HOW ARE CAPITAL GAINS TAXED?

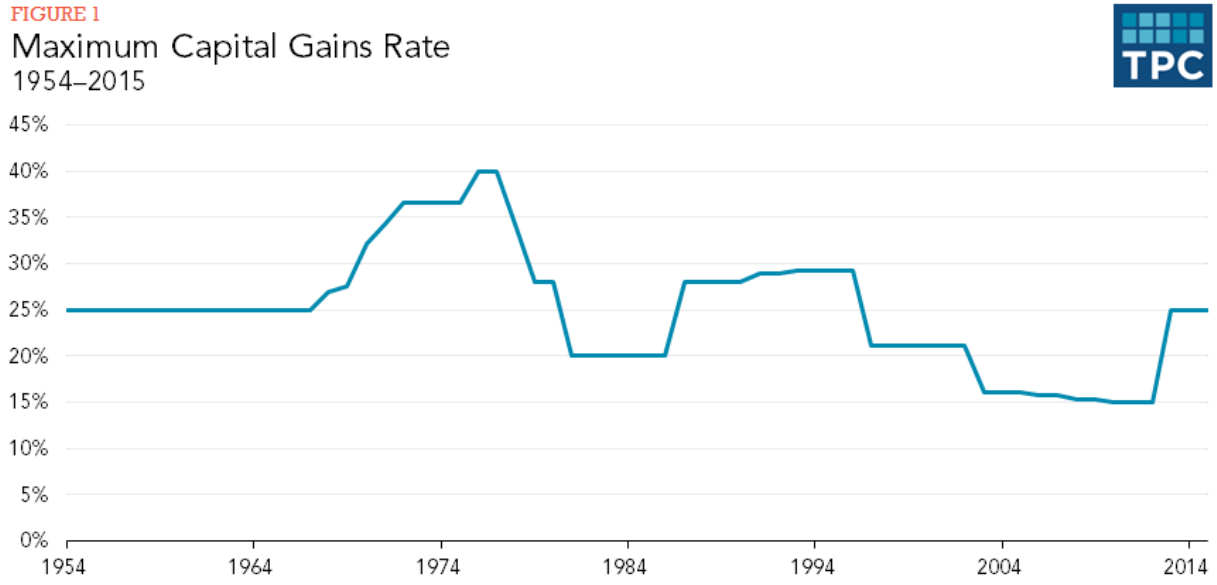
Capital gains are profits from the sale of a capital asset, such as shares of stock, a business, a parcel of land, or a work of art. Capital gains are generally included in taxable income, but in most cases are taxed at a lower rate.

Most long-term capital gains (capital gains from assets held for more than a year) face a top federal rate of 23.8 percent (including the 3.8 percent tax on net investment income) compared to a 43.4 percent rate for ordinary income. Short-term capital gains are taxed at the same rate as ordinary income. The lower maximum capital gains rate applies under both the regular income tax and the alternative minimum tax. Figure 1 below shows how the maximum long-term capital gains tax rate has changed over the years.

FIGURE 1

Maximum Capital Gains Rate

1954–2015



Sources: Department of Treasury, Office of Tax Analysis; Tax Policy Center.
Note: The maximum rate for 2013–15 includes the 3.8 percent tax on net investment income and adjusts for the phaseout of itemized deductions.

A capital gain is realized when a capital asset is sold or exchanged at a price higher than its basis. Basis is an asset's purchase price, plus commissions and the cost of improvements, minus depreciation. Similarly, a capital loss occurs when an asset is sold for less than its basis. Gains and losses (like other forms of capital income and expense) are all measured in nominal terms—that is, not adjusted for inflation.

Capital gains and losses are classified as long term if the asset was held for more than one year, and short term if held for a year or less. Taxpayers in the 10 and 15 percent tax brackets pay no tax on long-term gains on most assets; taxpayers in the 25-, 28-, 33-, or 35- percent income tax brackets face a 15 percent rate on long-term capital gains. For those in the top 39.6 percent bracket for ordinary income, the rate is 20 percent. There also is a 3.8 percent tax on net investment income for certain high-income taxpayers (e.g., married taxpayers filing jointly with a modified adjusted gross income of more than $250,000). Note, too, that capital gains in some cases face an effective tax rates above the 23.8 percent statutory rate because of phaseouts in the tax code.

Gains on art and collectibles are taxed as ordinary income up to a maximum 28 percent rate. Taxpayers may realize up to $250,000 of gains on their principal residences tax free (or up to $500,000 for married taxpayers filing jointly). Individuals may exclude up to 50 percent of capital gains on stock held for more than five years in a domestic C corporation with gross assets under $50 million on the date of the stock's issuance.

Capital losses may be used to offset capital gains, along with up to $3,000 of other taxable income. The unused portion of a capital loss may be carried over to future years.

The tax basis for an asset received as a gift equals the donor's basis. However, the basis of an inherited asset is "stepped up" to the value of the asset on the date of the donor's death. The step-up provision effectively exempts any gains on assets held until death from income tax.

C corporations pay the regular corporation tax rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.

DATA SOURCES

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