A primer on capital gains

What are capital gains (or losses)?

Capital gains (or losses) result from the sale or exchange of a capital asset. Capital assets are defined in the negative; capital assets are all property **except**:

- Inventory
- property used in a trade or business or for the production of income;
- supplies used by the taxpayer in the ordinary course of business;
- copyrights or musical works in the hands of its creator or a donee of the creator;
- accounts or notes receivable;
- certain US government publications;
- hedging transactions; and
- commodities derivative financial instruments.

When most people think of capital assets, they think of property held for investment. Common examples include stocks, bonds, mutual funds, precious metals, and real estate held for investment (not rental).

When is a capital gain (or loss) short-term versus long-term? And why does it matter?

When capital assets are sold or exchanged, the gain or loss realized is either short-term or long-term. Short-term is when the capital asset is held for one year or less. Long-term is when the asset is held more than one year (i.e., a year and a day).

For individuals, capital gains are calculated separately from ordinary income. However, short-term capital gains are taxed at ordinary tax rates. Long-term capital gains are taxed at preferential marginal rates of 0%, 15%, or 20% (see table below). Capital gains are subject to the net investment income tax, which is 3.8% tax on unearned income above certain thresholds. Capital losses — both short-term and long-term — can be deducted against ordinary income but only up to $3,000 of income annually (or $1,500 if the taxpayer is married and filing a separate return).

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2021 INCOME TAX RATES							
Ordinary Income	Married Filing Jointly	Single	Trusts & Estates	Capital Gains*	Married Filing Jointly	Single	Trusts & Estates
10%	Above $0	Above $0	Above $0	0%	Above $0	Above $0	Above $0
12%	Above $19,900	Above $9,950		15%	Above $80,800	Above $40,400	Above $2,700
22%	Above $81,050	Above $40,525		20%	Above $501,600	Above $445,850	Above $13,250
24%	Above $172,750	Above $86,375	Above $2,650				
32%	Above $329,850	Above $164,925					
35%	Above $418,850	Above $209,425	Above $9,550				
37%	Above $628,300	Above $523,600	Above $13,050				

* Long term capital gains and qualified dividends

OTHER 2021 INCOME TAX AMOUNTS			
	Married Filing Jointly	Single	Trusts & Estates
Standard Deduction for Most Taxpayers	$25,100	$12,550	N/A
3.8% Net Investment Income Tax Threshold Amount	$250,000	$200,000	$13,050

For C corporations, capital gains and losses are also accounted for separately, but C corporations do not enjoy preferential rates (what's more, C Corporations are taxed at a flat 21% rather than at marginal rates). Losses from capital assets can only be offset against capital gains.

What is tax loss harvesting and the wash-sale rules?

Tax loss harvesting is selling securities to generate capital losses which can offset capital gains within an investor's portfolio. The general concept is to minimize the tax drag on an investor's portfolio. Advisers often look at tax loss harvesting when the stock market dips for asset repositioning or at the year-end.

However, one concept that can hurt investors when tax loss harvesting is the wash sale rule. A wash sale rules occurs when a security is sold at a loss and a "substantially identical" security is purchased within a 30-day window before the sale date or a 30-day window after the sale date (i.e., a sixty-one day period). Note, there is no wash sale if there is a gain; only when the sale results in a loss. Wash sales include buying and selling securities in nonqualified investment accounts and IRAs (both traditional and Roth IRAs), and between different brokers. If the investor meets the wash sale definition, the capital loss is disallowed. The result is the repurchased security will generally have a higher basis, the purchase price of the new security plus the disallowed wash sale.

What are the mechanics for calculating capital gains and losses?

Capital gains are "netted" in a series of steps, but it is generally:

1. Short-term capital gains are netted against short-term capital losses;
2. Long-term capital gains are netted against long-term capital losses; and
3. If needed,
   a. Short-term losses are netted against long-term gains; or
   b. Short-term gains are netted against long-term losses.

The net result will be a capital gain or loss.

To figure out the rate at which capital gains will be taxed, taxpayers first determine their taxable ordinary income. Then, after the taxable ordinary income is determined, the taxable gains are placed "on top" of that amount to figure out at which rate the capital gains will begin to be taxed. For example, if ordinary income is $80,000, then the first dollar of capital gains will be taxed at whatever capital gains rate applies to $80,001. And if the capital gains exceeding that amount are large enough, then a portion of that excess might very well be taxed at the next highest capital gains rate(s) too.

Examples – Using rates and rules for tax year 2021

1. **Hudson is an engineer and files as a single taxpayer. He has $80,000 of ordinary income from wages but sustains a $10,000 capital loss from the sale of mutual funds. He uses the standard deduction. What are the tax results?**
   a. Hudson's capital loss is limited to $3,000 (the amount allowed to offset ordinary income). The excess of $7,000 is carried forward to the following year.
   b. Hudson pays ordinary income tax on $64,450 ($80,000 less $12,550 [standard deduction] less $3,000 [capital loss]).
   c. Hudson's total federal tax is $9,928.

2. Hemmingway is a retiree and files as a single taxpayer. He has $500,000 of long-term capital gains from the sale of stocks and bonds and no ordinary income. He uses the standard deduction. What are the tax results?

   a. It is not the case that all his capital income is taxed at 20%, merely because he is above the $445,850 threshold.

   b. Instead, the first $40,400 is taxed at 0%. The amount between $40,400 and $445,850 ($405,450) is taxed at 15%; $60,818. The remaining amount of capital gains of $41,600 between $445,850 and $487,450 (total income, less standard deduction) is taxed at 20%; $8,320. Total capital gains tax is $69,138. For more detail, see Qualified Dividends and Capital Gain Tax Worksheet imbedded in Form 1040 Instructions.

   c. The 3.8% net investment income tax applies to the $300,000 of taxable income above $200,000, with no deduction; $11,400. For more detail, see IRS form 8960.

   d. Total federal tax for Hemmingway is $80,538.

3. Ophelia is an executive at a local company and files as a single taxpayer. She has $180,000 of ordinary income from wages and a $300,000 long-term capital gain from the sale of land. She uses the standard deduction. What are the tax results?

   a. Ophelia is taxed on her ordinary income first, followed by capital gains. This is a good thing, as it results in Ophelia going through her ordinary income tax brackets first. The capital gains are then added on top.

   b. Ophelia's ordinary income is taxed without adding in the capital gains using the marginal brackets above, less the standard deduction. In her case, $167,450 ($180,000 less $12,550 standard deduction). Going through the tax brackets, this results in an ordinary income tax of $34,487.

   c. Ophelia's capital gains are taxed using the capital gains tax table after adding her capital gains on top of her ordinary income, resulting in capital gains between $167,450 and $445,850 ($278,400) taxed at 15%; $41,760. Her capital gains between $445,850 and $467,450 ($21,600) are taxed at 20%; $4,320. Total capital gains tax is $46,080.

   d. Ophelia has $3,800 of net investment income tax ([$300,000 - $200,000] X 3.8%).

   e. Total federal tax for Ophelia is $84,367.

Conclusion

Calculating capital gains and the resulting tax can be accomplished following IRS forms and instructions. These rules are complicated in the application, but relatively easy to understand in theory. Often tax advisers will have access to tax software that makes these computations easy but understanding the underlying mechanics can be beneficial for estimating a client's tax results.

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