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Capital Gain/Loss

What is Capital Gain/Loss?

Capital gain is what the tax law calls the profit you receive when you sell a capital asset, which is property such as stocks, bonds, mutual fund shares and real estate. This does not include your primary residence. Special rules apply to those sales.

Did you know that almost everything you own and use for personal or investment purposes is a capital asset? Capital assets include a home, household furnishings and stocks and bonds held in a personal account. When a capital asset is sold, the difference between the amount you paid for the asset and the amount you sold it for is a capital gain or capital loss.

A capital loss is a loss on the sale of a capital asset such as a stock, bond, mutual fund or real estate. As with capital gains, capital losses are divided by the calendar into short- and long-term losses.

A capital loss is the result of selling an investment at less than the purchase price or adjusted basis. Any expenses from the sale are deducted from the proceeds and added to the loss.

The key point is that capital losses are losses only after you sell them. A stock sitting in your portfolio with a deflated price may cause you distress, but it doesn't do you any tax good until you dump it. (The sale of personal-use property, such as a car, doesn't get this favored tax treatment. Such losses can't be deducted as capital losses.)

You can recoup a percentage of a true loss from the taxman. This is one of the best deductions available to investors. A capital loss directly reduces your taxable income, which means you pay less tax. It makes for a nice consolation prize.

Capital gains and losses are classified as long-term or short-term. To determine how long you held the asset, count from the day after the day you acquired the asset up to and including the day you disposed of the asset.

- Long Term: If you hold the asset for more than one year before you dispose of it, your capital gain or loss is long-term.
- Short Term: If you hold it one year or less, your capital gain or loss is short-term.

Top 10 Important Facts About Capital Gains and Losses

1. Almost everything you own and use for personal purposes, pleasure or investment is a capital asset.
2. When you sell a capital asset, the difference between the amount you sell it for and your basis – which is usually what you paid for it – is a capital gain or a capital loss.
3. You must report all capital gains.
4. You may deduct capital losses only on investment property, not on property held for personal use.

5. Capital gains and losses are classified as long-term or short-term, depending on how long you hold the property before you sell it. If you hold it more than one year, your capital gain or loss is long-term. If you hold it one year or less, your capital gain or loss is short-term.
6. If you have long-term gains in excess of your long-term losses, you have a net capital gain to the extent your net long-term capital gain is more than your net short-term capital loss, if any.
7. The tax rates that apply to net capital gain are generally lower than the tax rates that apply to other income. For 2010, the maximum capital gains rate for most people is 15%. For lower-income individuals, the rate may be 0% on some or all of the net capital gain. Special types of net capital gain can be taxed at 25% or 28%.
8. If your capital losses exceed your capital gains, the excess can be deducted on your tax return and used to reduce other income, such as wages, up to an annual limit of $3,000, or $1,500 if you are married filing separately.
9. If your total net capital loss is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you incurred it in that next year.
10. Capital gains and losses are reported on Schedule D, Capital Gains and Losses, and then transferred to line 13 of Form 1040.

10 Helpful Facts to Know

When you sell a capital asset, the sale normally results in a capital gain or loss. A capital asset includes most property you own for personal use or own as an investment. Here are 10 facts that you should know about capital gains and losses:

1. Capital assets include property such as your home or car, as well as investment property, such as stocks and bonds.
2. A capital gain or loss is the difference between your basis and the amount you get when you sell an asset. Your basis is usually what you paid for the asset.
3. You must include all capital gains in your income and you may be subject to the Net Investment Income Tax if your income is above certain amounts. The rate of this tax is 3.8 percent. For details, visit IRS.gov.
4. You can deduct capital losses on the sale of investment property. You cannot deduct losses on the sale of property that you hold for personal use.
5. If your capital losses are more than your capital gains, you can deduct the difference as a loss on your tax return. This loss is limited to $3,000 per year, or $1,500 if you are married and file a separate return.
6. If your total net capital loss is more than the limit you can deduct, you can carry it over to next year’s tax return.
7. Capital gains and losses are treated as either long-term or short-term, depending on how long you held the property. If you held it for one year or less, the gain or loss is short-term.
8. If your long-term gains are more than your long-term losses, the difference between the two is a net long-term capital gain. If your net long-term capital gain is more than your net short-term capital loss, you have a net capital gain.
9. The tax rate on a net capital gain usually depends on your income. The maximum tax rate on a net capital gain is 20 percent. However, for most taxpayers a zero or 15 percent rate will apply. A 25 or 28 percent tax rate can also apply to certain types of net capital gain.

10. You often will need to file Form 8949, Sales and Other Dispositions of Capital Assets, with your federal tax return to report your gains and losses. You also need to file Schedule D, Capital Gains and Losses, with your tax return.

How Capital Losses Work

It's never fun to lose money in an investment, but declaring a capital loss on your tax return can be an effective consolation prize in many cases. Capital losses have limited impact on earned income in subsequent tax years, but they can be fully applied against future capital gains. Investors who understand the rules of capital losses can often generate useful deductions with a few simple strategies.

For tax purposes, capital losses are only reported on items that are intended to increase in value. They do not apply to items used for personal use such as automobiles (although the sale of a car at a profit is still considered taxable income).

Although novice investors often panic when their holdings decline substantially in value, experienced investors who understand the tax rules are quick to liquidate their losers, at least for a short time, to generate capital losses. Smart investors also know that capital losses can save them more money in some situations than others. Capital losses that are used to offset long-term capital gains will not save taxpayers as much money as losses that offset short-term gains or other ordinary income. Wealthy taxpayers will now find capital losses more valuable than ever because of the capital gains rate increase for those in the top two brackets.

Capital losses are reportable as deductions on the investor's tax return, just as capital gains must be reported as income. Unlike capital gains, capital losses can be divided into three categories. Realized losses occur on the actual sale of the asset or investment, whereas unrealized losses are not reportable. Example:

- An investor buys a stock at $50 a share in May. By August, the share price has dropped to $30. The investor has an unrealized loss of $20 per share. He holds on to the stock until the following year, and the price climbs to $45 per share. He sells the stock at that point and realizes a loss of $5 per share. He can only report that loss in the year of sale; he cannot report the unrealized loss from the previous year.

You must fill out Form 8949 and Schedule D, where you'll discover that losses are categorized as short-term and long-term, just like gains. The value of the deductible loss depends on how the loss is applied. Sadly, the taxpayer doesn't get to choose.

Short-term losses counterbalance those expensive short-term gains. What's left at the end of Part I of Form 8949 is the net short-term capital gain or loss. If there were no gains, then obviously the net would equal the total loss.

Long-term losses are applied to long-term gains. The result, at the end of Part II of Form 8949, is the net long-term capital gain or loss. Again, if you have only a loss, then the net is a negative number.

Next, you combine the short-term and long-term results on Schedule D. At this point, a loss in one section can offset a gain in the other section. For example, if you have a net short-term loss of $1,000 and a net long-term gain of $1,200, then you'll pay tax on only $200.

If there's still a loss, you can deduct up to $3,000 from other income.

If you had a really bad year and ended up with a net loss of more than $3,000, you can carry forward the leftover portion to next year's taxes. The unused loss can be applied to next year's gains, as well as up to $3,000 of earned income. A big loss can be used as a deduction indefinitely -- another important reason to keep good records.

Capital Gains and Losses in Business

There are two ways a business gains or loses money:

1. The business makes a profit on its sales activities or loses money by spending more than it brings in from sales.
2. The business gains or loses money through its investments or the sale of assets (items of value the business owns).

Each of these types of gain or loss is taxed differently. Business profits are taxed as ordinary income and at the "regular" business or personal tax rate, depending on the type of business.

On the other hand, gains or losses on investments or the sale of assets are taxed as capital gains or losses.

Capital Gains or Capital Losses are the gains or losses a company or individual experiences on the sale of a capital asset. In other words, if the sale price of an asset is higher than the owner's basis in that asset, the result is a capital gain. If the selling price is less than the basis, the result is a capital loss.

Capital gains and losses are also experienced when a business writes off an asset, that is, takes the asset off its balance sheet.

Almost everything a business owns and uses as an investment is a capital asset. When a capital asset is sold for a profit, a capital gain results. If a capital asset is sold at a loss, a capital loss results.

For example, if a company purchases a building for $200,000 and sells it two years later for $300,000, the $100,000 is considered a long-term capital gain.

Individual shareholders or business owners who sell their capital shares or owners equity in a business also incur capital gains or capital losses from those sales.

Capital gains and losses result from single transactions in which the business incurs a gain or loss.

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