

Navigating the Muddied Waters of Capital Gains

The 2003 Tax Act brought further confusion to the area of capital gains. There are now more than six different tax rates at which long term capital gains can be taxed. The objective of this article is to examine how capital gains are reported and taxed on 2003 income tax returns.

The favorable rates of the Tax Act apply to long-term capital gains generated on certain types of property. First, the property sold must have been a capital asset in the hands of the Seller. The Internal Revenue Code (“the Code”) provides a definition of capital property as all property except a few categories of property that can be generalized as including property sold in the ordinary course of business and depreciable business property.

When a capital asset is sold, one has to calculate whether a capital gain or loss was realized. Not all realized capital losses can be recognized for income tax purposes, but all gains must be recognized. In tax terminology, “realized” means that a transaction occurred and “recognized” means that the transaction must be reported for income-tax purposes. Losses on personal use capital assets can not be recognized for income-tax purposes.

Once you have narrowed your capital transactions to those that must be recognized, you must determine whether the transaction is long term or short term. Long term requires a holding period of more than twelve months. For a security, one must consider the trade dates and not the settlement dates. The holding period starts that day after the purchase and ends on the sale date. Thus, a security purchased on January 1st must be held until the following January 2nd (12 months later) for the capital gain to be long term.

As a result of the Tax Act, an additional step is required for transactions that occurred in 2003. The Tax Act decreased the maximum rate applicable to certain capital gains that were realized after May 6, 2003. Consequently, one must categorize transactions based on whether they occurred prior to May 6th or after May 5th. Now that the transactions have been categorized by term and pre/post May 6th, the next step is to categorize the transactions based on how they will be taxed.

Essentially, this step requires one to carve out transactions that do not qualify for the favorable tax treatment and label them either 28% gains or 25% gains. Sales of collectibles such as stamps, antiques, gems and most coins are taxed at a maximum rate of 28%. Capital gains on sales of depreciated property are often taxed at a variety of rates depending on the amount and timing of the depreciation taken on the property. A portion of the capital gain recognized on the sale of rental real estate is often taxed at a maximum rate of 25% to the extent of the depreciation previously allowed. The 25% portion must be broken out as a separate category.

Now that the gains to be recognized have been categorized by term, pre/post May 6th, and type, you can begin the cumbersome and confusing process of netting gains and losses. First, all the pre May 6th transactions must be netted based on each of the different rate categories. Then, any net short-term capital loss is applied to reduce 28% capital gains, then 25% capital gains and then finally against 20% gains.

The same procedure now must be completed for gains realized after May 5th with the exception that the 20% gain rate is now 15% as a result of the New Tax Act. (You should also be aware that the 20% gain rate was 10% for taxpayers in the 15% bracket. Now a maximum rate of 5% applies to those 20% category gains for the taxpayers in that bracket). After all of the pre/post May 6th gains and losses have been netted, any net loss is netted against any net gain. Once this process is complete, any remaining losses can be carried over indefinitely to offset future gains and up to \$3,000 of annual income.

The common result is that a taxpayer has capital gains that are taxed at different rates, including short-term gains taxed at regular tax rates, 28% gains, 25% gains, 20% gain, and 15% gains. Obviously, this netting process is cumbersome and confusing. As always, I recommend that you seek the assistance of a Certified Public Accountant or Tax Attorney.

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