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Capital Gains Tax

One important aspect of estate planning is the income tax consequence of employing a particular strategy. Many of our clients have expressed confusion concerning the capital gains tax. The purpose of this column is to explain the capital gains tax in general terms.

Capital gains tax, in its simplest terms, is a tax on the profit realized upon the sale of a capital asset. A **capital asset** is almost everything you own or use for investment purposes, such as stocks or mutual funds, or even your home. The difference between the sales price of the asset and your **basis**, which is your investment in the asset (what you paid for it with certain adjustments), is a **capital gain** or **capital loss**. A capital gain occurs when you sell the asset for more than your basis. A capital loss occurs if you sell the asset for less than your basis. For example, if you bought 100 shares of stock ten years ago for \$10 (your cost basis) and sold it today for \$100, you would have a capital gain of \$90.

In some instances, your basis in an asset can not be determined by its cost. The most common examples are assets received by gift or inheritance. Since you did not pay for the asset, you have no cost basis by which to measure your profit if you were to sell it. Currently, the basis of an asset received as a gift will be the donor's basis at the time of the gift with certain adjustments if the donor's basis is less than the fair market value of the asset. For example, if your aunt gave you 100 shares of stock for your birthday, your basis in the stock will be the same as your aunt's basis before she gave it to you. This is known as **carryover basis**. If your aunt purchased the stock 10 years ago for \$10, then your basis in the shares would be \$10. If you then sold the stock for \$100, you would have a capital gain of \$90, which is the difference between the sales price of \$100 and your carryover basis of \$10.

If you *inherit* an asset, its basis is its fair market value as of the date of death of the person you inherited it from, the **decedent**. [This may change in the future depending on the action, or inaction, of Congress by 2010.] Let's assume that

the stock which your aunt purchased for \$10 was left to you in her will. If, at her death it was worth \$100, you would receive the stock with a **step up** in basis to \$100, rather than her \$10 cost basis. If you thereafter sold it for \$100, there would be no capital gain.

Capital gains and losses are further divided into two categories each having different income tax consequences. If you hold an asset for one year or less, on its sale you have a **short-term capital gain or loss**. If you hold an asset for more than one year, on its sale you have a **long-term capital gain or loss**. A short-term capital gain will be taxed according to your income tax bracket. Because the government encourages long term investing, long-term capital gain gets favorable tax treatment. The amount by which all your long-term capital gains exceed all your short-term capital losses in a given year is referred to as **net long-term capital gain**. Since 2003, the highest long-term capital gains tax rate for most taxpayers is 15%. However, for those taxpayers in the 10% and 15% tax brackets, long-term capital gains are taxed at 5%. [These rates are scheduled to return to the higher pre-2003 rates in 2011.] Thus, capital gains are taxed at a more advantageous rate than ordinary income.

If your capital losses exceed your capital gains, you can deduct up to \$3,000 (\$1,500 if you are married and file a separate return) against other income in a particular year. If your net capital loss is more than this limit, you can **carry forward** the excess amount to future years, until it is used up. The unused loss can be applied to future capital gains as well as up to \$3,000 of ordinary income in any given year.

It is important to have a general understanding of when and how the capital gains tax applies to various estate, gift, Medicaid and other planning strategies which you may consider. It is always advisable to consult with your legal and tax advisors to help you navigate complex tax matters. We look forward to answering your questions about this subject and would welcome the opportunity to meet with you to discuss its applicability to your own unique situation.

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