



Potential Impacts of Oklahoma's Capital Gains Exemption and SB 1086

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Recent days have seen much discussion about the capital gains tax exemption in Oklahoma, and that discussion has become much more intense since the proposal of Senate Bill 1086 (SB 1086). This analysis is not intended to be a statement in support of or opposition to passage of SB 1086, but rather an objective analysis to help you determine the bill's potential impacts to you.

What does SB 1086 propose?

As of this writing, the current text of SB 1086 ([click here](http://webservice1.lsb.state.ok.us/cf_pdf/2017-18%20ENGR/SB/SB1086%20ENGR.PDF) or go to http://webservice1.lsb.state.ok.us/cf_pdf/2017-18%20ENGR/SB/SB1086%20ENGR.PDF for the full text) would eliminate the exemption of capital gains income from Oklahoma income tax. Under current Oklahoma law, an Oklahoma taxpayer uses their federal adjusted gross income, or AGI, and makes specified additions or subtractions to arrive at Oklahoma taxable income. The amount of "capital gains" reported for federal tax purposes can be deducted from the income of individuals and corporations (and other entities, such as LLCs) when calculating Oklahoma taxable income. SB 1086 would eliminate that deduction for both individuals and corporations with respect to any capital gains transactions occurring after December 31, 2018.

What is a capital gains transaction?

To understand this question, you need to understand what your "tax basis" in an item. Perhaps the easiest example of tax basis is associated with the purchase of a piece of land. If land is bought in a normal, arms-length transaction (there are dozens of other ways the transaction could happen, of course), the tax basis in that piece of property is the price paid for it. If the land is bought for \$1,500 per acre, the tax basis in the land is \$1,500 per acre. If the land is held for the required "holding period" (Oklahoma holding periods vary, as discussed later), then sell it for \$2,500 per acre, the amount by which the sale price exceeds the tax basis is treated as a capital gain. In this case, here is \$1,000 per acre in capital

gains (\$2,500 sale price - \$1,500 tax basis = \$1,000 capital gain).

Next, you need to understand the definition of a "capital asset" and what transactions result in capital gains. A capital asset is an asset held for investment purposes, used in a production process or used to facilitate the sale of other assets; it does not include inventory or items for sale to others. The most common capital assets a business might own are land, buildings, machinery and equipment, but they also can include investments owned by individuals (for example, shares of stock or bonds). Following are some common examples to illustrate what is – and is *not* – considered a capital gain transaction.

Example 1

Widget Manufacturing of Oklahoma owns 10 acres of land, a building and a variety of machines all used to produce widgets. Since this property is used to produce other items for sale (and are not held as inventory for sale themselves), the land, buildings and machines are capital assets. If the company owns them for five years or more and later sells them for a value greater than their purchase price, then a capital gain on the transaction is recognized. Under current Oklahoma law, Widget Manufacturing's capital gain is eligible for the Oklahoma capital gain exemption. On the other hand, the sale of widgets produced by these items would generate ordinary income, since these are sold to customers, therefore, are taxed as ordinary income. Also, note that if any of the capital items (land, buildings or equipment) are sold for less than their purchase price, no capital gain is recognized.

Example 2

Gracie's Groceries owns a building, freezers, coolers and shelving to hold food and other items she sells. The building, freezers, coolers and shelving are capital assets (they are owned and used to facilitate the sale of other items, and are not inventory for sale themselves). If Gracie sells a walk-in freezer she owned for five or more years and it sells for more than what she paid for it, the capital gain is eligible for the Oklahoma capital gain exemption. The food and other items sold generate ordinary income, since these are sold to customers; income from the sale of these items is taxed as ordinary income.

Example 3

Stella, an Oklahoma resident, buys 100 shares of stock in an Oklahoma-based corporation and pays \$25 per share for the stock as an investment. She holds the stock for two years or more and decides to sell it when its price is \$85 per share. As a result, Stella will realize \$60 per share of capital gain income from the sale, and the capital gain is eligible for the Oklahoma capital gain exemption. No portion of her income from the transaction would be taxed as ordinary income.

From these examples, it is shown that capital gain is recognized whenever a business or individual sells a capital asset for more than its purchase price. That is an important thing to note: capital gain is only recognized when the asset is sold. There is no effect if the asset continues to be held. Thus, under current Oklahoma law, someone recognizing a capital gain would be taxed at the federal level using the federal capital gains rate, and no Oklahoma tax would be paid on the gain, since it would be excluded from Oklahoma taxable income. The 2018 federal capital gain rates are dependent on the amount of the taxpayer's taxable income, with rates of 0, 15 and 20 percent. For capital gains not subject to the current Oklahoma exclusion, ordinary Oklahoma income tax rates are applied (with a current maximum rate of 5 percent). If SB 1086 were enacted, those capital gains would effectively be taxed at Oklahoma's ordinary income tax rates.

What are some common capital gains transactions in agriculture?

Much of the discussion about SB 1086 has focused on agriculture. To illustrate some examples of capital gains transactions in agriculture, consider the following examples:

Example 4

Hank is a farmer, and all of his property is located in Oklahoma. Hank owns land, buildings, cattle production and farming equipment, breeding cows and bulls, which is all used to produce food and fiber for sale.

Land: If Hank sells a parcel of land he has held for five years or more for a price higher than its purchase price, the capital gain is eligible for the Oklahoma capital gain exemption. Note: in this case, Hank's purchase price is his tax basis in the property; if Hank had inherited the property, the property's basis could have been stepped up to its fair market value at the time of the inheritance.

Let's say Hank purchased a farm in 2010 for \$150,000, then sold the farm in 2018 for \$230,000. The amount of Hank's capital gain in this case would be \$80,000 (\$230,000 sale price - \$150,000 purchase price = \$80,000 capital gain). Under current law, Hank would pay federal capital gains tax on the \$80,000 capital gain, but that amount would not be taxed at the state level. If SB 1086 is enacted, and assuming Hank's Oklahoma tax rate is 5 percent, he would pay \$4,000 in Oklahoma income tax on the transaction (\$80,000 capital gain x 5 percent Oklahoma income tax rate).

Buildings and Equipment: What if Hank sells a grain storage facility? First, Hank could have taken a deduction against his ordinary income for the depreciation of the facility. Depreciation affects ordinary income, and not the nature of the sale price as a capital gain. Say Hank's facility had an initial price of \$10,000, but he has taken a total of \$7,500 in

depreciation deductions against it. Those depreciation deductions reduce Hank's ordinary income (thus, his income taxes) in those prior years, but they also reduce Hank's tax basis in the facility. Hank's basis started at \$10,000, but is now \$2,500 (\$10,000 initial cost - \$7,500 in depreciation deductions = \$2,500 new tax basis). Now, let's say Hank sells the facility for \$13,500. First, Hank has to "recapture" the depreciation he took on the building. That means \$7,500 of the sale price will be taxed as ordinary income, since Hank's depreciation deductions were taken against ordinary income. The portion of the sale price consisting of Hank's tax basis - \$2,500 - is not taxed. The remaining \$3,500 (\$13,500 sale price - \$2,500 tax basis - \$7,500 recaptured depreciation) is treated as a capital gain. Under current law, this \$3,500 would be taxed at the federal level at the federal capital gains tax rates. If SB 1086 is enacted, the gain would be taxed at Hank's ordinary Oklahoma income tax rate. Assuming that rate is 5 percent, the additional income tax owed on the sale would be \$175 (\$3,500 capital gain x 5% tax rate = \$175).

What if Hank sold the facility for \$6,000? In this case, his tax basis is still \$2,500, so that portion of the sale price would not be taxed. The remaining \$3,500 above his tax basis would be recaptured depreciation (and note, this is not enough to recapture *all* of Hank's depreciation; this frequently happens in sales of equipment and sometimes in the case of buildings). Since the sale price was not large enough to recapture all of the depreciation, none of the sale price is treated as a capital gain.

Breeding livestock: An area of agriculture where understanding capital gains can be even more complicated than usual is with breeding livestock. Before discussing breeding livestock, it is important to note the following discussion does not apply to animals intended for sale to others (in other words, inventory); such animals are not capital assets.

When it comes to capital gains in breeding livestock transactions, there is a difference between purchased breeding animals and raised breeding animals.

Let's consider a breeding bull. If Hank purchased the bull for \$5,000 five years ago and took \$4,000 in depreciation deductions against the bull, its tax basis is now \$1,000. If Hank sells the bull for \$1,250, then \$250 (the amount of the sale price over Hank's tax basis in the bull, which is \$1,250 sale price - \$1,000 tax basis = \$250) is taxed as ordinary income since it is "recaptured" depreciation. The remaining amount of the sale price, \$1,000, is not taxable since it represents the tax basis Hank already had in the bull. In this situation, there is no capital gain.

On the other hand, if Hank raised the breeding bull, his tax basis in the bull is \$0. If Hank uses the bull for five years, then sells him for \$1,000, the entire sale price would be treated as a capital gain (\$1,000 sale price - \$0 tax basis = \$1,000). Under current tax law, the \$1,000 would be taxed at Hank's capital gains rate at the federal level, and would be excluded from his Oklahoma taxable income. If SB 1086 is enacted, the \$1,000 would be added to Hank's Oklahoma taxable income and taxed as ordinary income for his Oklahoma taxes. Without the capital gain exemption, Hank's increase in Oklahoma tax due would be \$50.00 (\$1,000 x 5 percent), assuming that Hank's taxable income level places him in the 5 percent Oklahoma tax bracket.

What about culled breeding cows? If Hank bought a breeding cow for \$1,000 and took \$750 in depreciation against her

over five years (again, meaning Hank has a five-year holding period), his tax basis in the cow is now \$250. If Hank culls her from the herd and she sells for \$300, then \$50 (the amount by which her sale price exceeds the tax basis; \$300 sale price - \$250 tax basis = \$50) is treated as recaptured depreciation and is taxed as ordinary income. The remaining \$250, which is the tax basis, is not taxed. However, if the cow was raised by Hank rather than purchased, Hank's tax basis in her was \$0; if she is culled and sold for \$300, all \$300 is considered capital gains. Under current law, that \$300 would be taxed at Hank's federal capital gains rate and would be excluded from Oklahoma taxable income. If SB 1086 is passed, the \$300 would be included in Hank's Oklahoma taxable income and taxed as ordinary income for Hank's Oklahoma taxes.

Let's say 10 of Hank's breeding cows were born to his herd in February of 2013. In April of 2018, he decides to cull and sell them, receiving \$10,000 for the sale. Since the cows were raised by Hank, his tax basis in them is \$0. Thus, the entire amount of the sale is considered capital gain. Under current law, the \$10,000 would be taxed at the federal level at federal capital gain rates. If SB 1086 is enacted, and again assuming Hank has an Oklahoma ordinary income tax rate of 5 percent, Hank would owe an additional \$500 in Oklahoma income tax as a result of the sale (\$10,000 capital gain x 5 percent ordinary income tax rate = \$500).

Note that breeding animals that are raised specifically for sale to others are not capital assets, and under both current law and SB 1086, their sale prices are not eligible for capital gains treatment.

Some of the discussion about the effects of SB 1086 on agriculture, and specifically livestock operations, has focused on the fact ranchers can deduct the cost of feed, medicine and other items from their taxes. Generally, those items are deductible against ordinary income for the farmer, but taking such deductions does not affect the tax basis of the animal. Only depreciation deductions taken against breeding animals (held for breeding purposes and not for sale to others) affect the animals' tax basis. Further, depreciation deductions can have the effect of changing what portion of an animal's sale price is treated as recaptured depreciation, but they may not eliminate a capital gain. Again, that depends on the tax basis of the animal, the amount of the sale price and how much depreciation must be recaptured before capital gain can be recognized.

What is the required holding period for assets to get the capital gain exemption?

As discussed in several of the examples above, the holding period (the amount of time an asset must be owned) matters in determining whether it meets qualification for the Oklahoma capital gains deduction.

As Oklahoma law currently stands, you can deduct qualifying gains receiving capital treatment, which are included

in federal AGI from the Oklahoma taxable income. "Qualifying gains receiving capital treatment" means the amount of net capital gains, as defined under federal Internal Revenue Code (IRC) Section 1222(11). The qualifying gain must:

- Be earned on real property (land) or tangible personal property located within Oklahoma that you have owned for at least five uninterrupted years (the holding period) prior to the date of the sale;
- Be earned on the sale of stock or ownership interest in an Oklahoma headquartered company, limited liability company or partnership where such stock or ownership interest has been owned by you for at least two uninterrupted years prior to the date of the sale; or
- Be earned on the sale of real property, tangible personal property or intangible personal property located within Oklahoma as part of the sale of all or substantially all of the assets of an Oklahoma headquartered company, limited liability company or partnership or an Oklahoma proprietorship business enterprise or owned by the owners of such entity or business enterprise for a period of at least two uninterrupted years prior to the date of the sale (in other words, the business is liquidating).

Determining the impacts to taxes if SB 1086 passes

Of course, to determine the impact, you must know what your taxable income will be in the future, and that is obviously difficult in agriculture. Past tax returns can be a place to start in determining the average taxable income. You could then add the average or estimated revenues from the sale of raised breeding livestock to Oklahoma taxable income to estimate the change in Oklahoma income tax due. The potential tax liability arising from sales of stocks or land can be calculated from the tax basis of the property and using an estimated sale price as well. The easiest way to get a reasonable estimate of the impact is to simply multiply the exempt capital gain amount by 5.0 percent, which is the maximum Oklahoma tax rate. Taxpayers filing as single reach the maximum rate at \$7,200 of taxable income and married filing joint at \$12,200 of taxable income.

Conclusion

If you anticipate the sale of capital assets for more than your tax basis in those assets (remember the tax basis in raised breeding livestock is \$0), SB 1086 will have an impact on your taxes, but the amount of that impact depends on your taxable income, the tax basis you hold in the property and the sale price. To calculate the potential impact, gather as much information as possible about the tax basis in all of your property and work with a tax professional to estimate the potential tax liability of any asset sales you are likely to make in the future.

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