

Memorandum

To: HJ 35 Tax Study Committee

From: Aaron McNay, Tax Policy and Research *AM*

Date: March 19, 2020

Subject: Types of Capital Gains Income

During the previous HJ 35 Tax Study Interim Committee meeting, there was a request for additional information on the types of capital gains income and how it is reported in Montana. This memorandum provides the requested information on how the types of capital gains income are reported on Montana's income tax returns.

Capital Gains Income

The State of Montana bases its personal income tax structure and return on the federal government's personal income tax. Because of this, the types of capital gains income, and the information collected, is going to be based on how the federal government defines capital gains and the information that is collected on federal income tax forms.

Capital gains income is the net income a taxpayer receives from the sale of a capital asset, which generally includes: real property, stocks, bonds, livestock, business supplies, collectables, etc. The sale of capital assets can result in either a net income gain, or a net loss in income, depending on the conditions of the asset sale. Capital gains are only included in taxable income once the capital income is sold (realized), and not if the asset increases its value but is not sold (recognized).

At the federal level, there are two types of capital gains income, short-term and long-term gains. Short-term gains are any gains realized from assets held for periods of less than 12 months. Long-term gains are all remaining gains from the sale of assets held for more than a year.

While there are only two types of capital gains income, taxpayers do report different sources of capital gains income on different line items when estimating the taxable portion of their income. On the federal Schedule D return, taxpayers report income from five separate categories before determining net short-term and long-term capital gains income. A list of each line and the corresponding source of income is provided on the next page.

1. Short-Term Gains
 - a. Line 1: Sales of securities, principal residences, land, and income not reported on another line
 - b. Line 4: Casualty and theft loss, installment sales, futures, currency, options contracts, and like-kind exchanges
 - c. Line 5: Gains or losses from a pass-through entity
 - d. Line 6: Short-term losses carried forward from a previous year
2. Long-Term Gains
 - a. Line 8: Sales of securities, principal residences, land, and income not reported on another line
 - b. Line 11: Casualty and theft loss, installment sales, futures, currency, options contracts, and like-kind exchanges
 - c. Line 12: Gains or losses from a pass-through entity
 - d. Line 13: Long-term gains distribution from an investment company or real estate investment trust
 - e. Line 14: Long-term losses carried forward from a previous year

To determine net capital gains income, taxpayers are required to perform a netting process based on short-term and long-term gains and losses. First, short-term gains and losses are offset from each other, resulting in net short-term gains or losses. Second, the same process is performed for long-term gains, resulting in net long-term gains or losses. Finally, net short-term gains or losses are combined with long-term gains or losses to generate net capital gains income. If the combined amount is a net loss, the loss is limited to a maximum of \$3,000, or \$1,500 if filing separately.

Department of Revenue Data

For Montana's personal income tax, the estimation and reporting of capital gains income is the same as the federal process. Taxpayers report their net capital gains income on Montana's Form 2 and provide the state with their federal Schedule D. Because the Montana taxpayers provide the state with the Schedule D, the state also has information on the share of capital gains income that comes from short-term and long-term gains, as well as some limited information on the types of capital gains income based on the categories listed above.

While the Department of Revenue is sent the federal Schedule D when people file their income taxes, the department does not keep an electronic record of all the schedules. Only schedules that are sent through the Modernized e-File (MeF) system are recorded in the department's tax processing software. Because of this, the department's records do not have a complete records of Schedule D information for each year. For tax year 2018, approximately 60 percent of full-year resident returns had matching electronic copies of a federal Schedule D. In total, these returns comprised nearly 89 percent of net capital gains income reported on Montana resident tax returns.

Table 1 on the next page contains information on the amount of capital gains income reported by full-year resident taxpayer returns in Montana. In total 121,404 returns

reported capital gains income on their returns, with approximately \$2.7 billion in net capital gains income. Of these returns, 77.3 percent reported net gains, while the remaining 22.7 percent reported net losses.

Table 1			
Capital Gains Income Reported By Full-Year Residents			
Type of Capital Gains	Returns	Total Net Income	Average Net Income
Form 2			
Capital Gains Reported	121,404	\$2,709,410,414	\$22,317
Capigal Gains	93,805	\$2,760,899,582	\$29,432
Capital Losses	27,599	(\$51,489,168)	(\$1,865)
Schedule D			
Net Short-Term Gains Income	34,586	(\$312,946,908)	(\$4,370)
Capigal Gains	13,734	\$68,493,410	\$4,987
Capital Losses	20,852	(\$381,440,318)	(\$18,292)
Net Long-Term Gains Income	67,527	\$1,826,315,764	\$25,507
Capigal Gains	50,869	\$2,504,269,542	\$49,229
Capital Losses	16,658	(\$677,953,778)	(\$40,698)
Net Capital Gains Income	71,594	\$1,513,368,856	\$21,137
Capigal Gains	51,043	\$2,453,404,410	\$48,065
Capital Losses	20,551	(\$940,035,554)	(\$45,741)
Net Capital Gains Income With Losses Limited to \$3,000	71,594	\$2,408,160,120	\$19,835
Capigal Gains	51,043	\$2,453,404,410	\$48,065
Capital Losses	20,551	(\$45,244,290)	\$2,201

When combined with full-year resident tax returns, 71,594 Schedule D forms were matched to returns. Of these, 34,586 reported short-term capital gains income, with \$313 million in combined net losses. For long-term gains, 67,527 returns reported \$1.8 billion in net income. When combined, the 71,594 matched returns reported approximately \$1.5 billion in net income, with \$2.45 billion in gains and \$940 million in losses. When losses are limited to the \$3,000 maximum, combined net capital gains income increases for the 71,594 returns to \$2.41 billion, which is nearly 89 percent of the income reported on the Montana income tax return.