Taxes Tax Laws & Regulations - Capital Gains Tax

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What Is Capital Gains Tax?
Capital gains tax is a levy assessed on the positive difference between the sale price of the asset and its original purchase price. Long-term capital gains tax is a levy on the profits from the sale of assets held for more than a year. The rates are 0%, 15%, or 20%, depending on your tax bracket. Short-term capital gains tax applies to assets held for a year or less and is taxed as ordinary income.

Capital gains can be reduced by deducting the capital losses that occur when a taxable asset is sold for less than the original purchase price. The total of capital gains minus any capital losses is known as the "net capital gains."

Tax on capital gains is triggered only when an asset is sold, or "realized." Stock shares that appreciate every year will not be taxed for capital gains until they are sold, no matter how long you happen to hold them.

Capital Gains Tax

Capital Gains Tax Rates 2019
The profit on an asset sold after less than a year of ownership is generally treated for tax purposes as if it were wages or salary. Such gains are added to your earned income or ordinary income. You're taxed on the short-term capital gain at the same rate as for your regular earnings. An exception is when the amount of the gain happens to push you into a higher marginal tax bracket.

The same applies to dividends paid by an asset, which aren't capital gains but do represent a profit. In the U.S., dividends are taxed as ordinary income for taxpayers who are in the 15% and higher tax brackets.

KEY TAKEAWAYS

- Capital gains tax is only paid on realized gains after the asset is sold
- Capital gains treatment only applies to “capital assets” such as stocks, bonds, jewelry, coin collections, and real estate property
- The IRS taxes all capital gains but has different tax approaches for long-term gains vs. short-term gains
- Taxpayers can use strategies to offset capital gains with capital losses in order to lower their capital gains taxes

A different system applies, however, for long-term capital gains. The tax you pay on assets held for more than a year and sold at a profit varies according to a rate schedule based on income thresholds. For 2019, those rates are shown in the table below:

TAX RATES FOR LONG-TERM CAPITAL GAINS			
Filing Status	**0%**	**15%**	**20%**
Single	Up to $39,375	$39,376 to $434,550	Over $434,550
Head of household	Up to $52,750	$$52,751 to $461,700	Over $461,700
Married filing jointly and surviving spouse	Up to $78,750	$78,751 to $488,850	Over $488,850
Married filing separately	Up to $39,375	$39,376 to $244,425	Over $244,425

Here's how much you'll pay in 2019 on the gains from taxable assets you've held for a year or more.

The tax rates for long-term capital gains are consistent with the trend to capital gains being taxed at lower rates than individual income, as this chart from the Tax Policy Center demonstrates.

Special Capital Gains Rates and Exceptions
Some categories of assets get different capital-gains treatment than the norm.

Collectibles

Gains on collectibles, including art, antiques, jewelry, precious metals, and stamp collections, are taxed at a 28% rate, regardless of your income. So, if you're in a lower bracket than 28%, you'll be levied at this higher tax rate. If you're in a tax bracket with a higher rate, your capital gains taxes will be limited to the 28% rate.

Owner-Occupied Real Estate

Real estate capital gains are taxed under a different standard if you're selling your principal residence. Here's how it works: $250,000 of an individual's capital gains on the sale of a home are excluded from taxable income ($500,000 for those married filing jointly). This applies so

long as the seller has owned and lived in the home for two years or more. However, unlike with some other investments, capital losses from the sale of personal property, such as a home, are not deductible from gains.

Here's how it can work. A single taxpayer who purchased a house for $200,000 and later sells his house for $500,000 had made a $300,000 profit on the sale. After applying the $250,000 exemption, he must report a capital gain of $50,000, which is the amount subject to the capital gains tax. In most cases, significant repairs

and improvements can be added to the base cost of the house, thus reducing even more the amount of taxable capital gain.

Investment Real Estate

Investors who own real estate are often allowed to take depreciation deductions against income to reflect the steady deterioration of the property as it ages. (This decline in the home's condition is unrelated to a possible appreciation in the value of the entire property driven by the real-estate market.)

The deduction for depreciation essentially reduces the amount you're considered to have paid for the property in the first place. That in turn can increase your taxable capital gain if you sell the property. That's because the gap between the property's value after deductions and its sale price will be greater.

For example, if you paid $100,000 for a building and you're allowed to claim $5,000 in depreciation, you'll be treated subsequently as if you'd paid $95,000 for the building. The $5,000 is then treated in a sale of the real estate as recapturing those depreciation deductions. The tax rate that applies to the recaptured amount is 25%. So, if the person then sold the building for $110,000, there would be total capital gains of $15,000. Then, $5,000 of the sale figure would be treated as a recapture of the deduction from income. That recaptured amount is taxed at 25%. The remaining $10,000 of capital gain would be taxed at one of the 0%, 15%, or 20% rates indicated above.

Investment Exceptions

You may be subject to another levy, the net investment income tax, if your income is high. This tax imposes an additional 3.8% of taxation on your investment income, including your capital gains, if your modified adjusted gross income (not your taxable income) exceeds certain maximums. Those threshold amounts are $250,000 if married and filing jointly, or a surviving spouse; $200,000 if you’re single or a head of household; and $125,000 if married, filing separately.

Investors who are near retirement should plan carefully when selling profitable assets to make sure they don't raise their taxes through paying capital gains tax.
Computing Your Capital Gains

Capital losses can be deducted from capital gains to yield your taxable gains, if any, for the year. The calculations become more complex, though, if you've incurred capital gains and capital losses on both short-term and long-term investments.

First, it's necessary to add all like-kind gains and losses together. All short-term gains must be reconciled to yield a total short-term gain. Then the short-term losses are totaled. Finally, long-term gains and losses are tallied.

The short-term gains are netted against the short-term losses to produce a net short-term gain or loss. The same is done with the long-term gains and losses. Finally, these two numbers, for the short-term and long-term, are reconciled to produce the final net capital gain (or loss) that is reported on the tax return.

Most individuals figure their tax (or have pros do it for them) using software that automatically makes computations. But you can use a capital gains calculator to get a rough idea of what you may pay on a potential or actualized sale.

Capital Gains Tax Strategies

The capital gains tax effectively reduces the overall return generated by the investment, of course. But there is a legitimate way for some investors to reduce or even eliminate their net capital gains taxes for the year.

The simplest of strategies is to simply hold assets for more than a year before selling them. That's wise because the tax you will pay on long-term capital gains is generally lower than for short-term gains.

1. Use Any Excess in Capital Losses in Other Ways

Capital losses will offset capital gains and effectively lower capital gains tax for the year. But what if the losses are greater than the gains? Two options are open. If losses exceed gains by up to $3,000, you may claim that amount against your income. The loss even rolls over, and any excess loss not used in the current year can be deducted from income to reduce your tax liability in future years.

Let's consider the example of an investor who realized a gain of $5,000 from the sale of some securities, while also incurring a loss of $20,000 from selling others. The capital loss can be used to cancel out tax liability for the $5,000 gain. The remaining capital loss of $15,000 can then be used to offset income, and thus the tax on those earnings. If the investor's annual income is $50,000, they can, in the first year, report $50,000 minus a maximum annual claim of $3,000. That makes a total of $47,000 in taxable income. The investor still has $12,000 of capital losses and so could deduct the $3,000 maximum from their taxable income for the next four years.

However, be mindful of selling securities at a loss to realize a tax advantage, before turning around and buying much the same investment all over again. If you do that within 30 days or less, you could run afoul of the IRS wash-sale rule against such a sequence of transactions.

Material capital gains of any kind must be reported to the IRS on a Schedule D form. Consider enlisting the help of an accountant or other financial advisor.

Capital losses can be rolled forward to subsequent years to reduce any income in the future and lower a taxpayer's tax burden.

2. Use Tax-Advantaged Retirement Plans
Among the many reasons to hold retirement plans, including 401(k)s, 403(b)s, Roth IRAs and traditional IRAs, is that your investments grow within them without being subject to capital gains tax. In other words, within a retirement plan, you can buy and sell without losing a cut to Uncle Sam.

Additionally, most plans do not require participants to pay tax on the funds until they are withdrawn from the plan. That said, distributions are taxed as ordinary income regardless of the underlying investment. Taking money out of the plan at retirement means you'll likely be in a lower tax bracket. Your money will also have grown in a tax-free environment.

3. Time Gains Around Retirement
As you actually approach retirement, consider waiting until you actually stop working to sell profitable assets. The capital gains tax bill might be reduced if your retirement income is low enough. You may even be able to avoid having to pay capital gains tax at all. In short, be mindful of the impact of taking the tax hit when working rather than after you're retired. Realizing the gain earlier might serve to bump you out of a "no-pay" bracket and cause you to incur a tax bill on the gains.

4. Watch Your Holding Periods
Remember that a security must be sold after more than a year to the day in order for the sale to qualify for treatment as a long-term capital gain. If you are selling a security that was bought about a year ago, be sure to find out the actual trade date of the purchase. You might be able to avoid its treatment as a short-term capital gains if you wait to sell for a few days.

These timing maneuvers will matter more with large trades than small ones, of course. The same applies if you are in a higher tax bracket rather than a lower one.

5. Pick Your Basis
You will typically use the first in, first out (FIFO) method to calculate cost basis when you acquire shares in the same company or mutual fund at different times. However, there are four other methods to choose from: last in, first out (LIFO), dollar value LIFO, average cost (only for mutual fund shares) and specific share identification. The best choice will depend on several factors, such as the basis price of shares or units that were purchased and the amount of gain that will be declared. You may need to consult a tax advisor for complex cases. Computing cost basis can be a tricky proposition. Finding out when a security was purchased and at what price can be a real nightmare if you have lost the original confirmation statement or other records from that time.