How Do I? Net Capital Gains and Losses for Year-End Tax Planning?

In order to effectively plan your investment transactions, you have to understand how, under federal tax law, you need to net or "offset" capital gains and losses that you experience. Netting your capital gains and losses can help achieve lucrative tax savings benefits and should be part of your year end tax strategy if you sell capital assets that result in gains and losses in 2009.

Historic lows

The current, historically low capital gains tax rates for 2009 and 2010 are only temporary. The current maximum rate of 15 percent is scheduled to sunset after 2010, as will the zero percent rate for individuals in the 10 and 15 percent income tax brackets. For 2011 and thereafter, the maximum long-term capital gains rate of 15 percent reverts to 20 percent, and for taxpayers in the 10 and 15 percent tax brackets, the capital gains rate increases to 10 percent, unless Congress takes action to extend the lower rates.

The Obama administration has signaled support for maintaining the lower capital gains rates for all but higher-income taxpayers. The Obama administration has proposed to increase the tax rate to 20 percent for single individuals with incomes above $200,000. The tax rate would also increase to 20 percent for married couples filing jointly whose incomes exceed $250,000. The higher rates would apply to tax years beginning after December 31, 2010.

Caution. Although qualified dividends are also taxed at the long-term capital gain rate (a maximum 15 percent), you cannot treat them as long-term capital gains for purposes of netting capital gains and losses. They are taxed independently of that process.

Important holding periods

Capital gains are taxed at different rates depending on how long you have held the asset. Capital gains and losses are classified as long-term (you've held the property for more than 12 months) or short-term (you've held the property for 12 months or less), also depending on how long you hold the property before you sell it. Net capital gain is the amount by which your net long-term capital gain is more than your net short-term capital loss.

Note. Capital gains and losses are reported on Schedule D, Capital Gains and Losses, and then transferred to line 13 of Form 1040.

Netting

Under the basic netting procedure, your total short-term capital gains and losses, and your total long-term capital gains and losses must be figured separately.

Note. Netting applies to all capital assets. There is no separate netting of stocks with stocks, for example. However, many individuals find that stocks are the only capital assets they have sold each year on a regular basis.

Your short-term capital losses (including short-term loss carryovers from a prior year) are applied first against your short-term capital gains (which would be taxed at ordinary income tax rates), if any.

If you have a net short-term loss at this point, it would then be applied against your net long-term gain. If you have a net short-term gain after netting against long-term losses,

then your short-term gain is taxed at ordinary income tax rate. The netting process lets you offset your net long-term capital loss against any net short-term capital gain.

You can deduct from your ordinary income a net capital loss of up to $3,000. You can carry forward any unused net capital loss for an unlimited number of years until it is used up. Unlike a corporation, however, you generally cannot carry a capital loss back to an earlier year (although there are some specific exceptions).

Net short term capital gain (from assets held for 12 months or less) is taxed at the same rates as your ordinary income. Both long-term and short-term capital losses can always be used to offset capital gains, as well as up to $3,000 of ordinary income. However, an individual can only use $3,000 ($1,500 for married individuals filing separately) of net capital losses left after reducing capital gains by capital losses to off set ordinary income in any one year.

Moreover, if your net capital losses exceed the $3,000 deduction limit, you can deduct $3,000 of your losses against ordinary income and carry over the excess loss to the following year. The excess losses that are carried over can then be netted against capital gains in that year with any excess again deductible against ordinary income up to $3,000.

The $3,000 amount has not changed for many years. It is one of the few provisions in the Tax Code that is not indexed for inflation. Bills to increase the allowable amount have been introduced in Congress but so far none has come close to passage.

Example

In 2008, Mary had $30,000 of ordinary income, a net short-term capital loss of $2,000, and a net long-term capital loss of $3,000. Mary's total capital loss deduction is $5,000. She can use $3,000 of her net losses to offset her ordinary income in 2008, and then carry over the remaining $2,000 of net capital losses to be used in 2009.

Caution. In selling securities, you also may have to contend with what's known as the "wash sale" rule. This rule prevents you from realizing a capital loss if you engage in buy and sell transactions of "substantially identical" assets within 30 days of each other.