

Capital gains and losses (key rules) (Please read, and Instructor will Explain)

Certain types of income are treated differently than other types of income for purposes of computing a taxpayer's taxable income and income tax liability.

The most common types of income are:

Ordinary Income

Ordinary income is taxed at the ordinary rates.

An ordinary loss offsets ordinary income.

Capital gains and losses

These are gains or losses on the disposition or sale of capital assets. In general, capital assets are all assets *other than*

1. Accounts receivable from the sale of goods or services.
2. Inventory and other assets held for sale in the ordinary course of business.
3. Assets used in a trade or business, including land, buildings, equipment, supplies, etc.

[Note: The purchase of a building or equipment is commonly called a capital expenditure, but the tax law is funny here, those assets are not "capital assets" in the tax law. But there are exceptions that cause gains from sale of those assets to be treated as capital gains. More later]

Nonbusiness assets such as a personal-use automobile or a personal residence and assets held for investment such as stocks and bonds are capital assets.

Short-term (and Long-term) Gains and Losses

Capital gains and losses are short-term (ST), or long-term (LT -- when the taxpayer owned the capital asset for more than one year before selling).

A gain on a sale of a capital asset is generally included in gross income. If the gain is a **short-term capital gain**, the gain is taxed using **ordinary income rates**.

If the gain is a **long-term capital gain**, it is taxed at a 15% tax rate (20% for high income taxpayers and 0% for low income taxpayers).

Netting Gains and Losses

If a taxpayer has capital gains and losses, losses are netted against gains (**ST losses against ST gains**, and **LT losses against LT Gains**).

Note that even though a short-term capital gain is taxed at ordinary rates, it is still considered to be a capital gain and not ordinary income.

Assuming a taxpayer has **losses only** (or has **more losses than gains**), the net loss on the sale of a capital asset(s) [no matter how long the taxpayer held the asset before selling] generates a deduction for the taxpayer in the year of sale (a "for AGI deduction").

However, an individual's deduction for the capital loss is limited to \$3,000 for the year (losses in excess of the limit are carried forward indefinitely).

[In other words, a taxpayer with a net capital loss \$3,000 or more -- is allowed to deduct a \$3,000 loss against regular income such as salary, etc.]

If the taxpayer sells a personal-use asset (like a personal automobile or personal residence) at a loss, the loss is not deductible (because individuals only deduct losses incurred in a business, in an investment activity or from a casualty event).

Capital Gains Rates for Individuals

When a taxpayer sells more than one capital asset during the year, the gains and losses are netted together. A net loss for an individual is subject to the \$3,000 annual deduction limit. A net gain may be taxed at 15%, 20%, or 0% or at the ordinary rates depending on the outcome of the netting process and the taxpayer's taxable income.

Dividend Income Earned by Individuals

Individual shareholders receiving dividends from corporations include the dividend income in gross income. If the dividend meets the "qualified dividend" requirements, it is taxed at a rate of 15% (20% for high income taxpayers and 0% for low income taxpayers).

If a dividend does not meet the qualified dividend requirement, it is taxed at ordinary rates. Because qualified dividends (and long-term capital gains) are taxed at a preferential rate (a rate lower than the ordinary income rate), qualified dividends (and long-term capital gains) can be referred to as **preferentially taxed income**. While qualified dividends are taxed at the same rate as long-term capital gains, qualified dividends are not included in the capital gain and loss netting process.

Therefore, qualified dividend is a separate and distinct character from capital.

Corporations do not have special tax rates for capital gains. Corporations may only deduct capital losses from capital gains. Corporate capital losses are carried back 3 years and forward 5 years.