Individual capital gains and losses

Several key rules and processes impact how taxpayers are taxed on capital gains and losses.

First, long-term gains and losses must be separated from short-term gains and losses. Long-term, for these purposes, means gains or losses from investments which you held for more than a year. Gains and losses from investments held for one year or less are short-term. In addition, long-term gains and losses must be separated into three rate groups:

(1) the 28% group, consisting of:

- Capital gains and losses from collectibles (including works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages) held for more than one year;
- Long-term capital loss carryovers; and
- Section 1202 gain (gain from the sale of certain small business stock held for more than five years that's eligible for a 50% exclusion from gross income).

(2) the 25% group, consisting of “unrecaptured section 1250 gain”—that is, gain on the sale of depreciable real property that's attributable to the depreciation of that property (there are no losses in this group); and

(3) the 15% or 5% group, consisting of long-term capital gains and losses that are not in the 28% or 25% group. This includes most gains and losses from assets held for more than one year.

Within each of the three groups listed above, gains and losses are netted to arrive at a net gain or loss.

The following additional netting and ordering rules apply:

(1) Short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary rates. If you have a net short-term capital loss, it reduces any net long-term gain from the 28% group, then gain from the 25% group, and finally reduces net gain from the 15%/5% group.

(2) Long-term capital gains and losses are handled as follows. A net loss from the 28% group (including long-term capital loss carryovers) is used first to reduce gain from the 25% group, then to reduce net gain from the 15%/5% group. A net loss from the 15%/5% group is used first to reduce gain from the 28% group, then to reduce gain from the 25% group.

If, after the above netting, you have any long-term capital gain, the gain that's attributable to a particular rate group is taxed at that group's marginal tax rate—28% for the 28% group, 25% for the 25% group, and the following rates for the 15% or 5% group:

5% in the case of gain that would otherwise be taxed at a regular tax rate below 25%, i.e., at 10% or 15%;

15% in the case of gain not subject to the 5% rate described above.

If, after the above netting, you're left with short-term losses or long-term losses (or both), you can use the losses to offset ordinary income, subject to a limit. The maximum annual deduction against ordinary income for the year is $3,000 ($1,500 for married taxpayers filing separately). Any loss not absorbed by the deduction in the current year is carried forward to later years, until all of it is either offset against capital gains or deducted against ordinary income in those years, subject to the $3,000 limit. If you have both net short-term losses and net long-term losses, the net short-term losses are used to offset ordinary income before the net long-term losses are used.

Dividends taxed at long-term capital gains rates. Dividends that you receive from domestic corporations and "qualified foreign corporations" are taxed at the same rates that apply to the 15%/5% group mentioned above. However, these dividends aren't actually part of that group, and aren't subject to the grouping and netting rules discussed above.

Some planning suggestions. Since losses can only be used against gains (or up to $3,000 additionally), in many cases, matching up gains and losses can save you taxes. For example, suppose you have already realized $20,000 in capital gains in Year 1 and are holding investments on which you have lost $20,000. If you sell the loss items before the end of the year, they will "absorb" the gains completely. Alternatively, if you wait to sell the loss items in Year 2, you will be fully taxed on Year 1 gains and will only be able to deduct $3,000 of your losses (if you have no other gains in Year 2 against which to net the losses).

Another technique is to seek to "isolate" short-term gains against long-term losses. For example, say you have $10,000 in short-term gains in Year 1 and $10,000 in long-term losses as well. You're in the highest tax bracket in all relevant years (assume that's a 35% bracket for Year 1). Your other investments have been held more than one year and have gone up $10,000 in value, but you haven't sold them. If you sell them in Year 1, they will be netted against the long-term losses and leave you short- term gains to be taxed at 35%. Alternatively, if you can hold off and sell them in Year 2 (assuming no other Year 2 transactions), the losses will "absorb" the short-term gains in Year 1. In Year 2, the long-term gains will then be taxed at only 15% (unless the gains belong in the 25% or 28% group).

Family tax planning opportunity. Given the 5% capital gains rate for low bracket taxpayers, if you have appreciated stock or other capital assets that you are thinking of selling, you may wish to consider transferring the asset to children over 13. To the extent their other taxable income would be taxed at a regular tax rate of less than 25% (i.e., for 2004, taxable income of less than $29,050 for single returns; for 2005, taxable income of less than $29,700 for single returns), they can take advantage of the 5% rate for net capital gains. (For children under 14 the "kiddie tax" rules can cause the child's income to be taxed at the parent's higher tax rates.)

Alternative minimum tax. The favorable rates that apply to long-term capital gain (and qualified dividend income) for regular tax purposes also apply for alternative minimum tax (AMT) purposes. In spite of this, any long-term capital gains you recognize in a year might trigger an AMT liability. This can happen if the capital gains increase your total income enough so that your AMT exemption phases out. The extra income from capital gains may also affect your entitlement to various exemptions, deductions and credits, and the amounts of those AMT preferences and adjustments, that depend on the amount of your income.