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*For tax years beginning in 2013 and beyond, adjusted net capital gain* is generally subject to a maximum rate of 0 percent for taxpayers in the 10 and 15 percent tax brackets, a maximum rate of 15 percent for taxpayers in the 25 percent, 28 percent, 33 percent, and 35 percent tax brackets, and, beginning in 2013, a maximum rate of 20 percent for taxpayers in the 39.6 percent tax bracket. However, detailed rules as to the exact calculation of the capital gains tax result in some exceptions.[[1]](#footnote-1)

“Adjusted net capital gain” is *net capital gain* reduced (but not below zero) by the sum of: (1) *unrecaptured IRC Section 1250 gain*; and (2) *28 percent rate gain* (both defined below); *plus* (3) “qualified dividend income” (as defined in IRC Section 1(h)(11)(B)).[[2]](#footnote-2)

Gain is determined by subtracting the adjusted basis of the asset sold or exchanged from the amount realized. Loss is determined by subtracting the amount realized from the adjusted basis of the asset sold or exchanged. The amount realized includes both money and the fair market value of any property received.[[3]](#footnote-3) Gains and losses from the sale or exchange of capital assets are either short-term or long-term. Generally, in order for gain or loss to be long-term, the asset must have been held for more than one year.

Generally, taxpayers may elect to treat a portion of net capital gain as investment income.[[4]](#footnote-4) If the election is made, any net capital gain included in investment income will be subject to the taxpayer’s marginal income tax rate. The election must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized. The election is to be made on Form 4952, “Investment Interest Expense Deduction.”[[5]](#footnote-5)

*Net capital gain* is the excess of net long-term capital gain for the taxable year over net short term capital loss for such year.[[6]](#footnote-6) However, net capital gain for any taxable year is reduced (but not below zero) by any amount the taxpayer takes into account under the investment income exception to the investment interest deduction.[[7]](#footnote-7)

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The Code provides that for a taxpayer with a net capital gain for any taxable year, the tax will not exceed the *sum* of the following six items:

A. the tax computed at regular rates (without regard to the rules for capital gain) on the *greater* of (i) taxable income reduced by the net capital gain, or (ii) the *lesser* of (I) the amount of taxable income taxed at a rate below 25 percent, *or* (II) taxable income reduced by the adjusted net capital gain;

B. 0 percent of so much of the taxpayer’s adjusted net capital gain (or, if less, taxable income) as does not exceed the *excess* (if any) of (i) the amount of taxable income that would (without regard to this paragraph) be taxed at a rate below 25 percent *over* (ii) the taxable income reduced by the adjusted net capital gain;

C. 15 percent of the lesser of (i) so much of the taxpayer’s adjusted net capital gain (or, if less, taxable income) as *exceeds* the amount on which a tax is determined under (B), above, or (ii) the *excess* of (I) the amount of taxable income which would be taxed at below 39.6 percent *over* (II) the sum of the amounts on which a tax is determined under (A) and (B), above;

D. 20 percent of the taxpayer’s adjusted net capital gain (or, if less, taxable income) in *excess* of the sum of the amounts on which tax is determined under (B) and (C), above;

E. 25 percent of the *excess* (if any) of (i) the unrecaptured IRC Section 1250 gain (or, if less, the net capital gain (determined without regard to qualified dividend income)), *over* (ii) the *excess* (if any) of (I) the sum of the amount on which tax is determined under (A) above, *plus* the net capital gain, *over* (II) taxable income; *and*

F. 28 percent of the amount of taxable income in *excess* of the sum of the amounts on which tax is determined under (A) through (E) above.[[8]](#footnote-8)

It is important to note that as a result of this complex formula, generally, the maximum capital gains rate on *adjusted net capital gain* for 2013 (and beyond) will be 20 percent to the extent an individual is taxed at the 39.6 percent income tax rate, 15 percent to the extent an individual is taxed at the 25, 28, 33 or 35 percent income tax rates, and 0 percent to the extent the individual is taxed at the 15 percent or 10 percent income tax rates.[[9]](#footnote-9)

IRC Section 1250 provides for the recapture of gain on certain property on which accelerated depreciation has been used. “Unrecaptured IRC Section 1250 gain” means the excess, if any, of: (i) that amount of long-term capital gain (not otherwise treated as

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ordinary income) that would be treated as ordinary income if IRC Section 1250(b)(1) included all depreciation and the applicable percentage under IRC Section 1250(a) were 100 percent; over (ii) the excess, if any of (a) the sum of collectibles loss, net short-term capital loss and long-term capital loss carryovers, over (b) the sum of collectibles gain and IRC Section 1202 gain. However, at no time may the amount of unrecaptured IRC Section 1250 gain that is attributable to sales, exchanges and conversions described in IRC Section 1231(a)(3)(A) for any taxable year exceed the net IRC Section 1231 gain, as defined in IRC Section 1231(c)(3) for such year.[[10]](#footnote-10)

“28 percent rate gain” means the excess, if any, of (A) the sum of collectibles gain and IRC Section 1202 gain (i.e., gain on certain small businesses), over (B) the sum of (i) collectibles loss, (ii) net short-term capital loss, and (iii) long-term capital loss carried over under IRC Section 1212(b)(1)(B) (i.e., the excess of net long-term capital loss over net short-term capital gain, carried over to the succeeding taxable year).[[11]](#footnote-11)

“Collectibles gain or loss” is gain or loss on the sale or exchange of a collectible that is a capital asset held for more than one year, but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.[[12]](#footnote-12) Examples of collectibles include artwork, gems and coins.[[13]](#footnote-13)

“IRC Section 1202 gain” means the excess of (A) the gain that would be excluded from gross income under IRC Section 1202 but for the percentage limitation in IRC Section 1202(a) over (B) the gain excluded from gross income under IRC Section 1202 (i.e., 50 percent exclusion for certain qualified small business stock).[[14]](#footnote-14) (JGTRRA 2003 provides that for alternative minimum tax purposes, an amount equal to 7 percent of the amount excluded from gross income for the taxable year under IRC Section 1202 will be treated as a preference item.[[15]](#footnote-15))

The foregoing rules essentially establish four groups of capital assets (based upon pre-existing tax rates):

(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;

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

(4) 20 percent (in tax years beginning after 2012 for taxpayers in the 39.6 percent income tax bracket)/15 percent (for taxpayers in the 25, 28, 33, or 35 percent income tax brackets) /0 percent capital assets (i.e., 0 percent for taxable years beginning after 2007, and 5 percent for 2003 through 2007) for taxpayers in the 15 and 10 percent tax brackets, consisting of all other long-term capital assets.

Within each group, gains and losses are netted. The effect of this process is generally that if there is a net loss from (1), it is applied to reduce any net gain from (2), (3), or (4), in that order. If there is a net loss from (2) it is applied to reduce any net gain from (3) or (4), in that order. If there is a net loss from (4), it is applied to reduce any net gain from (2) or (3), in that order.[[16]](#footnote-16)

After all of the netting above, if there are net losses, up to $3,000 ($1,500 in the case of married individuals filing separately) of losses can be deducted against ordinary income.[[17]](#footnote-17) Apparently, any deducted loss will be treated as reducing net loss from (1), (2), or (4), in that order. Any remaining net losses can be carried over to other taxable years, retaining its group classifications. If there are net gains, such gains will generally be taxed as described above.

Generally, to the extent a capital loss described above exceeds the $3,000 limit ($1,500 in the case of married individuals filing separately); it may be carried over to other taxable years, but always retaining its character as long-term or short-term. However, special rules apply in determining the carryover amount from years in which a taxpayer has no taxable income.[[18]](#footnote-18)

Collectibles gain and IRC Section 1250 gains under IRC Section 1(h) are subject to special rules when an interest in a pass-through entity (i.e., partnership, S corporation, or trust) is sold or exchanged. Regulations finalized in 2000 provide rules for dividing the holding period of an interest in a partnership.[[19]](#footnote-19)

Special rules apply in the case of wash sales, short sales , and IRC Section 1256 contracts.

*NOTE*: Beginning in 2013, taxpayers may also have to account for the 3.8% tax on investment-type income and gains under Code Section 1411.

1. . IRC Sec. 1(h), as amended by ATRA. [↑](#footnote-ref-1)
2. . IRC Sec. 1(h)(3). [↑](#footnote-ref-2)
3. . IRC Sec. 1001. [↑](#footnote-ref-3)
4. . See IRC Secs. 163(d)(4)(B), 1(h)(2). [↑](#footnote-ref-4)
5. . Treas. Reg. §1.163(d)-1. [↑](#footnote-ref-5)
6. . IRC Sec. 1222(11). [↑](#footnote-ref-6)
7. . IRC Secs. 163(d)(4)(B)(iii), 1(h)(2). [↑](#footnote-ref-7)
8. IRC Secs. 1(h)(1)(D); 1(h)(1)(A), 1(h)(1)(B), IRC Secs. 1(h)(1)(C), 1(h)(1)(E), as amended by ATRA 2012. [↑](#footnote-ref-8)
9. IRC Sec. 1(h). [↑](#footnote-ref-9)
10. IRC Sec. 1(h)(6). [↑](#footnote-ref-10)
11. IRC Sec. 1(h)(4). [↑](#footnote-ref-11)
12. IRC Sec. 1(h)(5). [↑](#footnote-ref-12)
13. See IRC Sec. 408(m)(2). [↑](#footnote-ref-13)
14. IRC Sec. 1(h)(7). [↑](#footnote-ref-14)
15. IRC Sec. 57(a)(7). [↑](#footnote-ref-15)
16. IRC Sec. 1(h)(1), as amended by ATRA; Notice 97-59, 1997-2 CB 309. [↑](#footnote-ref-16)
17. IRC Sec. 1211(b). [↑](#footnote-ref-17)
18. IRC Secs. 1211(b), 1212(b). [↑](#footnote-ref-18)
19. See TD 8902, 2000-2 CB 323. [↑](#footnote-ref-19)