capital gains and dividend income

Managing capital gains and losses can help you save taxes, defer taxes and obtain the highest after-tax yield on your assets. This planning is very critical when considering the various tax rates since the rate on short-term capital gains can be as high as 43.4% (including the 3.8% Medicare Contribution Tax for certain taxpayers) compared to the long-term capital gain rate of 23.8% (including the 3.8% Medicare Contribution Tax for certain taxpayers).

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CAPITAL GAIN TAX RATES

As a result of the ACA, an additional 3.8% Medicare Contribution Tax may be imposed on your net investment income depending upon your tax bracket. For more information on how this tax is computed, see the chapter on tax rate overview. As Chart 4 illustrates, for 2016 and thereafter, many different tax rates can apply to capital gains, but the most important rates to remember are the maximum tax rates of 39.6% on net gains from assets held 12 months or less (short-term) and 20% on most assets held more than 12 months (long-term). However, the actual rate of tax you pay on the sale of a capital asset can depend on more than just how long you have held the asset, including:

- Type of property sold.
- The AMT rate of 28% on assets held short-term.

chart 4

CAPITAL GAIN TAX RATES

	39.6%	28%	25%	20%*	15%	0%
Short-Term Rate (Holding period 12 months or less)						
Regular tax purposes	•					
AMT purposes		•				
Long-Term Rate (Holding period greater than 12 months)						
Regular tax purposes				•	•	
AMT purposes				•	•	
Exceptions to the 20% tax rate on property held more than 12 months						
Collectibles, such as artwork & precious metals		•				
Gain attributable to depreciation on real property			•			
Gains otherwise taxable at the 10% or 15% ordinary tax rate						•
Gain attributable to depreciation on tangible personal property	•					

Taxpayers are liable for the additional 3.8% Medicare Contribution Tax on net investment income if their Modified Adjusted Gross Income ("MAGI") exceeds the threshold amount for the applicable filing status:**

Filing Status	Threshold Amount
Married Filing Joint & Qualifying Widow(er)	$ 250,000
Single & Head of Household	$ 200,000
Married Filing Separate	$ 125,000

**The 20% tax rate applies to taxpayers with income above certain threshold amounts ($466,950 for married filing jointly; $441,000 for head of household; $415,050 for single filers; and $233,475 for married filing separately).*

***MAGI is AGI increased by the net income excluded from foreign income under Internal Revenue Code Section 911(a).*

tax tip

7 USE THE NETTING RULE TO GET THE BEST RESULTS

Assume you determine that your year-to-date net capital gains are $240,000, made up of short-term losses of $160,000 and long-term gains of $400,000. In 2016, your capital gains tax would be $48,000 ($240,000 of excess long-term gains at 20%). You also have assets with an unrealized short-term gain of $150,000 that you would like to sell, but are reluctant to pay the short-term capital gain rate of 39.6%. Since gains are netted, if you realized the gain you would have net capital gains of $390,000 (short-term losses of $10,000 and long-term gains of $400,000). Your capital gains tax would be $78,000 ($390,000 of excess long-term gains at 20%). So your tax increase would be $30,000 ($78,000 less the original tax of $48,000). You actually paid the long-term rate of 20% on the additional short-term gain of $150,000.

Note: *The above example is exclusive of the Medicare Contribution Tax, and also assumes that the top rates apply.*

- A netting rule that can flip the actual rate from 20% to 39.6% on long-term gains (and the reverse for short-term gains) since you must net excess losses from one holding period against the gains of the other holding period (see Tax Tip 7).
- 28% rate on the sale of collectibles, such as artwork and precious metals (including ETFs that invest in precious metals).
- Sale of real estate that is subject to depreciation recapture at a maximum rate of 25%.
- Exclusion and rollover provisions on the sale of certain assets.
- Capital loss limitations that only allow you to deduct $3,000 of losses in excess of gains against ordinary income, such as wages and interest income. (If married filing separately, the limit for each individual is $1,500.) It should be noted that net capital losses cannot reduce other categories of income in calculating the Medicare Contributions Tax.

YEAR-END TRADING STRATEGIES

If you have unrealized capital gains or losses, you should refer to Tax Tip 3 in the chapter on tax planning strategies to help you decide whether to take additional gains or losses before the end of the year. But as this tip illustrates, the exact nature of your gains and losses will dictate which stock positions you should consider selling.

COMPUTING YEAR-TO-DATE REALIZED GAINS AND LOSSES

Before determining which year-end strategy to use, it is important to compute your year-to-date realized gains and losses. Make sure you consider the following when determining your year-to-date realized gains and losses:

Trade date

The trade date, not the settlement date, determines the holding period and the year you recognize gain or loss on the sale of publicly traded securities, except for short sales closed at a loss.

Excess capital losses

Only $3,000 of capital losses in excess of capital gains can reduce your ordinary income per year ($1,500 if you are married filing separately). Excess losses are carried forward indefinitely (but not back) until used. Capital loss carryforwards are terminated when the taxpayer dies; however, you can carry back some losses on Section 1256 contracts against prior years' income from similar contracts.

Mutual fund distributions

Dividends paid by mutual funds typically include long-term capital gain distributions that are taxed as capital gains rather than dividend income. Many funds make their largest distributions in December, so make sure you consider them when computing your year-to-date net capital gain or loss. Short-term capital gain distributions and non-qualifying dividends, such as from money market constant dollar funds, are treated as dividend income subject to the ordinary income tax rates. However, mutual funds paying out qualifying dividends in 2016 and beyond are subject to rates of 15% or 20%. The 3.8% Medicare Contribution Tax rate also applies.

Note: *Absent unusual circumstances, and strictly from an income tax perspective, it is usually inadvisable to buy mutual funds shortly before an announced dividend distribution (see below).*

Pass-through entities

Gains and losses from pass-through entities, such as partnerships, S corporations, and LLCs, are taxable to you whether or not you actually receive a cash distribution. You will need to determine your projected share of any distributable capital gains and losses from any entities in which you are an owner or investor.

Mark-to-market assets

Capital gains and losses on mark-to-market assets such as S&P Index options and regulated futures contracts should also be considered when determining your year-to-date capital gains and losses. For the tax treatment of these "Section 1256 contracts," see the discussion later in this chapter.

TAX BASIS REPORTING REQUIREMENTS FOR INVESTORS

The Energy Improvement and Extension Act of 2008 provides that in the case of a covered security, every broker who is required to report the gross proceeds from the sale of the security must also report the adjusted basis in the security and whether any gain or loss with respect to the security is long-term or short-term. The reporting is generally done on Form 1099-B, "Proceeds from Broker and Barter Exchange Transactions." A covered security includes all stock acquired beginning in 2011 except stock in a regulated investment company for which the average basis method is available and stock acquired in connection with a dividend reinvestment plan, both of which are covered securities if acquired beginning in 2012. Options granted or acquired on or after January 1, 2014 are required to be reported.

The basis reported on Form 1099-B may not reflect application of the wash sale rules. Brokers are only required to report wash sales when the purchase and sale transactions occur in the same account. Therefore, you are required to adjust your basis for losses disallowed under those rules.

AVERAGE BASIS OF MUTUAL FUND SHARES

If you acquire shares in a mutual fund at various times and prices, you can calculate the gain or loss using an average cost basis. The shares need to be on deposit in an account handled by a custodian or agent who acquires or redeems those shares.

IDENTIFY LOTS TO REDUCE YOUR TAXES

If you only want to sell part of your holdings of a specific stock, you typically want to sell the lot with the highest cost first so that you can report the lowest gain. However, brokers frequently automatically sell the lots that you bought first, regardless of their relative cost. Avoid this mistake by instructing your broker in advance, in writing, that you want to sell the lots you have held long-term with the highest cost, assuming you are selling the position at a gain. If you are selling at a loss, generally sell the lowest cost lots first.

Note: *This assumes that the objective was to lower realized capital gains in the current year. It may have been more prudent to accelerate gains in the current year and postpone losses until the following year, if it is anticipated that your tax rate will increase in the subsequent year.*

WATCH OUT FOR THE AMT

Substantial net long-term capital gains will increase your deductible state and local income taxes, with the potential adverse effect of triggering the AMT either this year or next year. This will result in your losing the benefit of some or all of the deduction for the additional state income taxes. See Tax Tip 6 in the chapter on the AMT for an example of this. Also, substantial net long-term capital gains will increase your AGI, which will decrease applicable AMT exemptions and can result in triggering the AMT.

tax tip

8 MUTUAL FUND DISTRIBUTIONS ARE TAXABLE, EVEN IF THEY ARE AUTOMATICALLY REINVESTED

Typically, distributions from mutual funds are reinvested in the fund. The distribution itself does not change your aggregate value in the fund since it simply increases the number of shares you own at a lower per-share value.

However, a distribution is taxable in the year made, even if reinvested in the fund. For example, let's say you purchased 4,000 shares of an equity mutual fund on September 1, 2016 at $50 per share. Just before year-end, the fund makes a capital gain distribution of $5 per share when the fund is selling for $35 per share. You end up with capital gain income of $20,000 (4,000 shares at $5 per share), reportable on your 2016 return, even though the share value has decreased since your purchase. But your basis in the shares increases by the $20,000 that you reported as income.

Warning: *Exchanging mutual funds is generally considered a sale of the initial fund with potential capital gain or loss results, even if the new fund is in the same family of funds.*

AVOID CAPITAL GAINS TAX THROUGH CHARITABLE GIVING

You can avoid paying capital gains tax on appreciated securities that you have held for more than one year if you use them to make your charitable contributions. (For donations to private foundations, the stock must be publicly traded.) You receive a contribution deduction based on the fair market value of the security (subject to certain limitations based on your AGI), yet you never pay tax on the appreciation.

This can reap even greater rewards if you front load a private foundation or a donor-advised fund with appreciated long-term securities to fund future contributions. See the chapter on charitable contributions for a detailed discussion.

BEWARE OF THE MUTUAL FUND TRAP

A capital gain distribution from a mutual fund may include significant gains realized by the fund before you bought the shares.

As Tax Tip 8 shows, you end up paying tax on the gains, regardless of whether or not your position in the fund has appreciated. In effect, you have converted part of your initial investment into taxable income.

A benefit of owning stocks directly rather than through a mutual fund is that you can control when you realize gains and losses, giving you the advantage of deferring the tax on the gain, or taking losses to minimize your tax. However, by having direct ownership of stocks you may sacrifice some of the investment diversity that may be available in a mutual fund.

An alternative to an actively managed mutual fund would be a passively managed exchange traded fund or indexed fund.

TAKE LOSSES FROM WORTHLESS SECURITIES AND BAD DEBTS

When a security or non-business loan becomes completely worthless, you can at least recover some of your losses through tax savings. A worthless security is treated as a capital loss in the year it becomes totally worthless. For determining whether the loss is long-term or short-term, the security is deemed to be sold on December 31. To be considered worthless, a security must have absolutely no value. If it has even negligible value, you will usually be prevented from claiming it as a worthless security. You can avoid the absolute-no-value test by selling the security (in a bona fide sale) to an unrelated party for a nominal amount. If you complete the sale before the end of the year, you will be able to take the loss in the current year.

Note: *Do not confuse bankruptcy with worthlessness. Shares of stock of many companies in bankruptcy have some value.*

A non-business bad debt, typically an uncollectible loan, is similarly deductible as a capital loss at the end of the year in which it becomes entirely worthless. However, the loss is treated as a short-term loss regardless of how long the debt was outstanding. But make sure that it is not really a loan that you have simply forgiven. A forgiven loan will be treated as though you made a gift. If the total amount of gifts to any one person exceeds $14,000 for 2016, it will either reduce your lifetime gift tax exclusion or result in a gift tax if you have already exhausted the exclusion. See the chapter on gift and estate planning.

TREATMENT OF LOSSES FROM FRAUDULENT INVESTMENT ARRANGEMENTS

Unfortunately, taxpayers sometimes experience a loss from a fraudulent investment arrangement. For example, an investment advisor may have reported investment activities and resulting income amounts that were partially or wholly fictitious. In some cases, in response to requests for withdrawals, the investment advisor made payments of purported income or principal to the taxpayer, but these payments were made from amounts that other investors had invested in the fraudulent arrangement (e.g., a Ponzi scheme).

The Internal Revenue Code allows a deduction for losses sustained during the taxable year, not compensated by insurance or otherwise subject to various limitations. A loss from a fraudulent investment arrangement is deductible in the taxable year in which the taxpayer discovers the loss, provided that the loss is not covered by a claim for reimbursement or other recovery as to which the investor has a reasonable prospect of recovery. To the extent that the investor's deduction is reduced by such a claim, recoveries on the claim in a later taxable year are not includible in the investor's gross income.

The loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery.

If an amount is reported to the investor as income in years prior to the year of discovery of the theft, and the investor included the amount in his or her gross income, and the investor does not subsequently withdraw the amount previously reported as income, the fictitious income may be included in the amount of the deductible theft loss.

A theft loss in these types of transactions entered into for profit may create or increase a net operating loss that can be carried back and/or forward under special rules.

WASH SALE CAN DISALLOW YOUR LOSS

The wash sale rule prohibits you from realizing a loss on a security if you buy the same or a substantially identical security (or option to buy such a security) within 30 days before or after you sell it. This requires you to be out of the position and/or at an investment risk for those 61 days if you want to realize a loss on the security yet buy it back for future growth. If you fail the wash sale "test," your loss will be realized only when the replacement security is sold.

If you don't want to risk being out of the position for more than 61 days, consider the following alternatives:

- Buy securities of another company in the same industry, or
- Buy shares in a mutual fund (or an exchange-traded fund) that specializes in the same industry, or
- Double up on the position 31 days before selling at a loss.

You can sell the alternative security or mutual fund after 30 days and use the proceeds to buy back securities in your original company, if you prefer.

One planning technique available is to sell appreciated securities in the current year in order to utilize capital losses and then buy back the stock immediately, thereby securing a step-up in basis. The wash sale rule does not apply to gains.

USE A BOND SWAP TO REALIZE LOSSES

You may be holding losses in your bond portfolio where you can realize a loss and immediately purchase somewhat similar bonds, yet avoid the wash sale rule. This strategy is referred to as a bond swap because your net position after the sale and subsequent purchase is similar to your position prior to the swap. For example, the replacement bond is not considered a substantially identical security (the wash sale test) if it has a different issuer or has a materially different stated interest rate or maturity.

SELLING SHORT AGAINST THE BOX

The reverse of the wash sale rule — the "constructive sale" rule — prevents you from locking in the appreciation on a security without recognizing any taxable gain by selling an identical security short. The 2 positions are deemed to be a constructive sale and you must realize gain as if the appreciated security was sold for its fair market value on the date of the short sale, thereby preventing you from deferring the gain to a future year.

An exception to this rule allows you to close the short sale within 30 days after the end of the tax year if you keep your appreciated position open and at risk for at least 60 days following the close of the short sale. Since closing the short sale is based on the delivery date, you actually need to close the short sale earlier so that you have enough time to have the shares delivered within the 30 days.

LONG-TERM CAPITAL GAINS AND DIVIDEND INCOME TAXED AT 0%

Net long-term capital gains and qualifying dividend income that would normally be taxed are not taxed at all for taxpayers whose taxable income is below certain thresholds. This rule applies to taxpayers with taxable income that would otherwise be taxed at either 10% or 15% before application of this rule.

TRANSFER APPRECIATED STOCK TO SAVE TAXES

You can transfer appreciated securities that you have held long-term to your child, or other beneficiary, who is subject to a low income tax rate and then have the child sell the securities and pay no federal tax. The child must be over age 19 (or if a full-time student, over age 24) to avoid the kiddie tax rule that assesses tax based on your tax rate, as discussed in the tax rate overview chapter. However, keep in mind that gift tax issues must be considered, as discussed in the chapter on gift and estate planning.

As an example, assume you transfer securities with unrealized gains of $30,000 to your single child over age 19 (who is not a full-time student), and the child only has wages from a summer job of $4,000. He or she would pay no tax on the $30,000 gain. This is because of a provision that treats capital gain income that would otherwise be taxed at either the 10% or 15% graduated tax rates as being taxed at a rate of zero. A single taxpayer can have taxable income of up to $37,650 in 2016 ($37,950 in 2017) and still be in the 15% tax bracket, thereby qualifying the taxpayer to a 0% tax rate on his or her capital gains.

DEFER CAPITAL GAINS TAX ON HIGHLY APPRECIATED SECURITIES

If you have appreciated securities that you are reluctant to sell because of the capital gains tax, consider creating a charitable remainder trust. By doing so, you will defer the tax and the trust will make annual payments to you. The remainder amount at the end of the trust's term will go to a charity you designate. See the chapter on charitable contributions for a more detailed discussion of the different types of charitable trusts.

SECTION 1256 CONTRACTS

Section 1256 contracts include regulated futures contracts, foreign currency contracts, non-equity options (including stock index options), dealer equity options and dealer securities futures contracts. The tax issues related to these contracts are different than typical capital gain assets. The gain or loss on these contracts is automatically treated as 60% long-term and 40% short-term, regardless of the holding period. Thus, the maximum effective federal tax rate on Section 1256 gains for 2016 and 2017 is 27.84% (31.64% when considering the additional 3.8% Medicare Contribution Tax) for certain taxpayers. Any unrealized gain or loss on the contracts at year-end is taxable in the current year as if sold, with an adjustment to your tax basis for the gain or loss already treated as realized at the end of the previous year.

INSTALLMENT SALE REPORTING BENEFITS

An installment sale can be a very tax-efficient method to realize a gain on the sale of an asset. While typically considered for real estate sales, it can also apply to sales of non-publicly traded property, such as stock in a privately held corporation or an interest in an LLC or partnership. If you are considering selling any of these assets, see the discussion in the chapter on passive and real estate activities.

SECTION 1031 LIKE-KIND EXCHANGES

The like-kind exchange rule allows you to defer taxes by exchanging property for other property that has the same nature or character. You don't pay taxes on any gain until you sell the property that you have received in the exchange, except to the extent of any cash or other boot ("unlike" property) received. Typically, this rule applies to the sale of rental real estate, although certain other types of property are also eligible. See the chapter on passive and real estate activities for a more detailed discussion of like-kind exchanges.

Note: *Like-kind exchange reporting is mandatory if the replacement property is the same as the surrendered property. Unlike installment sales, you cannot "opt out" of like-kind exchange reporting. While a like-kind exchange does not have to be a simultaneous swap of properties, you must meet 2 time limits or the entire gain will be taxable. The first limit is that you have 45 days from the date you sell the relinquished property to identify potential replacement property. The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as the property identified within the 45-day limit described previously.*

QUALIFIED DIVIDEND INCOME

Qualified dividends received by an individual shareholder through December 31, 2016 and 2017 are taxed at 15% and 20% for taxpayers who fall into the 39.6% tax bracket. These rates are exclusive of the Medicare Contribution Tax of 3.8%. The following requirements and restrictions must be satisfied:

- The dividends must be paid by either a domestic corporation or a qualified foreign corporation (as defined below).
- You must hold the stock for more than 60 days during the 121 days beginning 60 days before the ex-dividend date. This increases to 90 days out of 181 days for certain preferred stock. The reduced rate is not available for dividends received if you are holding an equivalent offsetting short position in the same security.

Dividends taxed at 15% or 20% are not investment income for purposes of the investment interest expense limitation. However, just as is the case for net long-term capital gains, you can elect to tax the dividends at ordinary rates and eliminate some or all of this limitation on the deduction of investment interest. See the discussion in the chapter on interest expense.

Dividend income that is generally not eligible for the 15% or 20% rates, and therefore taxed at your ordinary income tax rate (as high as 39.6% or 43.4%, inclusive of the additional Medicare Contribution Tax), includes dividends received from:

- Money market mutual funds and bond funds.
- Real estate investment trusts ("REITs").
- Payments you received in lieu of dividends if your broker loans your shares to a customer (as part of a short sale) and dividends are paid to the short sale buyer before the short sale is closed.

A qualified foreign corporation is generally a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation if its stock is readily traded on an established securities market in the U.S. For this purpose, a share will be treated as so traded if an American Depository Receipt ("ADR") backed by the share is so traded. Dividends received from a foreign corporation that was either a foreign investment company or a passive foreign investment company ("PFIC") either for the year of distribution or the preceding year are not qualified dividends eligible for the 15% or 20% rates.

SECTION 1035 EXCHANGE

The law provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. The exchange treatment is for individuals who have merely exchanged one insurance policy for another which better suits their needs. The exchange without gain or loss recognition of an annuity contract for another annuity contract is limited to cases where the same person or persons are the obligee or obligees under both the original and exchanged contracts.

Under Revenue Procedure 2011-38, the direct transfer of a portion of the cash surrender value of an existing annuity in exchange for a second annuity contract will be treated as a tax-free exchange under Section 1035 if no amount (other than an amount received as an annuity for a period of 10 years or more or during one or more lives) is received during the 180 days beginning on the date of the transfer. A subsequent direct transfer of all or a portion of either contract involved in an exchange is not taken into account if the subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange.