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Chapter 8: Capital Gains and Losses

A. The Tax Treatment of Capital Gains and Losses

Reading: §§1(h), 1201, 1211, 1212, 1222

Historically, capital gain has been taxed at lower rates than so-called "ordinary" income (income other than capital gain). Today the maximum marginal rate on capital gain recognized by individuals, estates, and trusts is significantly lower than the maximum marginal rate on ordinary income. §l(h). However, capital gain recognized by corporations does not receive favorable treatment. §1201.

The flip side of favorable treatment for capital gain is unfavorable treatment of capital loss. Both corporate and noncorporate taxpayers can deduct the capital losses they recognize during a given year to the extent of the capital gains they recognize during that year. §1211. Corporate taxpayers are not allowed to deduct their capital losses in excess of their capital gains. §1211. However, they may carry the excess capital loss back three years and forward five years. §1212(a)(l). Noncorporate taxpayers are allowed to deduct up to $3,000 of their capital losses in excess of their capital gains in a given year and carry forward indefinitely the excess capital losses disallowed. §§ 1211(b) and 1212(b)(l). However, if the capital loss is large, the $3,000 a year allowance may seem paltry. For example, if a taxpayer recognizes a $900,000 capital loss and no capital gain in the current or future years,§ 1211 allows the taxpayer to deduct the entire $900,000, but only at a rate of $3,000 a year at that rate, it would take 300 years for the taxpayer to deduct the full $900,000!

The Code draws a distinction between long-term and short-term capital gain; long-term capital gain is taxed at the favorable §l(h) maximum rate, but short-term capital gain is taxed at ordinary income rates. Capital gain (or loss) is long-term if the taxpayer held the capital asset sold for *more than* one year and short-term if the taxpayer held the capital asset for a year or less. §1223(1)-(4). Both short-term and long-term capital losses are subject to the §1211 limitation described above.

If a taxpayer, in a given year, recognizes more than one type of capital gain or loss, the taxpayer must net the gains and losses as provided in §1222. Suppose a taxpayer has both long-term capital gain and long-term capital loss, short-term capital gain and short-term capital loss. The first step is to compute the taxpayer's *net long-term* capital gain or loss by netting the long-term capital gain and loss, and *net short-term* capital gain or loss by netting the taxpayer's short-term capital gain and loss. §1222(5)-(8). If, after that netting process, the taxpayer has a net long-term gain and a net short-term loss, the second step is to compute the taxpayer's *net capital gain* by netting the taxpayer's net long-term capital gain and net short-term capital loss for the year. §1222(11). If the short-term loss exceeds the long-term gain, a noncorporate taxpayer may deduct the short-term loss to the extent of the long-term gain plus $3,000, under §1211. Any loss in excess of the gain plus up to $3,000 of loss is referred to as a *net capital loss*. If the taxpayer has a net long-term loss and a net short-term gain, the same second-stage netting process occurs.

The following example may help to illustrate the netting system. Taxpayer Dale recognizes a long-term capital gain of $100,000 on the sale of Widget Company stock and a long-term capital loss of $40,000 on the sale of land. Dale recognizes a short-term capital gain of $20,000 on the sale of XYZ stock and a $30,000 short-term capital loss on the sale of Xeno stock. In the first stage of netting, the long-term gains are netted against long-term losses to produce a net long-term gain of $60,000; the short-term gains and losses are also netted to produce a net short-term loss of $10,000. In the second stage of netting, the long-term gain of $60,000 is netted against the short-term loss of $10,000. The result is a net capital gain of $50,000, which qualifies for the preferential capital gains rate.

Now suppose, instead, that Dale had recognized a $ 130,000 short-term capital loss on the sale of Xeno stock. In that case the first stage of netting would have produced a $60,000 long-term capital gain and a $110,000 short-term capital loss. The subsequent second-stage netting would leave Dale with a net capital loss of $47,000 ($50,000 less $3,000).

One recently adopted capital gain provision deserves brief mention. Under §1202, added to the Code in 1993, 50 percent of the gain from the sale or exchange of "qualified small business stock" held by noncorporate taxpayers for more than five years may be excluded from taxable income. The 50 percent exclusion comes on top of the existing capital gain preference, and cuts the already low tax rate on capital gain in half. Qualified small business stock is defined as stock issued by companies with not more than $50 million in assets. However, stock in corporations engaged in law, accounting, health, farming, banking, mining, and a variety of other activities does not qualify.

EXAMPLES

1. The following is a complete list of capital gains and losses taxpayer Ted recognizes in a taxable year. In each case, state whether the transactions generate a net short-term or long-term capital gain or loss.
    a. Ted recognizes a gain of $10,000 on the sale of a capital asset held 25 months.
    b. Ted recognizes a gain of $10,000 on the sale of a capital asset held 13 months.
    c. Ted recognizes a gain of $10,000 on the sale of a capital asset held three months.

d. Ted recognizes a loss of $10,000 on the sale of a capital asset held three years.
e. Ted recognizes a loss of $10,000 on the sale of a capital asset held three years and a gain of $13,000 on the sale of a capital asset held three months.
f. Ted recognizes a gain of $13,000 on the sale of a capital asset held three years and a loss of $10,000 on the sale of a capital asset held three months.
g. Ted recognizes a loss of $10,000 on the sale of a capital asset held three months and a gain of $200,000 on the sale of a capital asset held three months.
h. Ted recognizes a gain of $40,000 on the sale of a capital asset held three months and a gain of $70,000 on the sale of a capital asset held three years.
i. Ted recognizes a loss of $30,000 on the sale of a capital asset held four months and a loss of $70,000 on the sale of a capital asset held three years.
j. Ted recognizes a loss of $10,000 on the sale of a capital asset held eight months, a gain of $70,000 on the sale of a capital asset held six years, and a loss of $40,000 on the sale of a capital asset held four years.

2. In year one Rita recognizes a capital loss of $30,000 on the sale of a capital asset held three years. In year two Rita recognizes a capital gain of $20,000 on the sale of a capital asset held two years. In year three Rita recognizes no capital gains or losses. Discuss the tax treatment in years one, two, and three of the capital gains and losses.

EXPLANATIONS

1. a. Gain on the sale of a capital asset is long-term gain if the taxpayer held the capital asset for more than one year. §1222(3). Ted has $10,000 of long-term capital gain. Since he has no long-term or short-term capital loss, his net capital gain is also $10,000. That gain will qualify for the preferential capital gains rate of §l(h).
   b. Ted has $10,000 of net long-term capital gain, for the same reasons as in part (a).
   c. Ted has $10,000 of net short-term capital gain, which does not qualify for the preferential capital gains rate. Since he held the asset for only three months, the $10,000 of gain is short-term capital gain. §1222(1). The net short-term capital gain is also $10,000 because he did not recognize any short-term capital loss during the year. §1222(5).
   d. Ted has $10,000 of net long-term capital loss. The loss is long-term because he held the asset for three years. §1222(4). The net long-term loss is also $10,000 because he did not recognize any long-term capital gain during the year. §1222(8). Ted, who is a noncorporate taxpayer, will be allowed to deduct only

$3,000 of the loss in the current year. §121 l(b). The remaining $7,000 loss disallowed is carried forward to the next year. §1212(b). Ted's net capital loss is $7,000. §1222(10).

e. The $10,000 capital loss is long-term. §1222(4). The $13,000 capital gain is short-term. §1222(1). Ted has a net long-term loss of $10,000 because he has $10,000 of long-term capital loss and no long-term capital gain. §1222(8). Ted has a net short-term capital gain of $13,000 because he has $13,000 of short-term capital gain and no short-term capital loss. The $10,000 net long-term loss and $13,000 net short-term gain are netted to produce a short-term capital gain of $3,000. That gain will be taxed at ordinary income rates.

f. The $13,000 capital gain is long-term. §1222(4). The $10,000 capital loss is short-term. §1222(1). Ted has a net long-term gain of $13,000 because he has $13,000 of long-term capital gain and no long-term capital loss. §1222(8). Ted has a net short-term capital loss of $10,000 because he has $10,000 of short-term capital loss and no short-term capital gain. The net long-term gain and net short-term loss are netted to produce a net capital gain of $3,000. Ted will pay tax on that $3,000 of gain at the preferential capital gains rate of §l(h).

g. Both the gain and the loss are short-term. §1222(1), (2). After netting the short-term gain and loss, Ted has net short-term capital gain of $190,000. §1222(5).

h. Ted has short-term capital gain of $40,000 and long-term capital gain of $70,000. Short-term gains are netted against long-term losses, and short-term losses are netted against long-term gains, but short-term gains are not netted against long-term gains nor are short-term losses netted against long-term losses. Ted has $70,000 of net capital gain, which is subject to the preferential capital gains rate. The $40,000 of short-term capital gain is taxed at ordinary income rates.

i. Ted has short-term capital loss of $30,000 and long-term capital loss of $70,000. Since Ted had no capital gain for the year, he will be allowed to deduct only $3,000 of the loss. His net capital loss for the year is $97,000. §1222(10).

j. Ted has a $10,000 short-term capital loss, a $40,000 long-term capital loss, and a $70,000 long-term capital gain. These transactions require two levels of netting. The first step is to compute Ted's net long-term capital gain, which equals $30,000 ($70,000 long-term gain less $40,000 long-term loss), and net short-term capital loss, which equals $10,000 ($10,000 short-term loss less zero short-term gain). §1222(6), (7). Ted's net capital gain is $20,000, which equals the $30,000 net long-term gain less the $10,000 net short-term loss. §1222(11). That $30,000 of net capital gain is taxed at the preferential capital gains rate.

2. Rita may deduct only $3,000 of the $30,000 long-term capital loss in year one. §121 l(b). The remaining $27,000 capital loss carries over to year two. §1212(b). Rita can use $20,000 of that loss to offset the $20,000 of long-term capital gain recognized in year two. §121 l(b)(2). This leaves Rita with a $7,000 capital loss in year two. Rita can also deduct $3,000 of that amount in year two. §1211(b)(l). The year two net capital loss, which is the remaining $4,000 of long-term capital loss, is carried forward to year three. §§1222(10), 1212(b). In year three Rita can deduct $3,000 of that loss. The year three net capital loss, which is the remaining $1,000 of long-term capital loss, is carried forward to year four.