# Capital Gains

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- Background
- Capital Assets
- Basis
- Capital Gains and the Sales of Homes
- Mortgaged Property
- Long-Term and Short-Term Capital Gains
- Netting
- Lower Capital Gains Tax Rates and Low-Income Tax Bracket Taxpayers
- Additional Resources
- Organizations


## Background

The United States Tax Code is a complicated document. The power to levy taxes on the U. S. population belongs to Congress, and the authority to collect those taxes rests with the **E**XECUTIVE BRANCH. The Internal Revenue Service is the agency within the executive branch of the federal government that collects the taxes. But states also have the power to levy taxes on their own populations in addition to whatever the federal government does. One part of an individual's or CORPORATE entity's financial profile which is subject to TAXATION is capital gains. To determine taxation of capital gains, one must also consider capital losses. Gains are taxable, and losses may help offset tax liability.

When individuals sell or dispose of property and realize an amount over the adjusted basis of that property they have gain. When they sell or dispose of property and realize an amount below the adjusted basis of the property they have loss.

Capital gains are gains from the sale or exchange of capital assets. Capital losses are losses or reductions in value resulting from the sale or exchange of capital assets. To more fully understand the concepts of capital gains or losses, individuals need to understand the concepts of capital assets and basis. Once they understand these two concepts, then they can begin to see how they function within the broader context of the tax rules for capital gains and losses.

## Capital Assets

Almost everything individuals own and use for personal purposes or investment qualifies as capital assets. Homes, household furnishings, store equipment, computers, stocks and BONDS are all capital assets. When a person sells a CAPITAL ASSET, the difference between the sale price and the basis in the property, which is usually its previous cost, is either a capital gain or a capital loss. A capital gain occurs when property sells for more than the basis. A capital loss occurs if the asset sells for less than the basis. Losses from the sale of property that was acquired for personal use such as a home or a vehicle are not DEDUCTIBLE as capital losses.

Capital assets are any property held by a taxpayer except property that falls in one of the following categories:

- Used in business and is depreciable
- Stock in trade or inventory
- Held primarily for sale to customers in the ordinary course of taxpayer's trade or business
- Certain copyrights, compositions, letters, and memorabilia

Basically, most assets not used in business are capital assets. Assets used in a business are capital assets unless they may be depreciated or are inventory items.

Whether an asset is held primarily for sale is a question subject of much LITIGATION. If an owner is unsure of the status of an asset, he should consult his attorney or tax advisor. People need to remember that transactions involving stocks and bonds by someone who is not a dealer or an underwriter will always result in capital gain or loss, regardless of the frequency of sales. This rule affects so-called "day traders," many of whom may not be aware of the tax laws as applied to their small-scale trading.

## Basis

The basis of a capital asset is usually equal to the cost of the asset. Two exceptions to this general rule have to do with how the asset was acquired:

- Inheritance: the basis will be equal to the estate tax value in the decedent's estate. This amount is usually calculated on the value of the property on the date of death.
- Gift: the basis is the same as it would have been for the person who gave you the gift (the DONOR) or its FAIR MARKET VALUE, whichever is lower. If the recipient had to pay a gift tax on the gift, the amount of that tax gets added to the basis of the gift. This is true even though the tax is imposed on, and usually paid by, the donor.

In the end, gain or loss is measured against adjusted basis, and many things may adjust the basis of a capital asset. **D**EPRECIATION and rules relating to capitalizing property are some of the more common factors that adjust the basis of property.

## Capital Gains and the Sales of Homes

Changes to the tax laws in 1997 provided a new exclusion for gain from the sale of a principal residence. The law applies only to homes that qualify as a principal residence. This specification eliminates vacation homes, timeshares, or other types of real estate. The home must have actually been lived in as a principal residence for two of the five years immediately preceding its sale. For taxpayers in the categories of single HEAD OF HOUSEHOLD, or married filing separately, the exclusion is $250,000. For married taxpayers filing a joint return, the exclusion is $500,000. The exclusion can be used only once every two years. Gain in excess of the exclusion is taxable, usually as long-term capital gain.

## Mortgaged Property

There is a long-standing general principle in tax law: borrowing money is not taxable. Thus, if individuals sell a parcel of mortgaged property, the amount they realize is the NET purchase price. This is true regardless of whether they actually get to pocket any equity or profit in the sale of the property. For example, assume a

person buys a house for $100,000 and uses $50,000 of his own money and borrows the remaining $50,000 from a bank., The bank's $50,000 is secured by a MORTGAGE. Later, he sells it for $200,000, and assuming that his basis is then $80,000 after depreciation, his gain is $120,000, being the amount realized ($200,000) minus the basis. The amount of cash he receives will be $200,000 minus the amount of the mortgage, but that amount will have no particular bearing on the amount of gain.

## Long-Term and Short-Term Capital Gains

To determine the tax consequences that result from transferring capital assets one must first determine the rate his capital gains will be taxed. The tax rate that applies to capital gains depends on how long he holds a given capital asset. To calculate these rates, first separate the short-term capital gains and losses from the long-term gains and losses. While short-term gains are taxed as ordinary income, the taxes on long-term gains (assets held for more than one year) can range from 8 percent to 28 percent. Short-term assets are those investments held for one year or less. The government taxes short-term capital gains like any other income. These rates can be as high as 38.6 percent. On the other hand, short-term gains are taxed at the regular rate. The regular rate falls within a range of 10 percent to 39.1 percent for 2001. The rate is between 10 and 38.6 percent for 2002.

Long-term investments are those held for more than one year. Long-term gains are taxed at special rates. In 1998, the tax law was amended to reduce the holding period for the 20 percent rate to just 12 months. The holding period begins to run on the day after one acquires the investment asset. It ends on the day the asset is sold. Basically, the day an asset is bought does not count, although the day the asset is sold does. Long-term gains are taxed at lower capital gains rates. But there are exceptions to these rate rules. For example, a taxpayer in a low INCOME TAX brackets will have lower maximum tax rates. Also, if he had other regular losses, he may end up having to pay no tax at all.

In fact, there are six additional long-term capital-gains rates; the rates go from 8 percent to 28 percent. Which category applies in any case depends on the seller's income-tax bracket, the type of asset you sold, and how long the seller held it. There are many rules concerning capital gains and losses and with the holding period for assets. People should check with their attorney or tax or financial advisor to see if any of these apply in their case.

## Netting

The capital gains tax rules apply to net capital gains or losses. Capital gains and losses for any taxable year must first be netted, or calculated, so that the losses are subtracted from the gains. First the net of short-term gains and losses are calculated; next the net of long-term gains and losses are calculated against each other. The net short-term gain or loss and the net long-term gain or loss are calculated against each other for the net. This number is relevant to the tax year.

Taxpayers report capital gains and losses on Schedule D of Form 1040. If a taxpayer has a "net capital gain," that gain may be taxed at a lower tax rate. Net capital gain is the amount that results when net long-term capital gain for the year is more than net short-term capital loss. If capital losses exceed capital gains from the sale of capital assets, the amount of the losses that exceed the gains that may be claimed is limited to $3,000, or $1,500 if the taxpayer is married filing separately. If net capital loss is greater than this limit, the taxpayer can carry the loss forward to subsequent tax years.

Each gain or loss is calculated first by subtracting the purchase price of the asset from the sales proceeds. Then these figures are combined to come up with a net short-term gain or loss figure. Next, the same procedure is done with long-term assets. The result is either a net long-term loss or a net long-term gain. Next, the short- and long-term figures are netted to come up with a final tally.

## Lower Capital Gains Tax Rates and Low-Income Tax Bracket Taxpayers

There is a new, lower, capital-gains rate on investments held for more than five years. These rates are 8 percent or 18 percent, depending on the taxpayer's income. This can save you a lot of tax money if you plan to hold your investment long-term.

Taxpayers in the 15 percent federal tax bracket are eligible for a capital gains tax rate of only 8 percent on sales of stock and other investment SECURITIES held more than five years. This is a reduction from the standard 10 percent rate taxpayers in the lower tax bracket paid on long-term gains from investments held more than one year but not more than five years.

For gifts of stock or other investment securities, calculating the length of time the asset is held depends on the donor's ownership period added to the recipient's period of ownership. In these cases, it can be much easier to meet the more-than-five-year rule and thereby qualify for the 8 percent rate. This rate applies only to five-year gains triggered by sales of assets on or after Jan. 1, 2001.

### *Eligibility for the 8 Percent Rate*

To take advantage of the 8 percent rate on a 2001 return, the TAXABLE INCOME had to be less than the following amounts:

- $27,050 if single
- $45,200 if filing jointly
- $36,250 if head of household
- $22,600 if married but filing separately

To take advantage of the 8 percent rate on a 2002 return, the taxable income had to be less than the following amounts:

- $27,950 if single
- $46,700 if filing jointly
- $37,450 if head of household
- $23,350 if married but filing separately

It is important to remember that taxable income is the figure which results from subtracting personal exemptions and the standard DEDUCTION or itemized deductions. In this way, a taxpayer can be in the 15 percent bracket even if the person has a substantial salary.

### *The 18 Percent Rate*

There is a capital gains rate of 18 percent taxpayers in the 28 percent bracket and above. This is a reduction in the tax rate, although there is a substantial delay before a taxpayer may reap any tax savings. Gains from investments acquired on or after Jan. 1, 2001, and that were held for more than five years will be taxed at a maximum rate of only 18 percent. For investments acquired before 2001, a taxpayer may make a special

one-time election with the 2001 return and thereby become eligible for the 18 percent rate. By doing so, taxpayers proceed as though they sold the investment for its Jan. 2, 2001 MARKET VALUE. The taxpayers also act as though they repurchased the investment for the same price on that same day. Resulting capital gains tax from the imaginary profit on the imaginary sale are reported on the 2001 TAX RETURN. The benefit of this complicated scheme is that any future APPRECIATION of the value of the asset will be subject to an 18 percent tax rate (instead of 20 percent). To reap this benefit, taxpayers must hold on for at least another five years before selling the asset. This is where the delay comes in. They must wait until at least 2006 to actually realize any tax savings.

## Additional Resources

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*Taxes for Dummies 2002.* Tyson, Eric, David J. Silverman. Hungry Minds, Inc., 2001.

## Organizations

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