

TAX TALK
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WHAT ARE CAPITAL GAINS AND HOW ARE THEY TAXED?

There is always a great deal of discussion on capital gains and losses including special tax rates and short term and long term holding periods.

This article addresses some of the basic questions.

What Transactions Are Considered Capital Transactions?

Gains or losses resulting from the sales of capital assets are capital transactions. The Internal Revenue Code defines a capital asset as any property except:

- 1. inventory;**
- 2. depreciable or real property used in the taxpayer's trade or business;**
- 3. specified literary or artistic property;**
- 4. business accounts or notes receivable; or**
- 5. certain U.S. publications.**

The most common types of capital assets would include stocks, bonds, mutual funds and land held for investment.

What Are The Current Tax Rates on Capital Gains?

Short term capital gains are taxed at the same rates as ordinary income (somewhere between 10% and 35% depending on your tax bracket).

Long term capital gains are taxed at a maximum of 15%, but could be as low as 0% if you are in the 10% or 15% income tax brackets.

What Is The Difference Between Long Term And Short Term Capital Gains?

Assets held for 1 year or less are considered short term while assets held for more than 1 year are considered long term.

Can Capital Losses Be Used To Offset Capital Gains?

Although short term and long term capital gains are taxed at different rates, losses from one category can offset income in the other. For example if you have a \$10,000 short term capital gain and a \$5,000 long term loss, then you would be taxed on \$5,000 of gain at ordinary income tax rates.

If the situation was reversed (a \$10,000 long term gain and a \$5,000 short term loss) then you would be taxed on \$5,000 at long term capital gain rates.

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Keep in mind that although your losses can exceed your gains, you may only deduct \$3,000 of losses in excess of gains in any year. If we change the example above to a \$10,000 short term capital gain and a \$30,000 long term capital loss, then you would offset all of the \$10,000 short term gain plus an additional \$3,000 with the long term loss. Since your long term loss was \$30,000 and only \$13,000 was used, then the remaining \$17,000 is carried over to the next year's tax return.

Although capital losses can be carried forward indefinitely, they may never be carried back against prior year capital gains.

Conclusion

This article discusses capital gains and losses. While I have given a quick overview this area can be quite complex. I would encourage anyone with significant capital transactions to contact a tax professional.