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ResearchReport

Federal and State Taxes on Capital Gains

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Issue

Briefly explain capital gains and how they are taxed for personal income tax purposes by the federal government, Connecticut, and Massachusetts.

Summary

Capital gains are the profits from the sale of capital assets, which include property (e.g., homes and cars) and investments (e.g., stocks and bonds) held for personal, business, or investment purposes. A capital gain occurs when a capital asset is sold or exchanged at a price higher than its basis (generally the asset's purchase price, minus any depreciation deductions claimed for business assets). A capital loss occurs when an asset is sold for less than its basis. Special basis rules apply to assets received as a gift or an inheritance.

Under federal income tax law, capital gains and losses are classified as either short- or long-term, depending on how long the taxpayer held the asset. Long-term gains are taxed at preferential rates (generally from 0% to 20%, plus an additional 3.8% net investment income tax for certain filers), while short-term gains are taxed at the same rates as ordinary income. In either case, the rate that applies generally depends on the taxpayer's income level.

With the exception of capital gains and losses from Connecticut state or municipal bonds, Connecticut follows the federal tax law for calculating capital gains and losses. Unlike the federal government, however, Connecticut taxes capital gains income at the same rates as other income. Massachusetts generally applies the federal rules in calculating capital gains and losses, but it applies differential rates to short- and long-term gains.

Federal Tax Treatment of Capital Gains and Losses

Short-Term Versus Long-Term Gains and Losses

Under federal income tax law, capital gains and losses are classified as either short- or long-term, depending on how long the taxpayer held the asset. If the taxpayer holds the asset for one year or less, the gain or loss is considered short-term. Gains or losses on assets held for more than one year are considered long-term. Taxpayers may use their capital losses to offset capital gains, as described below.

Gains from the Sale of a Home

Taxpayers with a capital gain from the sale of their principal residence may exclude from their income up to $250,000 of the gain ($500,000 for joint filers). Generally, to qualify for the exclusion, the taxpayer must have owned and used the home as a principal residence for two out of the five years before the sale.

Net Capital Gains

If a taxpayer has a "net capital gain," that gain is usually taxed at a lower (i.e., preferential) tax rate than ordinary income. A net capital gain is the amount by which a taxpayer's *net long-term capital gain* for the year exceeds his or her *net short-term capital loss* for the year. The term "net long-term capital gain" means the amount by which long-term capital gains exceed long-term capital losses (including any unused long-term capital losses carried over from previous years). A "net short-term capital loss" is the amount by which short-term capital losses exceed short-term capital gains.

Net Capital Losses

If their total losses are more than their gains, taxpayers generally can deduct the difference (i.e., their "net capital loss") from ordinary income on their tax return, up to an annual limit. The deduction is limited to $3,000 per year ($1,500 if married filing separately); losses in excess of the $3,000 limit may be carried forward to future tax years. Losses from the sale of personal-use assets, such as a vacation home or car, are not deductible.

Tax Rates

The tax rate on net capital gains generally ranges from 0% to 20%, depending on the taxpayer's income level. (For most taxpayers, the 15% rate applies.) There are certain exceptions, however, including net capital gains from qualified small business stock and collectibles (e.g., rugs, antiques, and art), which are generally subject to a 28% rate. Short-term capital gains do not qualify for these preferential rates, but are taxed as ordinary income.

Taxpayers may also be subject to an additional 3.8% net investment income (NII) tax if their income is above $200,000 for single filers or $250,000 for joint filers.

Connecticut's and Massachusetts' Treatment of Capital Gains Income

Connecticut

Connecticut generally follows the federal rules for calculating capital gains and losses, except that it excludes capital gains from the sale or exchange of Connecticut bonds or notes from its income tax. But unlike the federal government, Connecticut does not apply differential tax rates to capital gains income.

The starting point for Connecticut's income tax is federal adjusted gross income (AGI), which includes a taxpayer's capital gains or losses, determined under the rules described above (Line 13 on Form 1040 and Line 10 on Form 1040A). To determine Connecticut taxable income, Connecticut requires a taxpayer to make various additions to and subtractions from federal AGI. Under federal law, capital gains and losses on state and municipal bonds are treated the same as gains and losses on other assets. But Connecticut's income tax exempts gains from sales of Connecticut state or municipal bonds from state income tax. Thus, it requires taxpayers to subtract any such capital gains (and add back any such capital losses) from their federal AGI when figuring their Connecticut taxes (CGS §12-701 (20)(A)(v) and (20)(B)(vii)).

Massachusetts

Massachusetts taxes most long-term capital gains at the same flat 5.1% rate that applies to ordinary income, but it imposes a 12% rate on income from short-term capital gains, long-term gains on the sale of collectibles, and certain pre-1996 installment sales.

Massachusetts generally incorporates the federal rules in calculating capital gains and losses, with exceptions for certain business assets and small business stock.

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