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November 2000 - Year End Capital Gains Tax Planning Strategies

Capital gains and losses generally result from the sale of property you have held for a period of time. How these property sales are taxed depends on the type of property sold, your purpose in owning it, and how long you owned it. This is an especially complex subject. My hope in this article is simply to give you some guidelines for the questions you should be asking to assure you are making the best decisions in choosing when each property item should be sold, which items to sell and which to hold longer, and how to sell. This discussion will also be limited to capital gains realized by individuals. Capital gains of entities such as corporations will not be covered here.

Capital Gains Tax Rates

Let's start with an overview of the various federal capital gains tax rates. There are four, 10%, 20%, 25%, and 28%. These rates are generally lower than comparable ordinary income tax rates, hence the advantage in qualifying for them. There are also ways to pay a zero capital gains tax rate, which will be covered a little later in this article.

The basic qualification for each of these tax rates is that the property must be held at least one year and one day. A shorter holding period will result in ordinary income tax rates being applied to the capital gain.

The 10% rate applies to gains on the sale of most properties, including stocks, bonds, mutual funds, and non-depreciated real estate (notably raw land) earned by individual taxpayers in the 15% ordinary income tax bracket. The 20% rate applies to these same gains realized by taxpayers in any of the 28%, 31%, 36%, or 39.6% ordinary income tax brackets.

The 25% rate applies to the portion of capital gain on the sale of real estate that represents the recapture of depreciation. For example, let's assume you bought rental real estate for $100,000 and claimed a total of $30,000 of depreciation on the property in the years you owned it. In this example the first $30,000 of any capital gain on the sale of the property would be at the 25% rate, and any remaining capital gain would be at either the 10% or 20% rate, depending on the taxpayer's ordinary income tax bracket as discussed earlier.

For capital gains on sales of collectible property, such as art, antiques, coins, sports memorabilia, and stamps, the tax rate is 28% if your ordinary income tax bracket is higher than 15%.

Planning Strategies

Timing is one of the most important considerations when planning the sale of capital assets. Often splitting the sale into two or more years can keep the amount of capital gain reported in each year low enough that better advantage of the lowest 10% rate can be achieved. It can also be advantageous to match the sale of a property with a gain in the same year as another property with a loss, since the losses are allowed as an offset reducing the taxable gains. Capital losses exceeding capital gains can be applied up to $3,000 each year against ordinary income, with the balance being carried forward to future years.

Careful planning can sometimes result in a zero capital gains tax. If you have investment interest expense you cannot otherwise claim as a deduction, and you are itemizing deductions anyway, you can elect to claim a portion of your capital gain as investment income rather than capital gain. This can then offset that portion of the gain in full so that no tax is due. Be sure to use care with this strategy to avoid alternate minimum tax!

Another great opportunity is to purchase or build a home to use as your personal residence for at least two years. Since up to $500,000 of the capital gain when you later sell can be tax free, this is a good way to convert "sweat equity" into cash without paying taxes. This can be especially appealing to those with construction skills, who are willing to move every two years. With good planning, you can earn and reinvest enough from the sale of each home at two year intervals, to have a home free from debt within 8 to 10 years, while legally avoiding taxes on the gains that helped make it possible!

Like kind exchanges are a way to postpone capital gains taxes for several additional years until the replacement property is sold. Identify the new "like-kind" property you will buy, and work with a title company specializing in the required paperwork. The title company will help you meet the requirements to exchange your old property for the new one without actually selling it. You can repeat this process when you are ready to sell the replacement property.

I hope you have gotten at least one new idea on capital gains tax planning by reading this article. I would enjoy hearing from you if you have personal questions you would like help with!