IRS TAX TIP 2004-34

CAPITAL GAINS AND LOSSES

Almost everything you own and use for personal purposes, pleasure or investment is a capital asset. The IRS says that when you sell a capital asset, such as stocks, 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. While you must report all capital gains, you may deduct only your capital losses on investment property, not personal property.

A "paper loss" – a drop in an investment's value below its purchase price – does not qualify for the deduction. The loss must be realized through the capital asset's sale or exchange.

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. For more information on the tax rates, refer to IRS Publication 544, "Sales and Other Dispositions of Assets."

If your capital losses exceed your capital gains, the excess is subtracted from other income on your tax return, up to an annual limit of $3,000 ($1,500 if you are married filing separately).

Capital gains and losses are reported on Schedule D, "Capital Gains and Losses," and then transferred to line 13 of Form 1040. This year, the capital loss carryover worksheet has been removed from the Instructions for Schedule D to simplify tax preparation. However, there will be a worksheet in the 2004 Instructions to Schedule D to figure a capital loss carryover to 2004.

If you have a taxable capital gain, you may be required to make estimated tax payments. See Publication 505, "Tax Withholding and Estimated Tax," for information on estimated tax.

The top tax rate on net capital gain (i.e., net long-term capital gain reduced by any net short-term capital loss) has been reduced from 20% to 15% (and from 10% to 5% for gains that would otherwise be taxed at a regular rate of 10% or 15%) for property sold or otherwise disposed of after May 5, 2003 (and installment sale payments received after that date). The reduced rate applies for both the regular tax and the alternative minimum tax. The higher rates that apply to unrecaptured section 1250 gain, collectibles gain, and section 1202 gain have not changed.

Dividends paid by most domestic and foreign corporations after December 31, 2002, are eligible for the new maximum capital gains tax rate of 15% (5% in some cases). Qualified dividends are reported on line 9b of Forms 1040 or 1040A.

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Additional information on capital gains and losses is available in Publications 550, "Investment Income and Expenses," and 17, "Your Federal Income Tax." You may download the publications from the IRS Web site at *IRS.gov* or order them by calling 1-800-TAX-FORM (1-800-829-3676).

Taxpayers who have experienced investment or other types of financial losses should also check out these other IRS publications:

- 564, "Mutual Fund Distributions"
- 547, "Casualties, Disasters, and Thefts"
- 527, "Residential Rental Property (Including Rental of Vacation Homes)" and
- 536, "Net Operating Losses (NOLs) for Individuals, Estates and Trusts"

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