What Is the Capital Gain Tax?

Capital gains are the profits realized from the sale of capital assets such as stocks, bonds, and property. The capital gain tax is triggered only when an asset is sold, not while the asset is held by an investor. However, mutual fund investors could be charged capital gains on investments in the fund that are sold by the fund during the year.

There are two types of capital gains: long term and short term; each is subject to different tax rates. Long-term gains are profits on assets held longer than 12 months before they are sold. The American Taxpayer Relief Act of 2012 instituted a 20% long-term capital gains tax rate for taxpayers in the 39.6% income tax bracket and extended both the 0% capital gains tax rate for individuals in the 10% and 15% tax brackets and the 15% capital gains tax rate for all other tax brackets. Short-term gains (on assets held for 12 months or less) are taxed as ordinary income at the seller's marginal income tax rate.

The taxable amount of each gain is determined by a "cost basis" — in other words, the original purchase price adjusted for additional improvements or investments, taxes paid on dividends, certain fees, and any depreciation of the assets. In addition, any capital losses incurred in the current tax year or previous years can be used to offset taxes on current-year capital gains. Losses of up to $3,000 a year may be claimed as a tax deduction.

If you have been purchasing shares in a mutual fund over several years and want to sell some holdings, instruct your financial professional to sell shares that you purchased for the highest amount of money, because this will reduce your capital gains. Also, be sure to specify which shares you are selling so that you can take advantage of the lower rate on long-term gains. The IRS may assume that you are selling shares you have held for a shorter time and tax you using short-term rates.

Capital gains distributions for the prior year are reported to you by January 31, and any taxes that must be paid on gains are due on the date of your tax return.

Higher-income taxpayers should be aware that they may be subject to an additional 3.8% Medicare unearned income tax on net investment income (unearned income includes capital gains) if their adjusted gross income exceeds $200,000 (single filers) or $250,000 (married joint filers). This is an outcome of the Patient Protection and Affordable Care Act.