Capital Gains and Losses

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Once it is determined that there are capital gains recognized and losses allowable in the current year, it is important to determine their reporting and taxability and limitations.

Section 1(a)-(e) provide the rates for ordinary income, though they have been modified by §1(i). As of 2003, the income tax rates on ordinary income are 10%, 15%, 25%, 28%, 33% and 35%.
The range of income taxed at each bracket is more than appears in the Code due to inflation adjustments. For example, for 2002, the income for joint filers at each bracket was as follows:

Up to $12,000 10%
$12,001-$46,700 15%
$46,701-$112,850 27% (now 25%)
$112,851-$171,950 30% (now 28%)
$117,951-$307,050 35% (now 33%)
Over $307,051 38.6% (now 35%)

By contrast, for the year 2003, the rates on "net capital gain," including dividends from domestic corporations and gains from the sale of §1231 assets, are taxed at less than half the rates of ordinary income. Net capital gains (exclusive of the gains taxed at 25% and 28%) are normally taxed at 5% in situations where the taxpayer's ordinary marginal rate is 10% or 15% (i.e., below 25%) and 15% in situations where the taxpayer's ordinary marginal rate is 25% or above. Some LTCGs are taxed at higher rates, i.e., 25% and 28%, based on the type of property sold rather than the rates at which ordinary income is taxed. The 25% rate applies to a portion of the gain on the sale of depreciated real estate and the 28% rate applies to the net gain on the sale of "collectibles" and the sale of "§1202 stock" (small business stock, after deduction of half the gain) as reduced by net STCL for the current year and LTCL carried over from the previous year.

As "net capital gain" is what gets preferred treatment, it is necessary to compute it. For that we have to look at §1222. NCG is the excess of NLTCG over NSTCL. NLTCG is the positive result of netting LTCGs and LTCLs. NSTCL is the negative result of netting STCLs and STCGs. Therefore, to get to NCG, we have to do several preliminary computations.

For example, assume eight capital transactions during the year: $10,000 and $25,000 LTCGs; $5,000 and $5,000 LTCLs; $5,000 and $30,000 STCGs; and $25,000 and $15,000 STCLs. We'd aggregate the LTCGs to reach $35,000, the LTCLs to reach $10,000 and then net them to reach $25,000 NLTCG. We'd aggregate the STCGs to reach $35,000, the STCLs to reach $40,000 and then net them to reach $5,000 NSTCL. Thus, NCG is $20,000, the difference between the $25,000 NLTCG and the $5,000 NSTCL.

While this income is included as part of gross income on the Form 1040, it is taxed at different rates than the other income on the return. Assuming none of these transactions are the result of 25% or

28% type gains, the $20,000 will be taxed at 5% or 15%, depending on the taxpayer's marginal tax rates for ordinary income exclusive of this item of income.

Notice how the capital losses are fully utilized in calculating NCG. In other words, all the losses, which totaled $50,000 ($5,000 and $5,000 LTCL and $25,000 and $15,000 STCLs) were able to be used to "shelter" the $70,000 income from capital gains ($10,000 and $25,000 LTCGs and $5,000 and $30,000 STCGs) from taxation.

By contrast, if the netting had produced a "net capital loss," any NSTCL would be allowed to be used to reduce current year's 28% rate gains, if any. If the net capital loss was LT and to the extent there was not enough 28% rate gain to offset, then §1211(b) would have only allowed the taxpayer to use $3,000 to shelter ordinary income from taxation, with the remainder being carried forward indefinitely until there is enough capital gains in the future to offset. The carryover is first used to reduce 28% rate gains in the future.