**8556. What is the netting process used to determine whether the taxpayer has a capital gain or loss?**

The complex rules applicable to capital gains taxation essentially establish four different types of capital assets. These groups of capital assets are:

(1) short-term capital assets, with no special tax rate;

(2) 28 percent capital assets, generally consisting of collectibles gain or loss, and IRC Section 1202 gain;

(3) 25 percent capital assets, consisting of assets that generate unrecaptured IRC Section 1250 gain; and

(4) all other long-term capital assets, which are taxed according to the taxpayer’s income tax bracket: 20 percent (39.6 percent income tax bracket), 15 percent (25, 28, 33, or 35 percent income tax brackets), and 0 percent capital assets for taxpayers in the 15 and 10 percent tax brackets.

Within each group, gains and losses must be netted. Generally, if, as a result of this process, there is a net loss from asset-group “(1),” it is applied to reduce any net gain from groups “(2),” “(3),” or “(4),” in that order. If there is a net loss from group “(2),” it is applied to reduce any net gain from groups “(3)” or “(4),” in that order. If there is a net loss from group “(4),” it is applied to reduce any net gain from groups “(2)” or “(3),” in that order.[[1]](#footnote-1)

If net capital losses result from the netting process described above, up to $3,000 ($1,500 in the case of married individuals filing separately) of losses can be deducted against ordinary income.[[2]](#footnote-2) Any losses that are deducted would be treated as reducing net loss from groups “(1),” “(2),” or “(4),” in that order.

If there are net gains, such gains would generally be taxed as described above and discussed in Q 8544 and Q 8545.

If the taxpayer has capital gains and capital losses from investment property as well as gains and losses from section 1231 business property (depreciable property used in a trade or business and held for more than one year), the latter gains and losses netted against each other. If the netting results in a net gain, the gain is treated as if it were a long-term capital gain and included in the netting process for capital gains in group (4). On the other hand, if the netting results in a net loss from Section 1231 assets, this net loss is fully deductible as an ordinary loss and not subject to capital gain and loss netting.

*Example:* Claire, an attorney, sold 500 shares of stock gain recognizing a $1,500 long-term capital gain and 200 shares of stock recognizing a $300 short-term capital gain. In the same year she sold an oriental rug used in her home for the past 5 years at a loss of $700 and a rental property, owned for 9 months, for a short-term capital loss of $5,000. From her office she sold a computer system (a section 1231 asset) at a loss of $1,200 and a set of law books (a section 1231 asset) at a gain of $200. Both of these had been used in her practice for more than one year.

Claire’s various gains and losses ("G/L") must first be grouped according to the following column headings and a net total computed for each group:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Long-Term Capital G/L** | **Short-Term Capital G/L** | **IRC 1231 Business Assets** |
| 500 shares of stock | 1,500 |  |  |
| 200 shares of stock  |  | 300 |  |
| oriental rug \* | --- | --- | --- |
| rental property  |  | (5,000) |  |
| computer  |  |  | (1,200) |
| law books |  |  | 200 |
|  Net totals  | 1,500 | (4,700) | (1,000) |
| \* No loss deduction is allowed for the oriental rug since it was held for personal use.[[3]](#footnote-3) |

Because the netting of the section 1231 assets resulted in a net $1,000, it is treated as a fully deductible ordinary loss and not subject to further netting. Netting short-term capital gain against short-term capital loss results in a net short-term capital loss of $4,700. That amount is netted against Claire’s net long-term gain of $1,500 resulting in a net short-term loss of $3,200. Capital losses in excess of capital gains are deductible only to the extent of $3,000. The remaining $200 capital loss is carried forward to subsequent tax years subject to the same rules.

**8556.02 What is the tax significance of short-term capital gain?**

 Although as discussed in Q 8556 above, like long-term capital gain, short-term capital gain is netted against capital losses, net short-term capital gain is *not* subject to the preferential capital gains rates. Instead, such gain is taxed as ordinary income (up to 39.6%).

1. . IRC Sec. 1(h)(1), as amended by ATRA; Notice 97-59, 1997-2 CB 309. [↑](#footnote-ref-1)
2. . IRC Sec. 1211(b). [↑](#footnote-ref-2)
3. . IRC Sec. 165. [↑](#footnote-ref-3)