Tax Reduction Letter

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IRS Notice 97-59

Capital Gains Rates

July 1997

PURPOSE

The Taxpayer Relief Act of 1997 (the "1997 Act") amended § 1 (h) of the Internal Revenue Code ("new § 1 (h)") to provide for new capital gains rates for noncorporate taxpayers (individuals, estates, and trusts), effective for tax years ending after May 6, 1997. Pub. L. No. 105-34, § 311, 111 Stat. 788 (Aug. 5, 1997). The chairmen and ranking members of both the House Ways and Means Committee and the Senate Finance Committee have advised the Department of the Treasury of their intent to pursue technical corrections legislation which would correct and clarify the rules for netting capital gains and losses under new § 1 (h) and coordinate new § 1 (h) with certain other provisions of the Code. Such legislation has already been approved by the House Ways and Means Committee. See H.R. 2645, 105th Cong. § 4 (d) (1997). When enacted, the legislation will be effective retroactively for tax years ending after May 6, 1997. This notice summarizes new § 1 (h) and describes how the Internal Revenue Service is taking into account the pending retroactive legislative corrections in administering the provision.

BACKGROUND

Under prior law, capital gains were taxed at the same rate as ordinary income, except that a noncorporate taxpayer was subject to a maximum marginal rate of 28 percent on net capital gain. Under § 1222, net capital gain is the excess of net long-term capital gain (from assets held for more than one year) over net short-term capital loss (from assets held for one year or less).

The definitions of net capital gain, net long-term capital gain or loss, and net short-term capital gain or loss were not changed by the 1997 Act. However, under new § 1 (h), if a noncorporate taxpayer has a net capital gain, the taxpayer's long-term capital gains and losses are separated into three tax rate groups.

(1) The 28-percent group. The 28-percent group consists of the following:

   (a) capital gains and losses properly taken into account before May 7, 1997, from assets held for more than one year;

   (b) capital gains and losses properly taken into account after July 28, 1997, from assets held for more than one year but not more than 18 months; and

   (c) capital gains and losses from collectibles (including works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages) held for more than one year, regardless of the date taken into account.

This group also includes long-term capital loss carryovers. For sales of certain small business stock after August 10, 1998, an amount equal to the gain excluded under § 1202 (a) will be included in the 28-percent group.

(2) The 25-percent group. The 25-percent group consists of unrecaptured section 1250 gain (there are no losses in this group). Unrecaptured section 1250 gain is long-term capital gain, not otherwise recaptured as ordinary income, attributable to prior depreciation of real property and which is from property held for more than one year (if taken into account after May 6, 1997, but before July 29, 1997), or for more than 18 months (if taken into account after July 28, 1997).

(3) The 20-percent group. The 20-percent group (10 percent in the case of gain that would otherwise be taxed at 15 percent) consists of long-term capital gains and losses that are not in the 28-percent or 25-percent group. Thus, for 1997 a rate of 20 or 10 percent applies to net capital gain (other than collectibles gain or unrecaptured section 1250 gain) from capital assets held for more than one year (if taken into account after May 6 but before July 29), or for more than 18 months (if taken into account after July 28).

New § 1 (h) also applies to gains and losses that are characterized as capital under § 1231, which covers certain transactions including sales of depreciable property or real property used in a trade or business. These gains and losses are included in the appropriate rate group, depending on the holding period and disposition date of the particular asset.

NETTING GAINS AND LOSSES

Within each group, gains and losses are netted to arrive at a net gain or loss. Taking into account the pending legislation, the following additional netting and ordering rules apply:

(1) Short-term capital gains and losses. As under prior law, short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary income rates. A net short-term capital loss is then applied to reduce any net long-term gain from the 28-percent group, then to reduce gain from the 25-percent group, and finally to reduce net gain from the 20-percent group.

(2) Long-term capital gains and losses. A net loss from the 28-percent group (including long-term capital loss carryovers) is used first to reduce gain from the 25-percent group, then to reduce net gain from the 20-percent group. A net loss from the 20-percent group is used first to reduce net gain from the 28-percent group, then to reduce gain from the 25-percent group.

Any resulting net capital gain that is attributable to a particular rate group is taxed at that group's marginal tax rate.

COORDINATION WITH OTHER PROVISIONS

The pending legislation coordinates the multiple rates of new § 1 (h) with certain other provisions of the Code. Accordingly, the following rules apply:

(1) Holding periods. Under prior law, certain inherited property, if disposed of within one year after the decedent's death, was deemed to have been held for more than one year under § 1223 (11) or (12). Such property, if disposed of within 18 months after the decedent's death, is now deemed to have been held for more than 18 months. A similar rule applies for certain patents described in § 1235 (a). Gain or loss from a section 1256 contract, to the extent that it is treated as long-term capital gain or loss under § 1256 (a) (3), is now treated as attributable to property held for more than 18 months. Rules similar to those of § 1233 (b) and (d) (involving short sales of substantially identical property) and § 1092 (f) (involving certain stock options) apply with respect to property held for more than one year but not more than 18 months.

(2) Recharacterized section 1231 gains. If a portion of the taxpayer's net section 1231 gain for the year is recharacterized as ordinary income under section 1231 (c), the gain so recharacterized consists first of any net section 1231 gain in the 28-percent group, then any section 1231 gain in the 25-percent group, and finally any net section 1231 gain in the 20-percent group.

(3) Alternative minimum tax. Newlyenacted § 55 (b) (3) provides favorable alternative minimum tax ("AMT") rates for certain categories of capital gain. The amounts of these gains are determined according to the principles used for regular tax purposes, although the AMT amounts can vary from the regular tax amounts because of AMT adjustments and preferences.

FORMS AND PUBLICATIONS

The Service is amending relevant forms, instructions, and publications (including Schedule D) to reflect the rules set forth above.