the lowest share of the total CGD, but the percentage increases from 0.7% to 1.3% from tax years 2004 through 2014 to tax year 2015.

History of the IA 100 Capital Gains Deduction Form

Since the cap on the capital gains deductions was eliminated, taxpayers with eligible Iowa capital gain deductions were only required to complete the Iowa capital gain deduction line on the IA 1040 to make a claim. Thus the statistics about usage were limited to the count and dollar amount of deductions claimed; the eligibility category and other characteristics about the asset sold were thus not readily available. In 2015, the Department attempted to gather statistics about eligibility categories and other characteristics using all available Iowa and federal forms filed with electronic returns. However, after 10 weeks of data analysis, the eligibility category for over 20% of claims could not be identified (see *Review of Capital Gain Deduction*).

These results were presented to Department staff. The examination team responsible for auditing the capital gain deduction noted how audit programs on the deduction required taxpayers and preparers to verify eligibility after making the claim, sometimes more than two years later. Attorneys who interact with tax preparers and handle protests about eligibility denials also reported that the lagged requests for information are problematic, and noted that preparers have suggested that the Department develop a method to gather the eligibility information at the time of claim. These internal discussions resulted in a decision by the Department to develop a form to be filed with the tax return in support of any Iowa capital gain deduction claimed beginning with the 2015 tax year. Those efforts resulted in the IA 100.

With the introduction of the IA 100, the taxpayer now must report with the return the eligibility category for each CGD claimed and provide other key details to support that the claim meets the relevant qualification standards. The specific qualification standards for each eligibility category are discussed separately in the following analysis. Taxpayers with multiple assets eligible for the CGD were instructed to file a separate IA 100 for each sale except in the case of livestock where a table allowed the taxpayer to report multiple livestock sales on one form. In the following analysis of CGD by category, if multiple livestock sales were reported on the same IA 100 or if multiple IA 100 forms were filed for livestock on the same return, all those sales are considered as one claim. Claims filed under all other categories are counted individually, thus the count of IA 100 forms can exceed the number of returns reporting capital gains deductions. The IA 100 information presented here is only from electronic filed returns. For tax year 2015 through July 2016, 90% of all individual income tax returns were filed electronically; for taxpayers with claims to the CGD, 85% filed electronically. The electronic data presented reflects information filed by the taxpayer through mid-July before any Department review.

Part I: Description of Property Sold

In tax year 2015, 6,910 IA 100 forms were filed for a total of $368 million in CGD claims. Over 4,000 (58.0%) claimed a total of $74.4 million CGD for *Livestock*, which is 20.2% of the total dollar amount of CGD claimed (see Figures 7 and 8 and Table 1). Although only 5.4% of the claims reported a sale of *Business*, the dollar amount claimed was 34.0% of the total. Business sales had the highest average CGD, $335,740, and the highest median, $50,000. All six categories demonstrate a high skewness in their distribution with the average well above the median (see Table 1). For example, while half of the taxpayers reporting gains from *Livestock* sales reported a gain less than $6,643, the average was nearly three times that, $18,552, and the 90th percentile was $40,811. For the past three tax years, no tax returns with a claim under the *ESOP* category could be identified, but the IA 100 revealed 16 in tax year 2015 with the median deduction of $3,074 and an average deduction of $14,354.

While the vast majority of CGD are claimed by residents each tax year (see Figure 4), enables the Department to look at the gains claimed by residents and nonresidents by category. All of the IA 100 forms claiming a sale to an *ESOP* were filed by taxpayers who reside in Iowa. Under sale of *Business*, 8.8% of the IA 100 forms were filed by taxpayers who reside outside of Iowa. Although only 5.4% of the IA 100 forms reporting a sale of *Farm Property* were filed by taxpayers outside of Iowa, claims filed by nonresidents equaled 11.3% of the total CGD claimed under the *Farm Property* category (see Table 2).

Part II: Details about the Property

Taxpayers were required to report the total property sale price, the total cost or other basis for property sold, and the total gain from the sale, which should be the difference between the sale price and the basis. It is possible that the property eligible for the CGD could be owned only in part by the taxpayer claiming the deduction, but the gains realized by all owners should have been reported in this section of the IA 100. By examining the distribution of the total sale price, cost or basis, and gain among the different eligibility categories, it is possible to consider the relationships across the three measures of asset value (see Figures 9-11).

The sales of employer securities to an *ESOP* accounts for only 0.3% of total sale price, but with the low basis share of 0.1%, the gains represent 0.4% of the total. As will be discussed further later, only one-half of the total gains reported for this category are eligible for the deduction. Taxpayers who reported under the *Business* category had the highest share 48.9% of the total property sale price. With the significantly higher basis share of 63.7%, the gains from the sale attributed to the *Business* category are lower at 40.4%, although still the highest share among the six categories. Although 7.6% of total sales were reported by taxpayers with claims for *Livestock*, the low 2.1% share of the basis results in a higher 10.7% share of the gains. Also, by dividing total gain from sale of each category to the number of tax returns filed, taxpayers who reported sale of *Business* had the highest average gain of $1.02 million across the six eligibility categories (see Table 3). Taxpayers who reported claims of *Livestock* have the lowest average gain of $25,309.

Taxpayers were required to report their ownership share of the property sold at the time of the sale. On 5,997 (85.8%) of the IA 100 forms filed, the taxpayers reported owning 100% of the property sold, accounting for 66.1% of the total CGD claimed (see Figure 12). About 10.6% reported an ownership percentage between 25% and 50%. Oddly, 113 IA 100 forms were filed for property for which the taxpayer reported an ownership percentage of 0% despite making CGD claims for that property. It is possible that reflects a misunderstanding of the question by the taxpayer. On the 14.2% of the IA 100 forms where the taxpayer reported owning less than 100% of the property sold, if multiple owners made a CGD claim for the same property, the value of the property would be reported on multiple returns and thus the sales, basis and gains shown in Figures 9-11 would be duplicated. Therefore, levels of these measures are not reported, only the distribution. Despite the possible double-counting, the distribution of values is reported by category to illustrate usage of the deduction. All later analysis will be based on the CGD claimed on the IA 1040 by the taxpayer and would be unique dollars.

Taxpayers were also asked to report if the capital gain arose from an installment sale of eligible property. An installment sale is a sale of property where taxpayers receive at least one payment after the tax year in which the sale occurs. In the case of installment sales, only the portion of the installment payments received in tax year 2015 attributed to capital gains on the property qualify for the deduction (no payments of interest qualify). Overall, 929 (13.2%) of IA 100 forms reported a CGD resulting from an installment sale; these claims reported 22.7% of the total capital gain deduction claimed on the IA 100 forms.

Nearly three-fourths of the CGD reported in tax year 2015 attributed to an installment sale were for a sale of *Business*, 19.2% were for a sale of a *Farm*, and 6.5% were for a sale of property in a *Nonfarm* business (see Figure 13). This distribution is not surprising given that higher priced assets are more likely to take multiple years for the buyer to pay off.

In order to gain a better understanding of the impact of the disproportionate sales by CGD eligibility category that were installment sales, the distribution of reported gains by eligibility category if installment sales are removed can be compared to the total reported gains for tax year 2015 (see Figure 11 compared to Figure 14). After the IA 100 forms that reported installment sales are removed, the proportion of gains from taxpayers who claimed a CGD under the *Livestock* category increases from 10.7% to 17.1%, while gains from claims under the *Business* category decrease from 40.4% to 26.7%. The proportion of the gains from sale of properties in *Nonfarm* business increases from 20.6% to 27.7%. *ESOP* and *Timber* shares are small under both measures.

Note that taxpayers reporting installment sales would have reported the full sale price and gain in the data used for the prior analysis, but in the remainder of the analysis, only the gain eligible for deduction in 2015 will be considered, where the gain could reflect a payment in the first, second, or thirtieth year after the sale.

Taxpayers reporting CGD attributed to installment sales were also asked to report the year of the sale and the end year of the installment payments. Among the 929 IA 100 forms, 19.7% of the installment sales were made in 2015 (see Figure 15). Despite the big jump in sales observed in 2012, 10.5% of the installment sales reported on the 2015 returns had a sale date in 2012, slightly higher than the 8.0% in 2013, but below the 13.1% in 2014. Another 20.0% of the properties for which an installment sale reported were sold between 2008 and 2011. Nearly 5% of the installment sales were made before

2000, all of them are from the sale of property either used in *Farm* or *Nonfarm* business. The remaining 24.0% of properties were sold during 2000-2007.

The Department also examined the length of installment sale period (see Figure 16). Taxpayers reported a length between 0 to 9 years for 39.3% of installment sales and a length of between 10 to 19 years for 35.7%. Taxpayers reported of an installment period of longer than 29 years for 5.7% of installment sales. Among those long installment periods, 3.8% were associated with a sale of a *Business*, 21.2% were for a sale of real property from a *Nonfarm* business, and 73.0% were for a sale of *Farm* property.

In some cases, the acquisition of the property could change the eligibility rules; therefore, taxpayers were asked to report how they acquired the property. The majority, 57.6%, of CGD properties were acquired by *Purchase*. A very small proportion, between 0.2% and 3.5%, was acquired *by Inheritance, Gift, Like-kind Exchange* and *Involuntary Conversion*. The remaining 34.3% of the IA 100 forms reported the property was acquired by *Other* methods including self-raised or self-started. The details of acquisition method will be discussed further in the analysis of each CGD eligibility category.

Part III: ESOP

Gains from the sale of stocks or bonds do not qualify for the CGD, except for the sale or exchange of employer securities of an Iowa corporation to a qualified Iowa employee stock ownership plan (ESOP) when the Iowa ESOP owns at least 30% of all outstanding employer securities issued by the Iowa corporations after completion of the transaction. Unlike all other categories where the full capital gain is eligible for the deduction, for this category that was first available in tax year 2012, only 50% of the gain is eligible.

Taxpayers reported sales of securities to a qualified ESOP as the category for 16 of the claims filed on the IA 100. All claimants indicated that the ESOP did own at least 30% of all outstanding employer securities necessary for eligibility. The capital gain from those sales exceeded $0.4 million, but with only 50% of the gain eligible for the capital gain deduction, those taxpayers claimed a total of $0.2 million of CGD. The average eligible capital gain deduction was $14,353. Although only 25% of the IA 100 forms with an *ESOP* sale are installment sales, 62.4% of the total capital gain deduction claimed under this category was from an installment sale reflecting that the largest sales are associated with multi-year payments. Taxpayers reported that 13 of the employee securities sales were acquired by *Purchase*, the remaining 3 were acquired by an *Other* method (see Table 4). The distribution of gains reported by these taxpayers was significantly uneven, with the top 50% representing 99.7% of the reported gains under this category.

Part IV: Timber

Gains from the sale of timber reported under IRC section 1231 are eligible for the deduction when the timber is held by the taxpayer for at least 12 months. Eligible timber includes evergreen trees that are more than six years old at the time they are cut and sold for ornamental purposes. Other eligible sales are for use as poles and lumber.

In tax year 2015, 397 IA 100 forms claimed a total of $6.7 million CGD for *Timber* sales. The average eligible capital gain deduction per tax return was $16,940. *Timber* installment sales were 2.8% of the IA 100 forms accounting for 4.0% of the total capital gain deductions. Approximately 50% of the timber was sold for use as lumber; the other 50% reported a variety of uses such as Christmas trees, veneer, and furniture. Taxpayers with claims reported 65% of the *Timber* was acquired by *Purchase*, nearly 10% were acquired by an *Other* method specified as grown by the taxpayer, and the remainder were acquired by *Inheritance, Gift* and *Involuntary Conversion* (see Table 4). All claimants reported that the timber was held for at least 12 months as required. The distribution of gains reported by taxpayers was uneven, with the top 50% representing 88.0% of the reported gains under this category.

Part V: Livestock

Sales of cattle and horses that are eligible for the Iowa capital gain deduction should be used for breeding, draft, dairy or sporting purposes and held for at least 24 months. For sales of livestock other than cattle and horses to be eligible for the CGD, the animals should be used only for breeding purposes and held by the taxpayer for at least 12 months. In both cases, the taxpayer must have received in excess of 50% of gross income from farming or ranching. However, a sale to an individual who is a lineal descendent of the taxpayer eliminates the requirement to have in excess of 50% of gross income from farming and ranching.

For the analysis in this paragraph, each taxpayer reporting livestock sales is counted only once, even if multiple IA 100 forms with livestock were filed by the taxpayer. Overall, 4,008 taxpayers claimed a total of $74.4 million in CGD under the *Livestock* category. The average CGD per taxpayer was $18,552. Only 0.3% of the taxpayers reported the sale of livestock was an installment sale which is not surprising given the lower gains reported for this eligibility category relative to other categories. However, 6.2% of the total capital gain deductions claimed under the *Livestock* category were attributed to installment sales suggesting that those sales were significantly higher than the average. Just 1.2% of the claimants reported a sale of livestock to a lineal descendant; among those who did not sell property to their lineal descendant, a small group, just under 1%, did not receive in excess of 50% of gross income from farming or ranching. While 37.7% of the livestock claimed for CGD were acquired by *Purchase*, 62.0% were self-raised. Also, five taxpayers reported livestock that were acquired *by Inheritance, Gift, Like-kind Exchange or Involuntary Conversion* (see Table 4). The distribution of gains reported by taxpayers was very uneven, with the top 50% representing 95.0% of the reported gains under this category.

To evaluate the qualifications of livestock claims for the CGD, these livestock are divided into two parts noted above: cattle and horses, and other breeding livestock. To accommodate multiple livestock sales on one IA 100, a table was provided for the taxpayer to report the type of livestock, the livestock use, acquisition date, sale date, holding period, and whether the sale was to a lineal descendent. Because taxpayers may have reported different types of livestock on their IA 100, each line claimed in every completed table for livestock is considered separately in the following part of the analysis. Because taxpayers could report multiple animals on one line of the table if the animals had the same details noted in the table, such as “9 cows”, the counts are less than the number of animals sold.

Among the 6,011 livestock entries, 5,331 were sales of cattle or horses, 88.7% of the entries claimed under the *Livestock* category on the IA 100. Among these entries, only 19 were sales of horses. The eligible uses for cattle and horses are limited to four: 74.2% of the cattle and horses were used for *Breeding*, 20.2% were used for *Dairy*, and the remaining 0.3% were used for *Sporting* or *Draft*. The taxpayers reported that 98% of the livestock were held for at least 24 months as required for eligibility (see Figure 17).

Breeding livestock other than cattle and horses were reported on 680 of the livestock entries, which is 11.3% of the total entries under the *Livestock* category on the IA 100. Among these livestock, despite the requirement that the only eligible use is breeding, 7.8% of the entries reported a use other than breeding, for example “dairy goats” or “hog farming”. For the other livestock entries, only 98% were reported to be held by the taxpayer for at least 12 months as required. Nearly 100% of the IA 100 forms with livestock sales reported the ratio of gross income from farming and ranching operations to gross income exceeded 50%. However, there were seven IA 100 forms where the taxpayer did not report meeting the income requirement and none of those taxpayers reported sales to a lineal descendent which would have eliminated the income requirement.

Part VI: Farm

Taxpayers making a CGD claim for a sale of farmland must have materially participated on that land during the ten years prior to the sale in order to meet eligibility requirements. The IA 100 requests information for each of the ten years before the sale about where income was reported on federal tax forms, who managed the land, and how acres sold were farmed including personally farmed, cash rent, crop share, conservation reserve program (CRP), or other. If the farmer or surviving spouse was retired or disabled at the time of the sale, the material participation requirement is limited to the eight years before retirement or disability; the date of disability or Old-Age Social Security receipt are requested as well.

Taxpayers filed 1,282 IA 100 forms to claim CGD under the *Farmland* category totaling $100.3 million. The average eligible capital gain deduction per IA 100 was $78,255. Although 43.1% of the taxpayers claimed *Farmland* sale as installment sale, only 16% of the total capital gain deductions claimed under this eligibility category were attributed to those sales, reflecting that the payment for the farmland was spread over time for that subset of sales. Taxpayers reported that 14.0% of *Farmland* sold was acquired by *Inheritance*, 86.3% were acquired by *Purchase*, and the remaining properties were acquired by *Gift, Like-kind Exchange, Involuntary Conversion,* and *Other* methods (see Table 4). The distribution of gains reported by taxpayers was very uneven, with the top 50% representing 94.3% of the reported gains under this category.

More than 97.0% of the properties were held by the taxpayer for at least 10 years. The taxpayers are required to report details about each of the ten years prior to the sale which should be the ten years before 2015 for sales completed in the tax year. Exceptions include cases where the taxpayer was retired or disabled at the time of the sale, where the details would reflect the eight to ten years prior to retirement or disability, or where the CGD is reported on an installment sale where the date of sale is some year prior to 2015. If the sale was made late in 2015, it is reasonable for some taxpayers to report activities in 2015, which was the case for 15% of the taxpayers. Nearly 10% of taxpayers reported an erroneous year (like year 2105).

For each of ten years prior to the sale, taxpayers were required to report the name of the land manager, or “Self” if self-managed, as one way to demonstrate material participation by the taxpayer. The form also inquires whether the manager was paid, the federal form where income from the land was reported each year by the taxpayer, and the farming or rental arrangements of all of the acres sold. Using data from the year prior to the sale, 36.4% of the IA 100 forms filed under the *Farmland* category reported that the land was self-managed. In the year prior to sale, 94.9% of the IA 100 forms reported a qualified federal form to report income from the land. Among these taxpayers, 84.7% of them used Schedule F, 12.4% used Schedule E, and 2.9% used Form 4835 (see Figure 18). Comparing how acres sold were managed in the first and tenth year of the ten-year period before the sale, it is reasonable to find an increase in cash rent acres and a decrease in acres farmed by the taxpayer as farmers become less involved in farming prior to selling the land, often as part of a move into retirement (see Figure 19).

As noted above, material participation requirements change if the taxpayer was retired or disabled at the time of the sale or the taxpayer is a surviving spouse. Among the IA 100 forms filed for *Farmland* sales, 65.7% reported the taxpayer was receiving Old-Age Social Security benefits at the time of the sale; among the taxpayers who were not receiving Social Security benefits, more than 95% were the surviving spouse of the farmer.

Part VII: Business

A business in which the taxpayer was employed or 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 is also eligible for the CGD. Sale to an individual who is a lineal descendent of the taxpayer eliminates the requirement for material participation. The sale of a business means the sale of all or substantially all of the tangible personal property or services of the business which is intangible personal property such as client lists, goodwill, patents, trade names, and similar items. The sale of the assets of a business during the tax year must represent at least 90% of the fair market value of the business assets on the date of sale in order to be eligible.

Comprising 5.4% of the IA 100 forms filed, 373 claimed more than $125.2 million CGD for *Business* sales, which is 34% of total dollar amount of CGD claimed. The average eligible capital gain deduction was $335,740. Installment sales were reported on 35.1% of the IA 100 forms claimed under the *Business* category, accounting for almost 50% of the total CGD claimed for this eligibility category. Taxpayers reported that 68.4% of the businesses were acquired by *Purchase*, 14.0% were self-founded businesses, and the remaining 17.6% were acquired by *Inheritance, Gift, Like-kind Exchange,* and *Other* methods (see Table 4).

The IA 100 form asked taxpayers to report the activity of the business that was sold; examples of what taxpayers reported are auto sales, restaurant, and insurance sales. The organization type of the businesses sold was predominantly an S corporation with 176 (47.2%), while 133 (35.7%) were reported as sole proprietorships (see Figure 20). Unexpectedly, 21 (5.6%) were reported by the taxpayer as a C corporation where gains from the sale of ownership in a C corporation are not typically eligible for the CGD except in limited cases. All of the businesses were held by the taxpayer for more than 10 years and all taxpayers reported that their sale of the assets represented at least 90% of the fair market value of all the property of the business.

Typically the sale of stock or ownership interest in a business is not eligible for the CGD. For 72.1% of business sales, taxpayers reported their capital gain was neither from the sale of capital stock nor an ownership interest in the business. Among the 27.9% of taxpayers who reported the capital gain was from the sale of capital stock or an ownership interest in the business, 95% reported the sales were treated as a sale or acquisition of assets for federal income tax purposes which makes the gain eligible.

The distribution of gains from sales is uneven with the top 50% representing 97.2% of the reported gains under this category (see Table 1)

Part VIII: Nonfarm Property

Gains from the sale of real property used in a *Nonfarm* business that was held by taxpayers for at least 10 years are also eligible for CGD. The taxpayer must also demonstrate material participation in the business. Different from the sale of the business discussed in the previous section where at least 90% of the assets of the business must be sole, the sale of real property used in a *Nonfarm* business allows the taxpayer to maintain ownership of the business. Examples include the sale of one rental unit from a rental business or the sale of a lot held by the business as storage for cars or other inventory.

A total of 834 IA 100 forms claimed $61.1 million CGD for sale of real property used in a *Nonfarm* business. The average eligible CGD per IA 100 is $73,269. Installment sales under the *Nonfarm* category comprise 24.3% of the IA 100 forms with claims whereas only 8.9% of the total capital gain deductions claimed are from installment sale, again suggesting that land purchases have smaller installment payments. Taxpayers reported 94.1% of the properties claimed for CGD were acquired by *Purchase*, 4.0% were acquired by *Inheritance,* and the remaining 1.9% were acquired by *Gift, Involuntary Conversion,* or *Other* method like self-constructed (see Table 4). Taxpayers also reported 97.2% of the nonfarm property was held for at least 10 years. The organization type of the Nonfarm business making the sale of the property is dominated by sole proprietorship with 480 (59.2%); just 94 (11.6%) were S Corporations, while the remaining were partnership, LLC, and other types of organizations (see Figure 21). The distribution of gains reported by taxpayers is uneven, with the top 50% representing 95.0% of the reported gains under this category (see Table 1).

Part IX: Material Participation

As noted above, taxpayers reporting a CGD which was a sale of *Business* or sale of real property used in a *Nonfarm* business must establish material participation. They are required to report the applicable calendar year for each of the ten years prior to the sale for which the taxpayer has documentation of meeting any one of the seven material participation tests. Only in cases where the *Business* was sold to the lineal descendant of the taxpayer is the requirement for material participation waived.

Together, 1,207 IA 100 forms reported a sale of *Business* or a sale of real property used in a *Nonfarm* business. In 32 cases, the taxpayer reported the *Business* was sold to a lineal descendant, thus eliminating the need for material participation. Among the remaining 1,175 IA 100 forms with claims, 50.7% of the IA 100 forms with claims reported meeting at least two material participation tests; 4.8% did not provide any answers to the material participation test questions, split almost equally between the sale of *Business* (53.6%) and the sale of *Nonfarm* property (46.4%). Under the *Business* category, the most common reported test is Test 1: Taxpayer participated in the business for more than 500 hours in the year (see Figure 22). On 6.4% of the IA 100 forms under the *Business* eligibility category, the taxpayer claimed to meet all of the seven tests. Under the *Nonfarm* category, the most commonly reported test which the taxpayer satisfied is Test 2: Taxpayer’s participation in the business constituted susbtantially all participation in the busines in the year (see Figure 23). On 3.7% of the IA 100 forms under the *Nonfarm* eligibility category, the taxpayer claimed to meet all of the seven tests.

Challenges

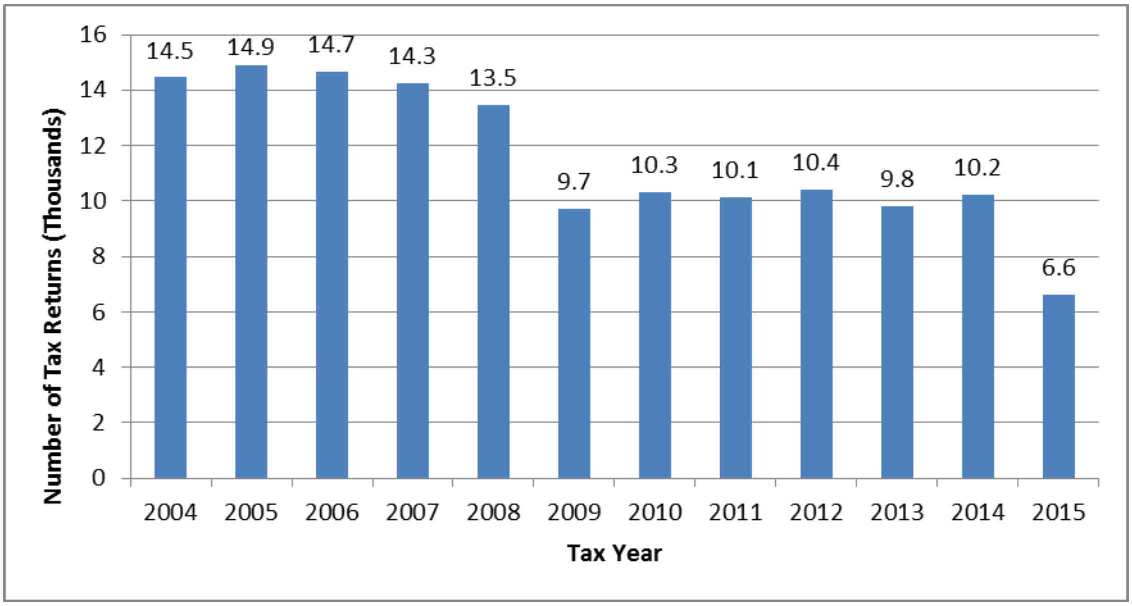
Some challenges occurred during the analysis. Although all of the data in this analysis was from electronic returns, avoiding the need to decipher hand writing on paper documents, data typed by preparers or self-reported by taxpayers can still have errors. Typos and misspellings, especially in the analysis of livestock use (e.g. “bredding” instead of “breeding”), made it more difficult to extract information and may have distorted counts presented above. Also, it is important to note that although some of the data suggests some taxpayers’ gains are not eligible, additional Department examination is required to definitively determine whether their gains truly are not qualified.

Conclusion

The introduction of the IA 100 form’s detailed questions may have informed taxpayers that they are not eligible for the CGD before making a claim, which resulted in what appears will be a decrease in the number of tax returns with claims in tax year 2015. In tax year 2015, the sale of *Livestock* account for the largest share of the tax returns with claims among the six eligibility categories while the sale of *Business* account for the largest share of dollars of CGD claimed. The IA 100 also revealed usage for the newest eligibility category, *ESOP*, although small at only 16 among electronic returns received as of July 2016.

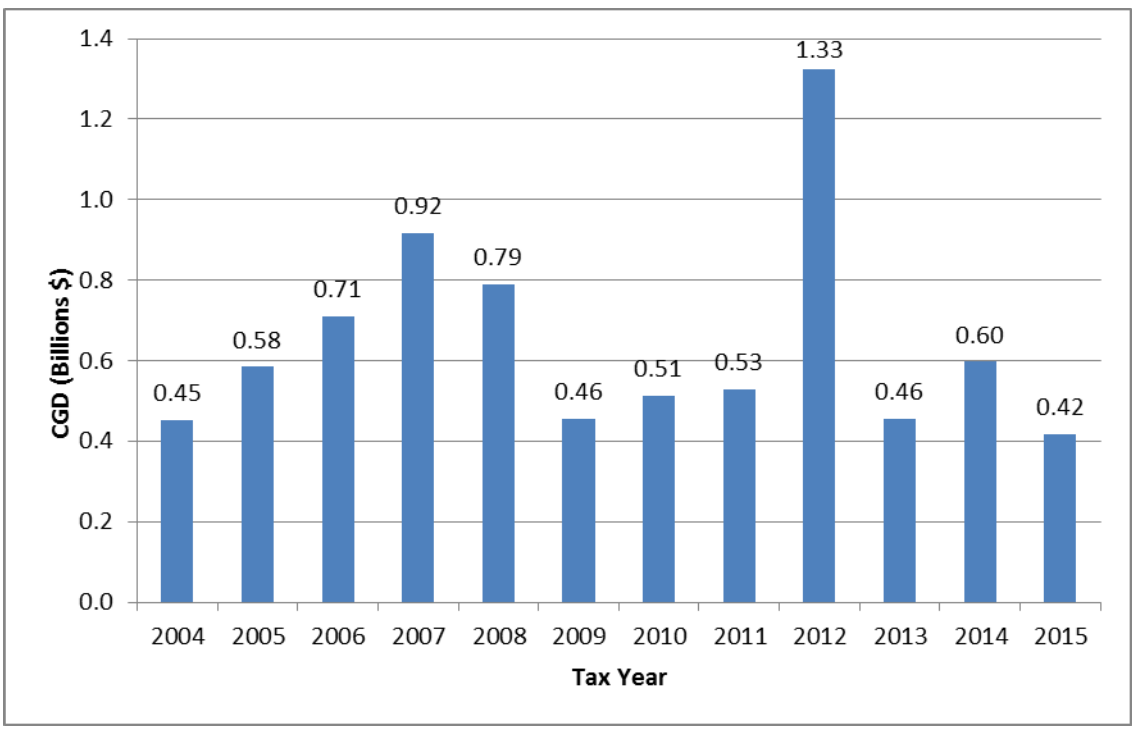
The data available in the IA 100 provides the Department with key information to determine the eligibility of the capital gain at the time of claim rather than years later when examiners review the return. This should reduce work for taxpayers,tax preparers, and Department staff as well as improve compliance with the Iowa Code. The IA 100 data also allows the Department to provide policymakers with definitive data about the usage of the various eligibility categories under the Iowa capital gain deduction, information never before available. This will greatly improve the accuracy of future fiscal analysis of any proposed changes to this deduction.

Figure 1. Count of Returns with CGD Claim by Tax Year



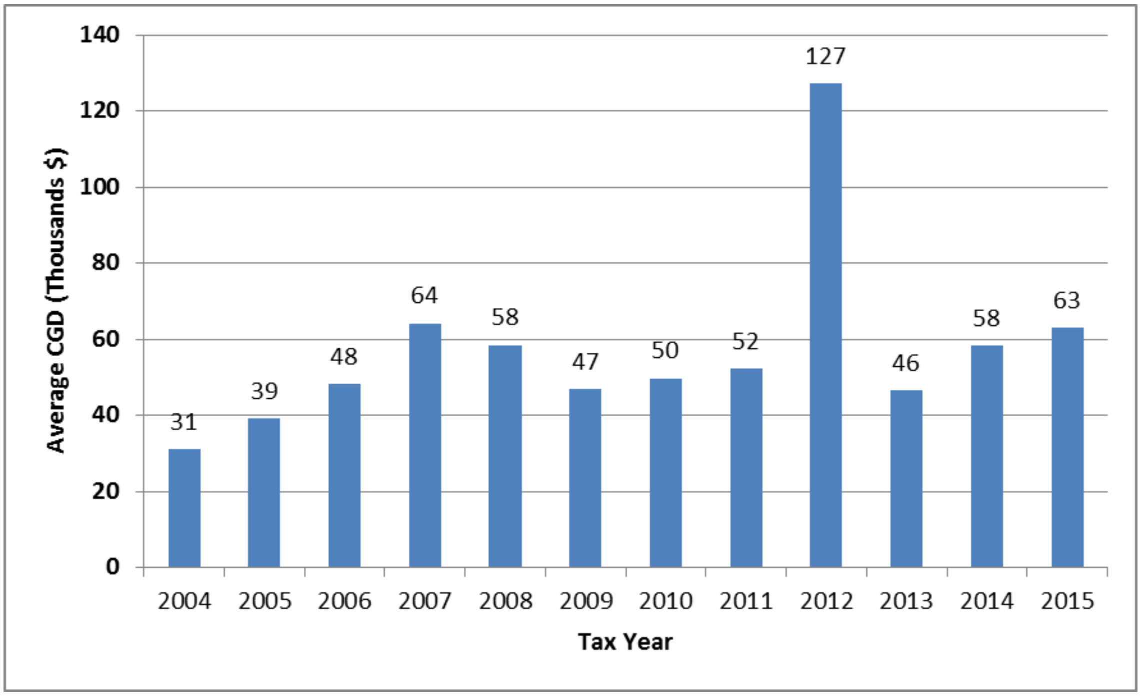
Source: Individual Income Tax Returns, Tax Year 2015 is preliminary.

Figure 2. Total CGD Claimed by Tax Year



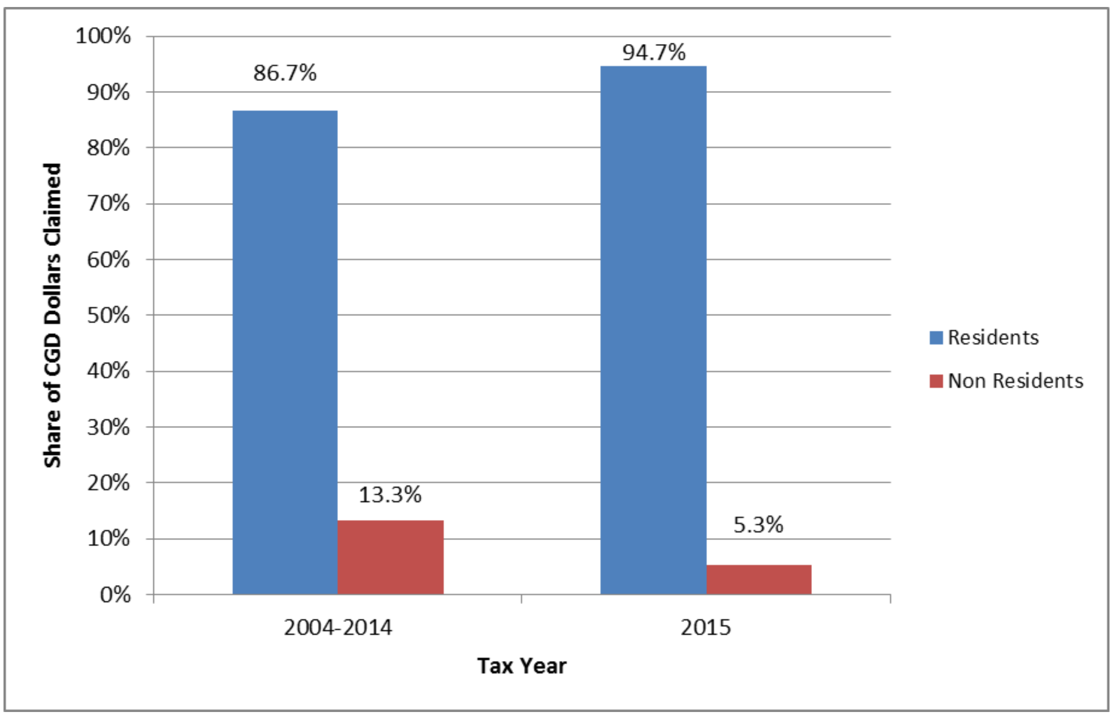
Source: Individual Income Tax Returns, Tax Year 2015 is preliminary

Figure 3. Average CGD Claim by Tax Year



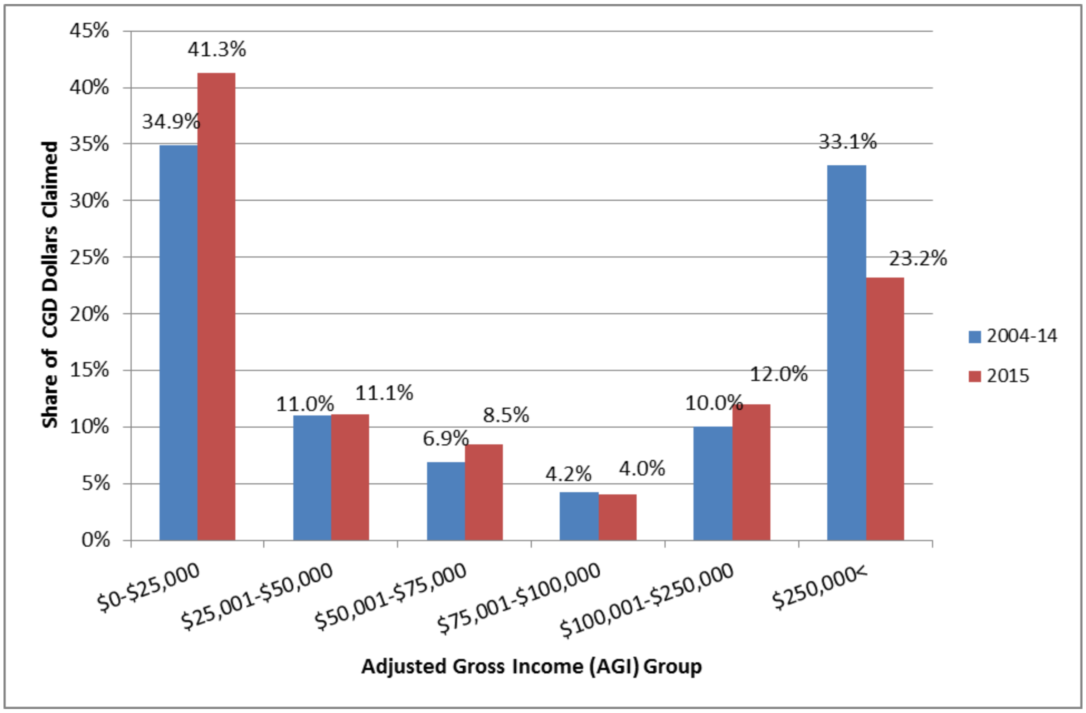
Source: Individual Income Tax Returns, Tax Year 2015 is preliminary

Figure 4. Share of CGD Dollars Claimed by Resident Status, Tax Years 2004-2014 vs. 2015



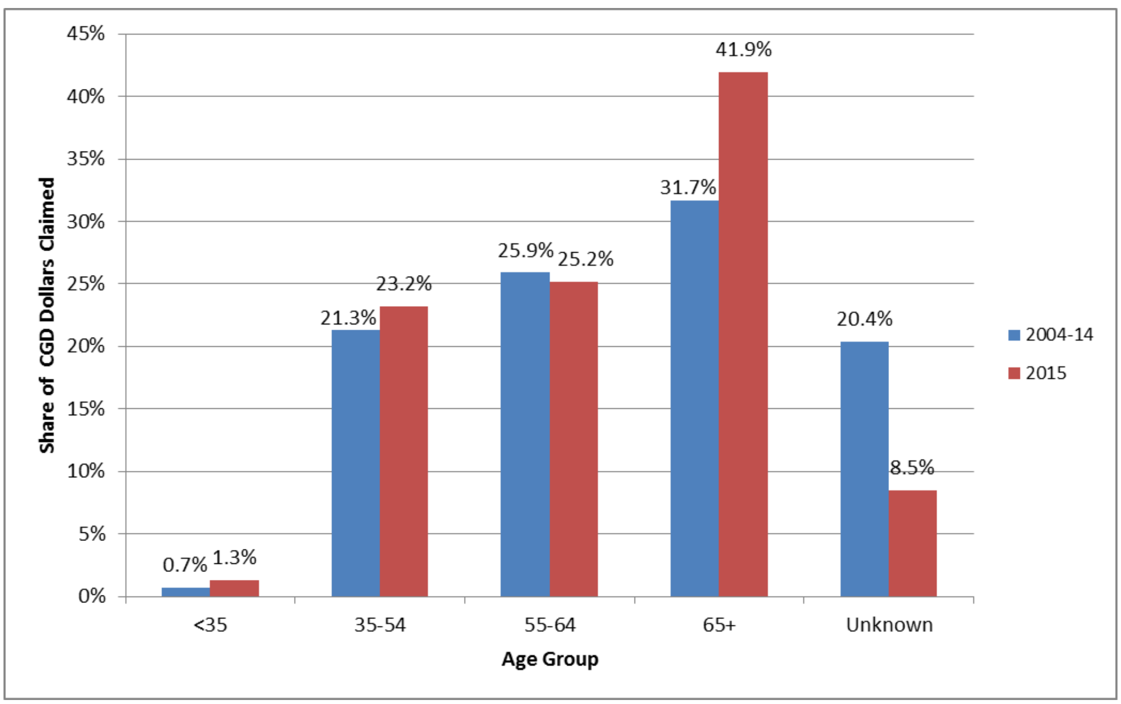
Source: Individual Income Tax Returns, Tax Year 2015 is preliminary

Figure 5. Share of CGD Dollars Claimed by AGI, Tax Years 2004-2014 vs. 2015



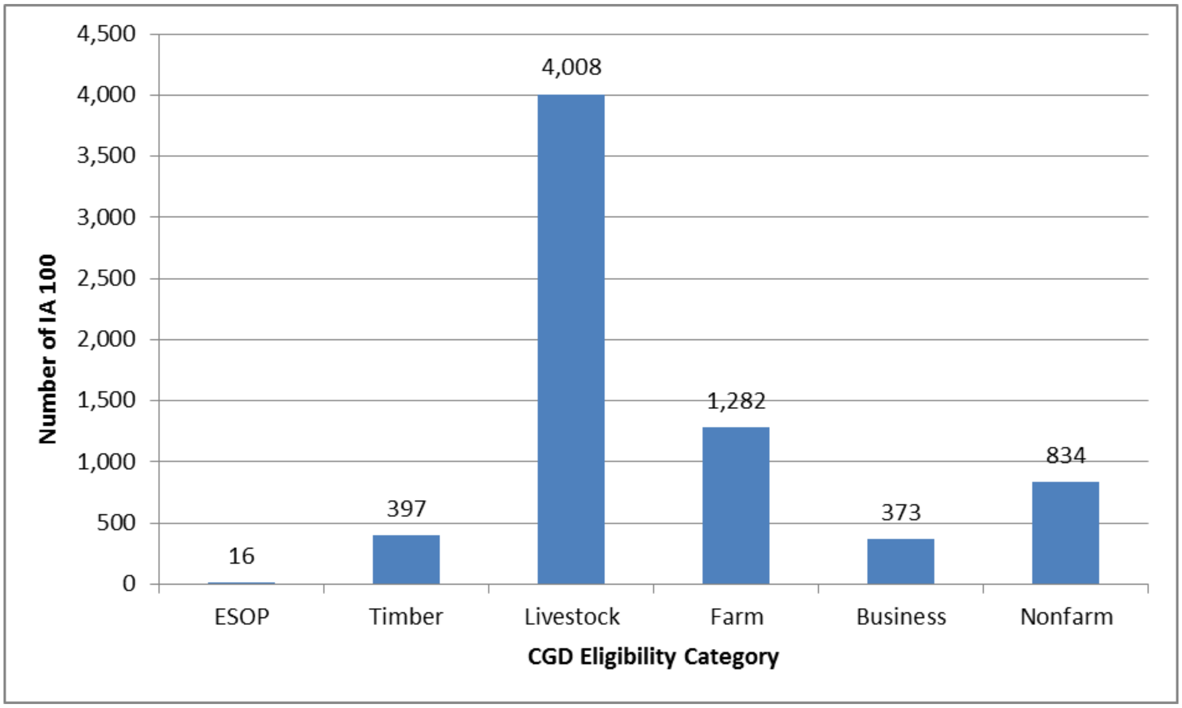
Source: Individual Income Tax Returns, Tax Year 2015 is preliminary

Figure 6. Share of CGD Dollars Claimed by Age, Tax Years 2004-2014 vs. 2015



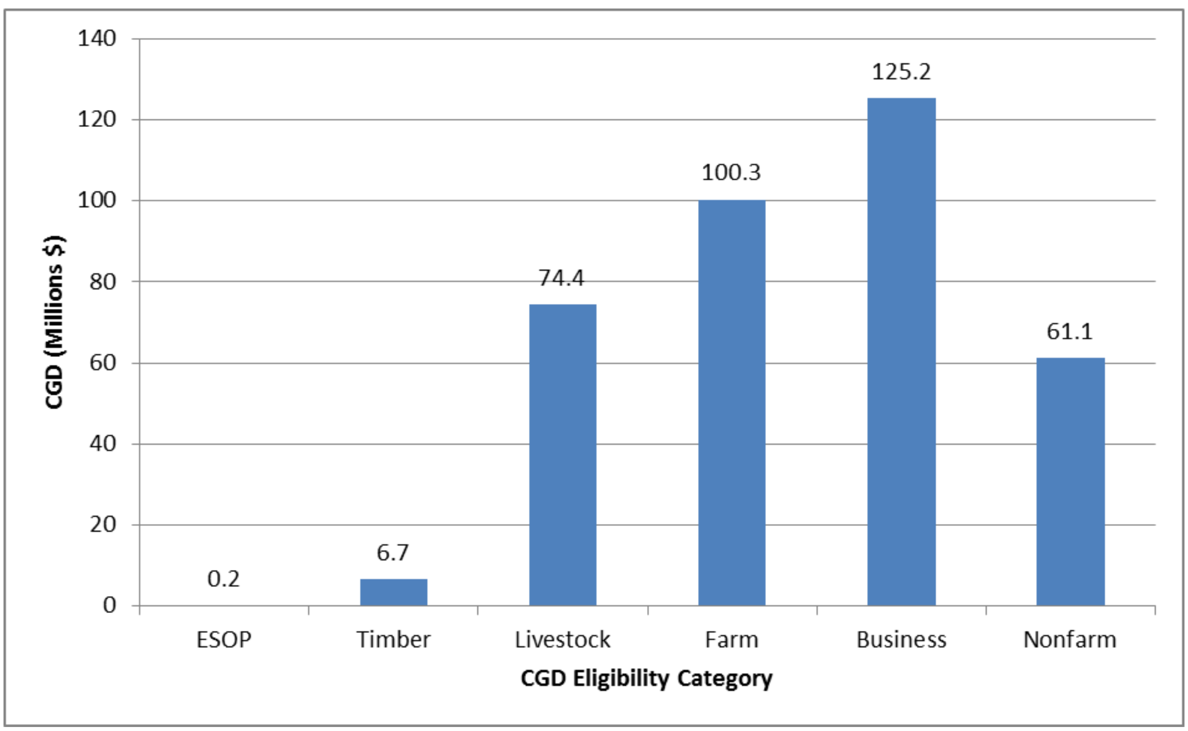
Source: Individual Income Tax Returns, Tax Year 2015 is preliminary

Figure 7. Number of IA 100 Claims by CGD Eligibility Category, Tax Year 2015



Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 8. Total CGD Claimed by CGD Eligibility Category, Tax Year 2015



Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Table 1. Distribution of CGD Claimed Amount by Eligibility Category, Tax Year 2015

CGD Eligibility Category	Distribution of Returns with Claims	Distribution of Total CGD	Average CGD	10th Percentile	Median - 50th percentile	90th Percentile	Share of CGD Reported by Top 50%
ESOP	0.2%	0.1%	$14,354	$56	$3,074	$60,000	99.7%
Timber	5.7%	1.8%	$16,940	$1,043	$8,827	$37,970	88.0%
Livestock	58.0%	20.2%	$18,552	$791	$6,643	$40,811	95.0%
Farm Property	18.6%	27.3%	$78,255	$2,747	$20,135	$202,167	94.3%
Business	5.4%	34.0%	$335,740	$5,250	$50,000	$437,500	97.2%
Nonfarm Property	12.1%	16.6%	$73,269	$1,201	$22,273	$179,005	95.0%

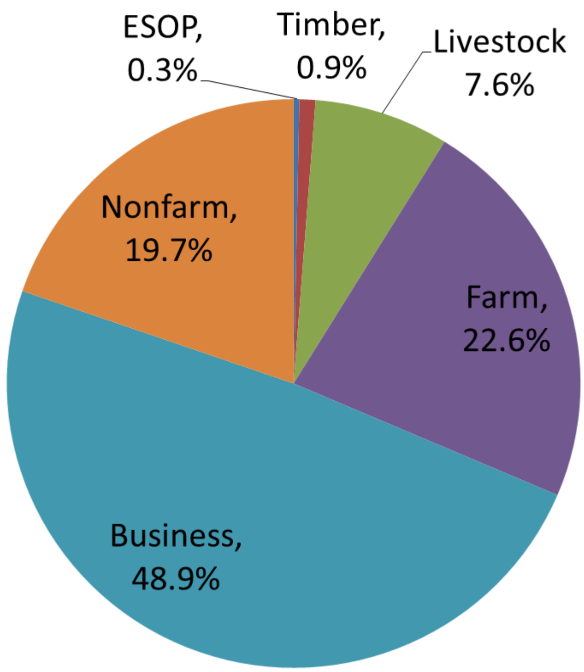
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Table 2. CGD Claimed by Non Residents by Eligibility Category, Tax Year 2015

CGD Eligibility Category	Total Count of IA 100	Non Resident Count of IA 100	Non Resident Share	Total CGD	Non Resident CGD	Non Resident Share of CGD
ESOP	16	0	0.0%	$229,667	$0	0.0%
Timber	381	4	1.0%	$6,725,357	$9,251	0.1%
Livestock	4,008	21	0.5%	$74,356,009	$689,341	0.9%
Farm Property	1,246	67	5.4%	$100,323,230	$11,298,499	11.3%
Business	363	32	8.8%	$125,231,084	$5,296,764	4.2%
Nonfarm Property	811	50	6.2%	$61,106,348	$3,751,124	6.1%

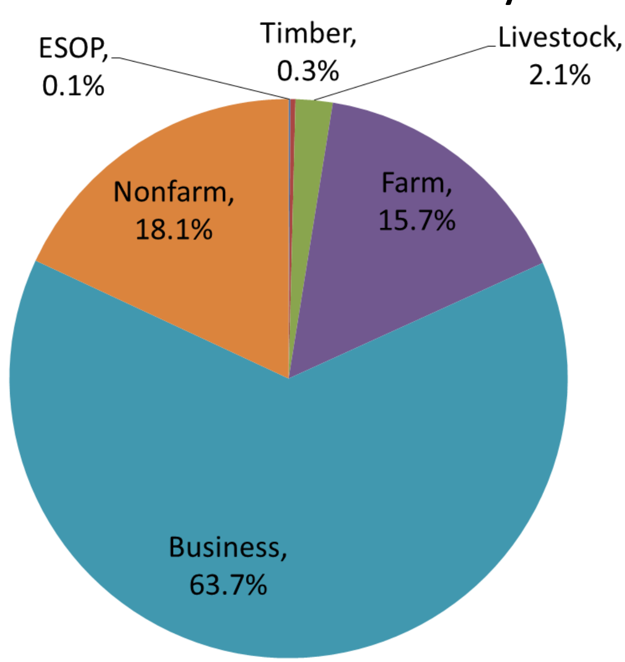
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 9. Distribution of IA 100 Property Sale Price by CGD Eligibility Category



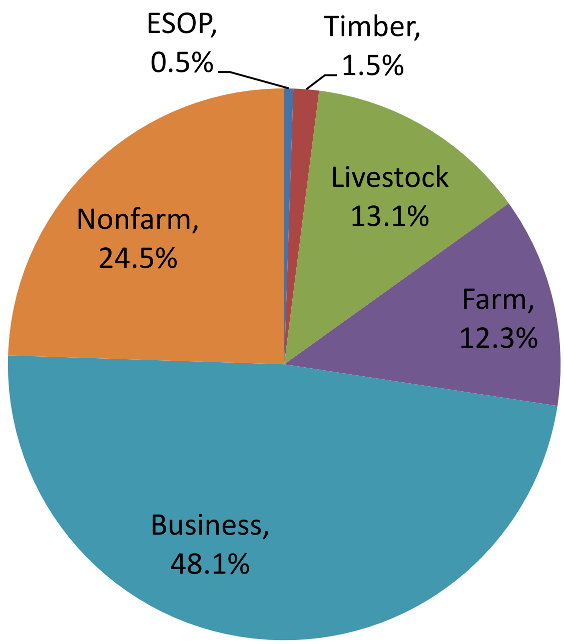
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 10. Distribution of IA 100 Total Cost or Basis by CGD Eligibility Category



Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 11. Distribution of IA 100 Total Gain by CGD Eligibility Category



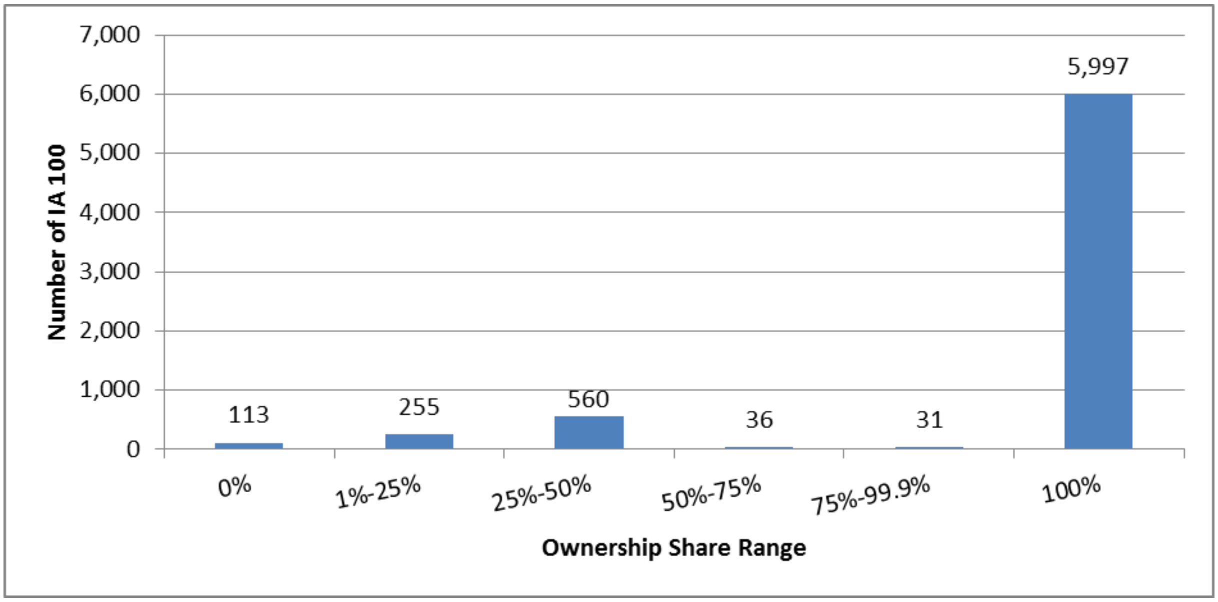
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Table.3 Distribution of Total Property Sale Price, Cost/Other Basis, Gain from Sale by Eligibility Category, Tax Year 2015

CGD Eligibility Category	Distribution of Property Sale Price	Distribution of Cost or Basis	Distribution of Gain from Sale
ESOP	0.0%	0.1%	0.5%
Timber	0.1%	0.3%	1.5%
Livestock	0.9%	2.1%	13.1%
Farm Property	11.3%	15.7%	12.3%
Business	4.2%	63.7%	48.1%
Nonfarm Property	6.1%	18.1%	24.5%

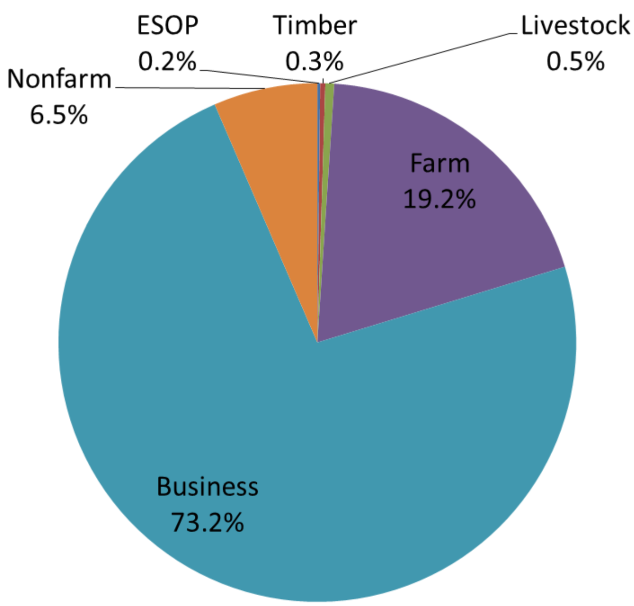
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 12. Number of IA 100 by Ownership Share, Tax Year 2015



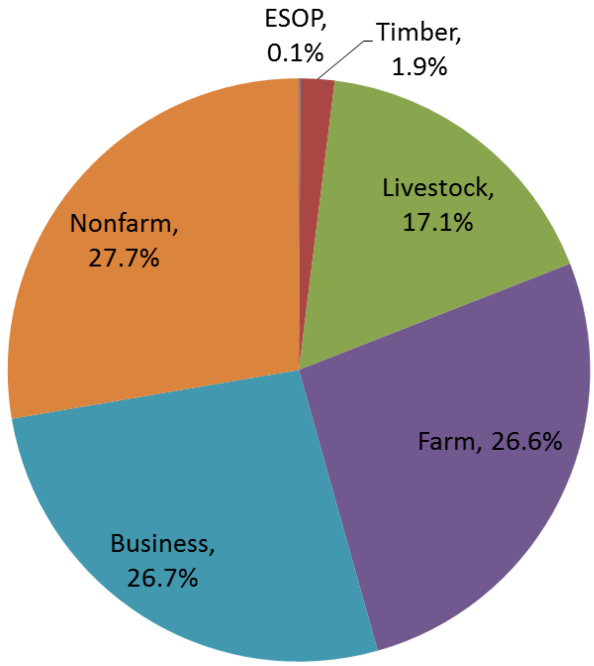
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 13. Distribution of CGD Subject to Installment Sale by CGD Eligibility Category



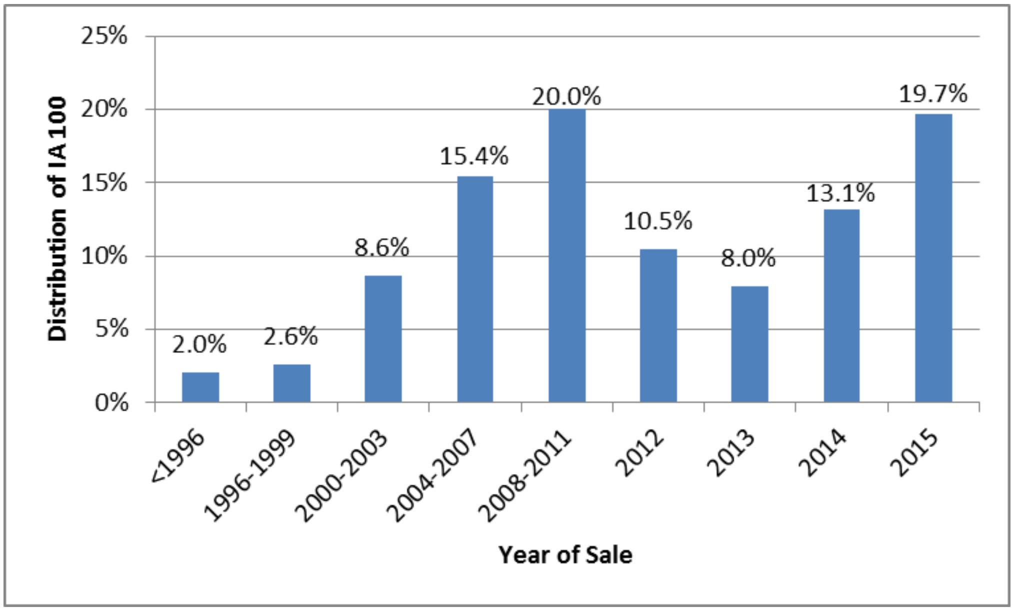
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 14. Distribution of Total Gain Excluding Installment Sales by CGD Eligibility Category



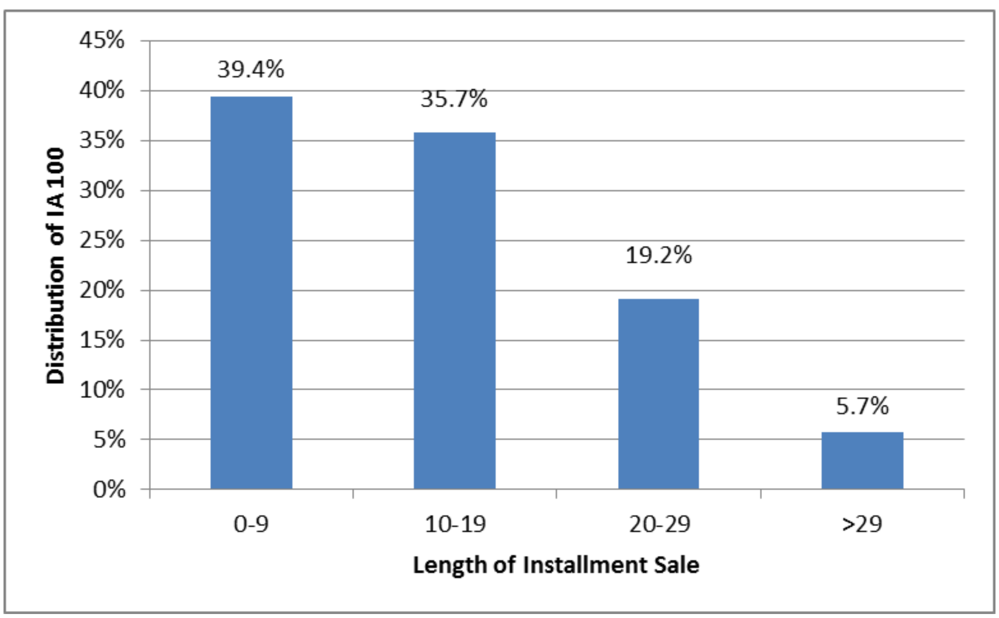
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 15. Distribution of IA 100 Reporting Installment Sales in Tax Year 2015 by Year of Sale



Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 16. Distribution of IA 100 Reporting Installment Sales in Tax Year 2015 by Length of Installment Sale



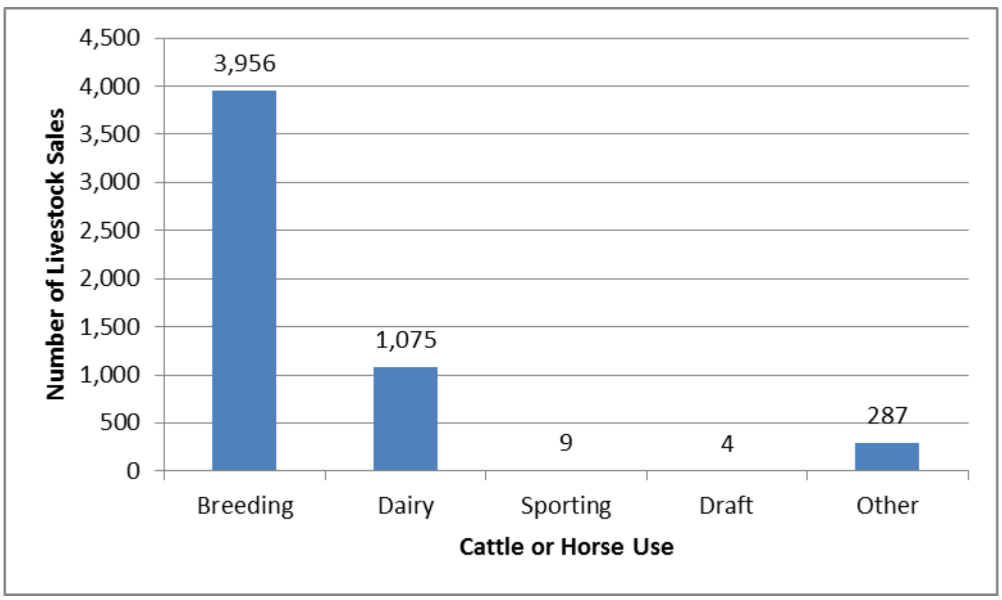
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Table 4. Acquisition Method by Eligibility Category, Tax Year 2015

CGD Eligibility Category	Inheritance	Purchase	Gift	Like-kind Exchange	Involuntary Conversion	Other	Common Explanation for Other
ESOP	0	13	0	0	0	3	-
Timber	25	260	13	0	0	56	Self-grown: 35
Livestock	10	1,517	1	0	6	2,487	Self-raised: 2,421
Farm Property	179	1,107	17	15	1	6	-
Business	6	255	9	0	1	105	Self-started: 52
Nonfarm Property	34	785	4	2	5	9	Self-constructed:3

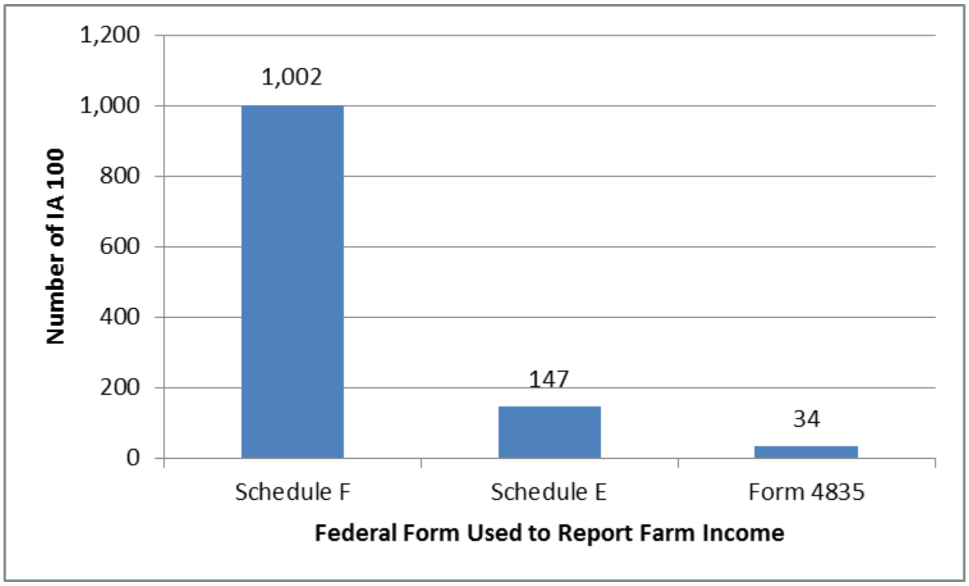
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 17. Reported Use of Cattle and Horses Sold, Tax Year 2015



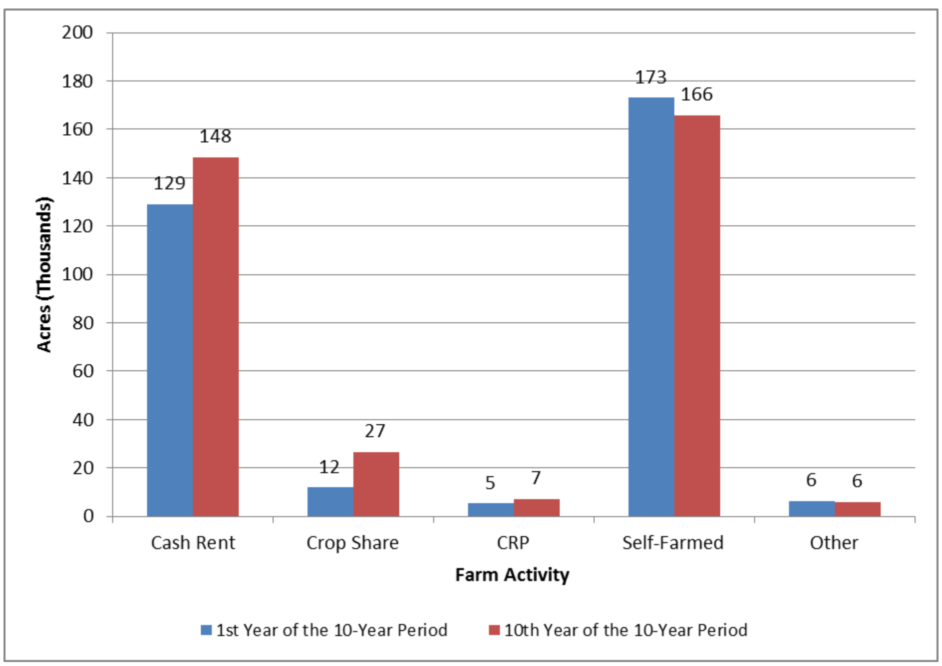
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 18. Federal Form Used to Report Farm Income by Taxpayers with Sales of Farm Property, Tax Year 2015



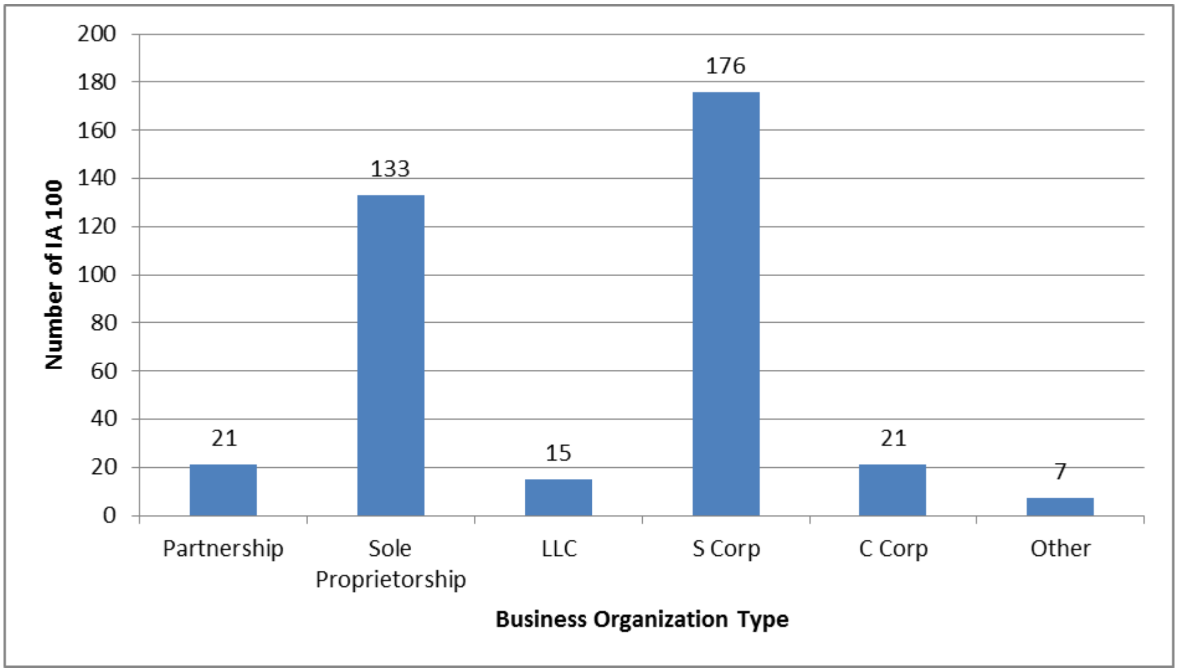
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 19. Management of Farm Property Acres in 1st and 10th Year in the 10 Year Period before the Sale, Tax Year 2015



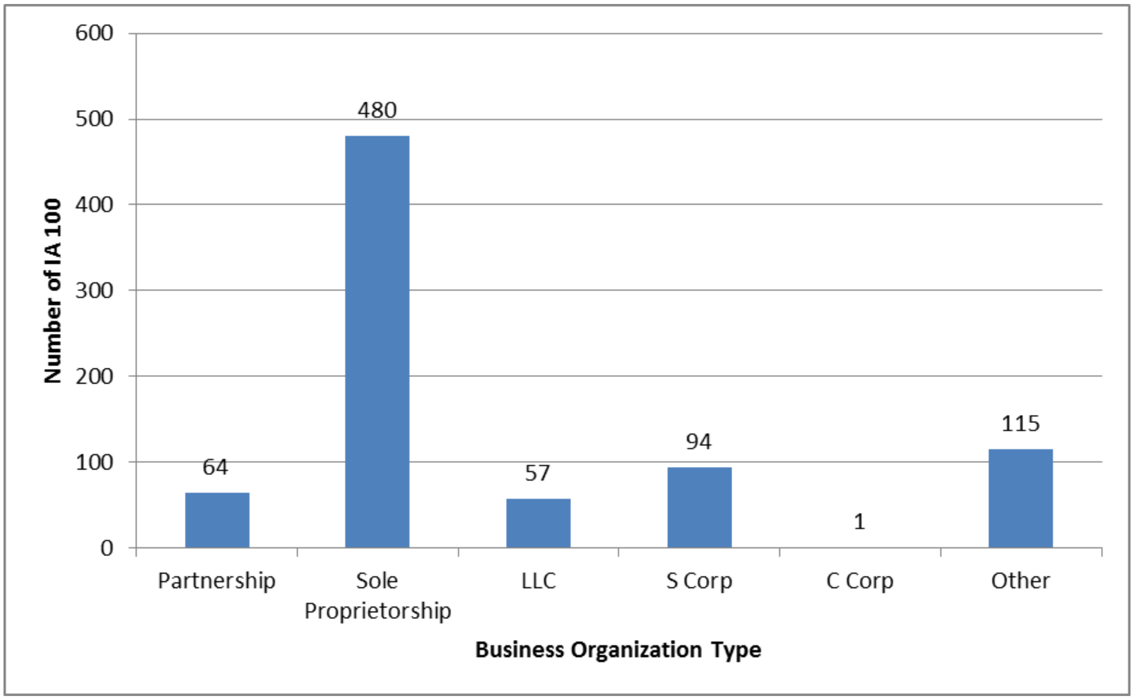
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 20. Organization Type of Businesses Sold, Tax Year 2015



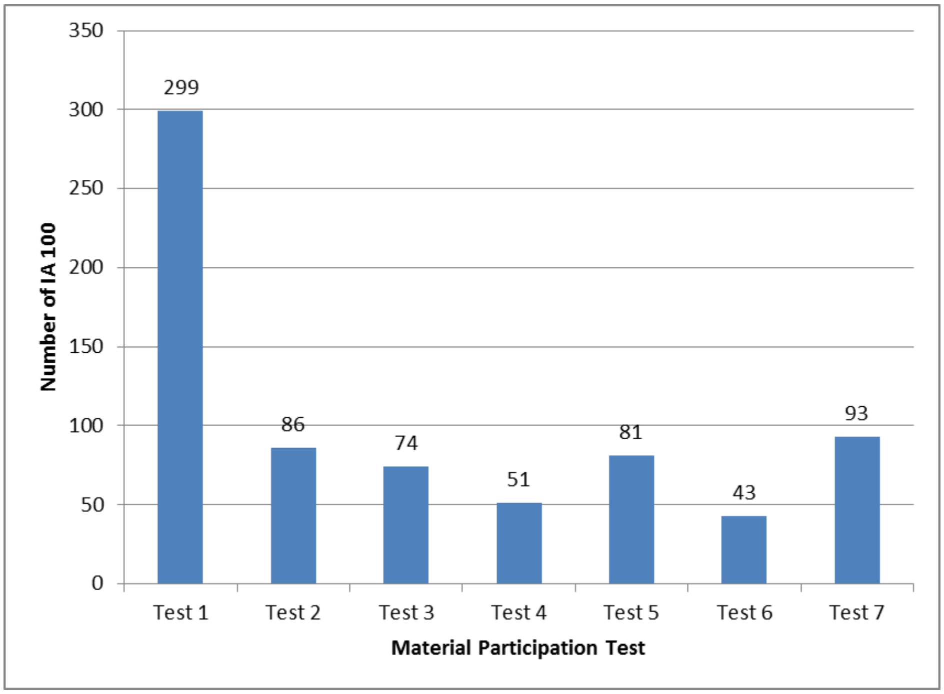
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 21. Organization Type of Businesses with Sales of Property, Tax Year 2015



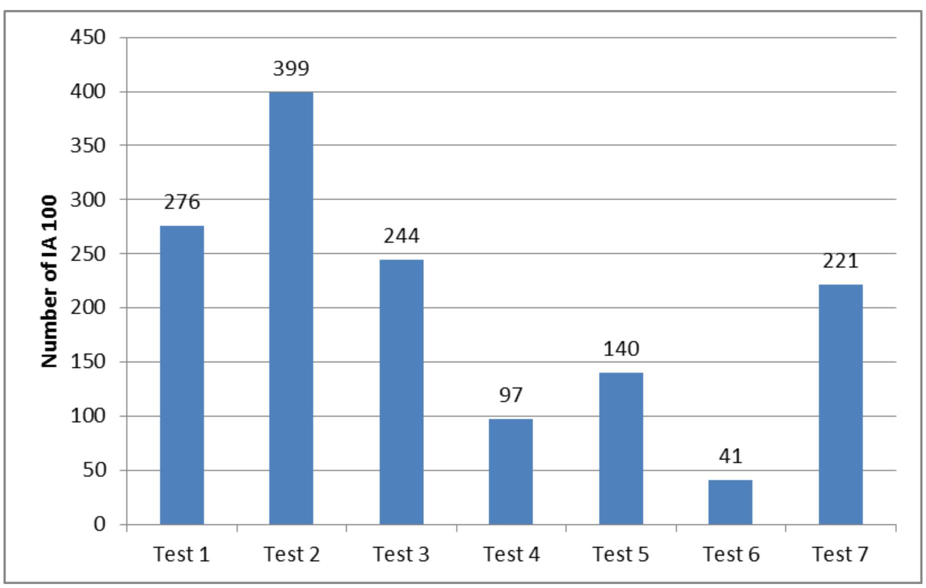
Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 22. Selected Material Participation Tests Met under the Business Eligibility Category, Tax Year 2015



Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review

Figure 23. Selected Material Participation Tests Met under the Nonfarm Property Eligibility Category, Tax Year 2015



Source: TY 2015 electronically-filed Individual Income Tax Returns as of July 2016 before Department review