Capital Gains and Losses

Individuals, Estates, and Trusts[1]

The Internal Revenue Code[2] has long distinguished between income paid due to a person's individual effort (such as wages or self-employment earnings), and income received from the profitable sale of assets known as "capital" assets. Wages and salaries are classified as "ordinary" income. Gain from the sale of a capital asset is termed a "capital" gain. Gains from the sale of capital assets that meet certain requirements are generally accorded more favorable tax treatment than ordinary income.

Basic Terminology

There are several concepts essential to understanding capital gains and losses.

- **Capital asset:** The law defines the term "capital" asset in a negative sense by first declaring that all types of property are capital assets, and then listing certain exceptions. (See IRC Sec. 1221.) Assets such as stocks, bonds and other securities held by individuals are capital assets. In general terms, assets that are held for investment purposes are capital assets. Some assets are not capital assets by definition, but may be treated as such if used in a trade or business, and sold or exchanged at a gain.
- **Holding period:** This is the length of time an asset is owned, beginning on the day after it is acquired and ending on the day it is disposed of. The amount of time an asset has been held impacts the tax treatment of any gain or loss when the asset is sold. The law currently provides for two holding periods: short-term and long-term. Generally, short-term assets are those held exactly 12 months or less. Long-term assets are those generally held more than 12 months.

Capital Losses

At the end of a tax year, a taxpayer's capital gains and losses are totaled and compared. If losses exceed gains, a taxpayer may use up to $3,000 of losses to offset other ordinary income ($1,500 if married filing separately). See IRC Sec. 1211(b). Losses that exceed the $3,000 limit may be carried to future tax years until used up. If a taxpayer dies, any un-used capital loss is gone forever; it may not be carried over to future tax years.

[1] Corporate taxpayers are subject to different rules regarding capital gains.

[2] The discussion here concerns federal income tax law; state or local income tax law may differ.

Capital Gains

Ordinary income such as wages and salaries can be taxed at marginal federal income tax rates as high as 37.0% Short-term capital gains are treated as ordinary income, taxable at the taxpayer's highest rate. Long-term capital gains are taxed at rates which are capped, and which may be less than a taxpayer's regular rate.

Long-Term Capital Gains Tax Rates

Prior to the Tax Cuts and Jobs Act of 2017, the tax rate applied to individual long-term capital gains was linked to two factors:

- **Taxpayer's income tax bracket -**Those with a marginal tax bracket of less than 15.0% (Tier I) paid tax on capital gains at a 0.0% rate. Taxpayers with a marginal tax bracket between 15.0% and 39.6% (Tier II) paid tax on capital gains at a 15.0% rate. Finally, those with a marginal tax rate of 39.6% (Tier III) paid tax on capital gains at a 20% rate.

- **Type of capital gain –** By statute, real estate depreciation treated as capital gain was taxed at a 25.0% rate and gain from the sale of collectibles was taxed at a 28.0% rate.

The Tax Cuts and Jobs Act of 2017 (JCTA), effective for 2018 – 2025, changed the individual income tax rate structure[1]. Under prior law, individuals paid tax at marginal rates that included 10.0%, 15.0%, 25.0%, 28.0%, 33.0%, 35.0%, and 39.6%. TCJA introduced a tax rate structure that included marginal rates of 10.0%, 12.0%, 22.0%, 24.0%, 32.0%, 35.0%, and 37.0%.

TCJA generally retained the prior-law maximum rates on long-term capital gains. However, rather than linking the capital gains tax rates to the new tax rate structure, TCJA retained the 2017 dollar breakpoints for the 15.0% bracket and the 20.0% bracket and indexed them for inflation. The table on the following page shows the capital gains tax rates applicable at various levels of taxable income in 2019 and 2020.

[1] Under the TCJA, the individual income tax rate structure applicable in 2017 will return for tax years after 2025.

Item	2019 Breakpoint	2020 Breakpoint	Capital Gains Rate
Tier I	Taxable income *less than*: Single: $39,376; HoH: $52,751; MFJ: $78,751; MFS: $39,376	Taxable income *less than*: Single: $40,001; HoH: $53,601; MFJ: $80,001; MFS: $40,001	0%
Tier II	Taxable income less *than*: Single: $434,551; HoH: $461,701; MFJ: $488,851; MFS: $244,426.	Taxable income *less than*: Single: $441,451; HoH: $469,051; MFJ: $496,601; MFS: $248,301	15%
Tier III	Taxable income *equal to or more than*: Single: $434,551; HoH: $461,701; MFJ: $488,851; MFS: $244,426.	Taxable income *equal to or more than*: Single: $441,451; HoH: $469,051; MFJ: $496,601; MFS: $248,301.	20%
Real estate depreciation treated as capital gain[1]	N/A	N/A	25%
Sale of Collectibles	N/A	N/A	28%

Special Rules for Personal Residence

Under current law, a taxpayer may exclude from income up to $250,000 of gain from the sale of a principal residence, if the taxpayer has owned and used the property as his or her principal residence for at least two years of the five-year period ending on the date of the sale or exchange. Only one such exclusion is permitted every two years.

For married couples filing a joint return, the maximum exclusion amount is increased to $500,000 if (a) either spouse meets the ownership requirement; (b) both spouses meet the use requirements, and (c) neither spouse is ineligible because of the one sale every two years rule. If a married couple does not meet the requirements for the $500,000 exclusion, the amount of gain eligible for exclusion is the sum of the amounts to which each spouse would be entitled if they had not been married.

[1] Gain in excess of recaptured depreciation is taxed at the taxpayers's regular capital gains rate.

The surviving spouse of a couple who had jointly owned and occupied a residence and who met the general requirements discussed above immediately before the deceased spouse's death, may exclude up to $500,000 of gain as long as the sale of the residence takes place within two years of the date of the deceased spouse's death.

The law also provides for a reduced maximum exclusion for taxpayers who do not meet the requirements to qualify for the full $250,000 ($500,000 if married) exclusion, and who sell or exchange a principal residence because of changes in place of employment, health, or unforeseen circumstances.

Beginning with sales or exchanges after January 1, 2009, gain from the disposition of a principal residence attributable to periods of "nonqualified use" is not excluded from gross income. Nonqualified use, generally, is a period of time (beginning on or after January 1, 2009) when the property is not used by the taxpayer or the taxpayer's spouse (or former spouse) as a principal residence. Common examples of such nonqualified use include use of the property as a rental or vacation home.

A member of the U.S. armed forces, U.S. Foreign Service, Peace Corps volunteers, or specified members of the intelligence community serving on qualified extended duty may choose to suspend the five-year period of use and ownership for up to 10 years.

An individual who acquires his or her principal residence in an IRC Sec. 1031 "like-kind-exchange" must own the property for five years before the exclusion applies.

Timing of Capital Gains Transactions

Note that a taxpayer generally controls when a capital asset will be sold and can, therefore, choose the year in which a gain or loss is to be included in his or her taxable income.

Seek Professional Guidance:

The income tax treatment of capital gains and losses is complex and often confusing. Individuals facing decisions concerning the tax implications of the sale or exchange of a capital asset are strongly advised to first consult with a CPA, IRS enrolled agent, or other competent professional.