Capital Gains Tax

It is often said that "patience is a virtue," and it seems the government couldn't agree more; the current U.S. tax code offers favorable rates to those who hold their investments for extended lengths of time. As with most tax benefits, however, the additional rules can make tax planning more difficult. Understanding how capital gains taxes work and knowing when they are relevant can be a major part of successful financial planning.

Capital Gains

Simply put, "capital gains" are the profits earned on the sale of assets that have grown in value from their trait of capital gains is their long-term tax rates, which can be much lower than the standard income tax rates. The government implemented these lower rates as a way to encourage people to invest in businesses and grow their money for the future.

Investments that are considered capital assets include public stocks, bonds, real estate, collectibles and appreciating property. All of these assets can qualify for different tax rates, depending on how long they are held. Assets held for less than a year are commonly referred to as "short-term investments," while those that are held for more than a year are called "long-term investments." Typically, the government only allows long-term investments to qualify for lower taxes.

It should be noted that qualified investment dividends are not technically considered capital gains. However, many people group the two together because qualified dividends are taxed at the same rate as capital gains and contribute to an investor's "unearned income."

What are Capital Gains Tax Rates?

While short-term gains are taxed at the same rate as income, long-term gains fall under a wide range of tax rates depending on things like income tax rates and the type of capital asset held. The accompanying table shows the tax rates applicable to most capital assets.

How are Capital Gains Determined?

Calculating capital gains is a relatively simple process of subtracting an asset's purchase price (called its "basis") from its sale price. If the sale price is larger than the basis, the difference is a capital gain. If, however, the asset decreased in value and is sold for less than its basis, the difference is a "capital loss." When an investor sells more than one asset during the year, he or she adds all capital gains and capital losses of the same type (short-term gains with short-term losses, long-term gains with long-term losses). The totals are then taxed at their appropriate rates. If one investment type totals a gain and another type totals a loss, the loss can be used to reduce the value of the gain, ensuring the investor is not taxed for more income than was actually realized. The remaining net

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Income tax bracket(s)*	Short-term capital gains tax on all assets	Long-term gains tax on securities (stocks and bonds) and property	Long-term gains tax on collectibles (art, coins, etc.)
10% and 15%	Same as income tax	0%	28%
25% and 28%	Same as income tax	15%	28%
33% and 35%	Income tax + 3.8%	18.8%	31.8%
39.6%	Income tax +3.8%	23.8%	31.8%

*The rates of the three highest income brackets include a 3.8 percent Medicare tax on unearned income.

gain is taxed at the rate appropriate for its source.

If an investor has a net loss, it can be used to reduce his or her taxable income by as much as $3,000 a year. If a loss exceeds this amount, the excess can be rolled over from year to year to reduce the taxes on future gains or income. However, investors should be aware of the "wash sale rule," an IRS regulation that prohibits claiming a capital loss if a "substantially identical" asset is purchased within 30 days of the loss sale. Effectively, the wash sale rule prevents investors from obtaining the tax benefits of a temporary loss when they intend to repurchase and hold the asset.

In some circumstances, capital gain is not determined using an asset's original basis but rather its value when its ownership was transferred. This most often occurs during estate transfers when an asset's basis is "stepped up" in value before being passed to an inheritor. This process effectively erases the original basis and creates a new one (determined by the current fair market value of the asset). The new, higher basis may increase estate taxes, but it will lower the capital gains taxes the inheritor must pay when the asset is sold.

This step up in the basis can be particularly important when it comes to property transferred to surviving spouses. When a spouse dies, his or her property automatically receives a step up in its basis value. Since a person can make a tax-free transfer of unlimited value to his or her spouse at death, property passing to the surviving spouse effectively gets a free upgrade in its basis. This can be a major boon to a survivor, who will be able to keep more of the profits if it becomes necessary to sell off property.

Avoiding Capital Gains Tax

Strictly speaking, very few appreciating assets can escape capital gains tax. The three most common cases of capital gains tax reduction involve tax-advantaged retirement accounts, charitable donations of appreciated assets and the sale of a primary residence.

Using a tax-advantaged account is the capital gains tax strategy familiar to most people. Government-designated retirement accounts, like IRAs and 401(k)s, allow investments to grow tax free (although distributions are taxed as income), increasing the speed at which retirement wealth builds. Of course, since the government does not want exorbitant amounts of capital going untaxed, these retirement accounts have limits on annual contribution amounts.

When appreciated assets are given directly to a charity, no taxes are assessed on the assets. The charity pays no taxes on the gift, and the donor receives an income deduction equal to the current value of the gift (the deduction is limited to 20 or 30 percent of the donor's income). If the assets were first sold and then donated as cash, the donor would have to pay capital gains taxes out of the profits before making the donation. Paying such taxes lowers the amount the charity receives and usually reduces the size of the donor's income tax deduction.

In the case of selling a primary residence, the government exempts the first $250,000 (or $500,000 for married filing jointly) of profits from capital gains tax, provided the house has been used as a primary residence for at least two of the past five years. Though this might seem to be a huge exemption, it is meant to give people flexibility when moving and protect them from inflationary price increases. For instance, a person living in the same house for over 30 years may see their home value triple from nothing more than average inflation.

For investment properties, Section 1031 of the IRS code allows individuals to defer (but not reduce) the tax on the gains from a sale of some property if the money goes to fund a new investment property. This allows a property investment to continue to grow, even when a current property peaks in value and its investor needs to seek an investment in a new building.

Complexities

Capital gains taxes can be extremely technical and have many nuances not listed here. Failure to report capital gains or accidentally filing false information on tax forms can lead to surprising tax obligations or even a tax audit. If you hold a considerable amount in capital assets, it is recommended that you seek professional help when dealing with your taxes. ■