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What You Need to Know About Capital-Gains Taxes (but Probably Don't)

The law is a lot more complicated than many people think

Investors can use capital losses to soak up capital gains. PHOTO: MIKEL JASO

By Tom Herman

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By tax-law standards, the rules on capital-gains taxes may appear fairly straightforward, especially for taxpayers who qualify for a zero-percent rate.

But many other taxpayers, especially upper-income investors, "often find the tax law around capital gains is far more complicated than they had expected," says Jordan Barry, a law professor and co-director of graduate tax programs at the University of San Diego Law School.

Here is an update on the brackets for this year and answers to questions readers may have on how to avoid turning capital gains into capital pains.

Who qualifies for the zero-percent rate?

For 2019, the zero rate applies to most singles with taxable income of up to $39,375, or married couples filing jointly with taxable income of up to $78,750, says Eric Smith, an IRS spokesman.

Then comes a 15% rate, which applies to most singles up to $434,550 and joint filers up to $488,850. Then comes a top rate of 20%.

But don't overlook a 3.8% surtax on "net investment income" for joint filers with modified adjusted gross income of more than $250,000 and most singles above $200,000. That can affect people in both the 15% and 20% brackets. For those in the 20% bracket, that effectively raises their top rate to 23.8%. "That 23.8% rate is the rate we use to plan around for high net-worth individuals," says Steve Wittenberg, director of legacy planning at SEI Private Wealth Management.

There are several other twists, says Mark Luscombe, principal analyst for Wolters Kluwer Tax & Accounting. Among them: a maximum of 28% on gains on art and collectibles. There are also special rates for certain depreciable real estate and investors with certain types of small-business stock. See IRS Publication 550 for details. There also are special rules when you sell your primary residence.

State and local taxes can be important, too, especially in high-tax areas such as New York City and California. This has become a much bigger issue in many places, thanks to the 2017 tax overhaul that included a limit on state and local tax deductions. As a result, many more filers are claiming the standard deduction and thus can't deduct state and local taxes. But some states, including Florida, Texas, Nevada, Alaska and Washington, don't have a state income tax. Check with your state revenue department to avoid nasty surprises.

How long do I typically have to hold stocks or bonds to qualify for favorable long-term capital-gains tax treatment?

More than one year, says Alison Flores, principal tax research analyst at The Tax Institute at H&R Block. Gains on securities held one year or less typically are considered short-term and taxed at the same rates as ordinary income, she says. The rules are “much more complex” for investors using options, futures and other sophisticated strategies, says Bob Gordon, president of Twenty-First Securities in New York City. IRS Publication 550 has details, but investors may need to consult a tax pro.

The holding-period rules can be important for philanthropists who itemize their deductions. Donating highly appreciated shares of stock and certain other investments held more than a year can be smart. Donors typically can deduct the market value and can avoid capital-gains taxes on the gain. But don’t donate stock that has declined in value since you purchased it. “Instead, sell it, create a capital loss you can use, and donate the proceeds” to charity, Mr. Gordon says. You can use capital losses to soak up capital gains. Investors whose losses exceed gains may deduct up to

$3,000 of net losses ($1,500 for married taxpayers filing separately) from their wages and other ordinary income. Carry over additional losses into future years.

If you sell losers, pay attention to the "wash sale" rules, says Roger Young, senior financial planner at T. Rowe Price. A wash sale typically occurs when you sell stock or securities at a loss and buy the same investment, or something substantially identical, within 30 days *before or after* the sale. If so, you typically can't deduct your loss for that year. (However, add the disallowed loss to the cost basis of the new stock.) Mr. Young also says some investors may benefit from "tax gain harvesting," or selling securities for a long-term gain in a year when they don't face capital-gains taxes.

While taxes are important, make sure investment decisions are based on solid investment factors, not just on taxes, says Yolanda Plaza-Charres, investment-solutions director at SEI Private Wealth Management. And don't wait until December to start focusing on taxes.

"We believe in year-round tax management," she says.

What if I sell my home for more than I paid for it?

Typically, joint filers can exclude from taxation as much as $500,000 of the gain ($250,000 for most singles). To qualify for the full exclusion, you typically must have owned your home—and lived in it as your primary residence—for at least two of the five years before the sale. But if you don't pass those tests, you may qualify for a partial exclusion under certain circumstances, such as if you sold for health reasons, a job change or certain "unforeseen circumstances," such as the death of your spouse. See IRS Publication 523 for details. When calculating your cost, don't forget to include improvements, such as a new room or kitchen modernization.

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