

1) 5% maximum tax rate (0% for tax years beginning after 2007) on adjusted net capital gains that otherwise would be taxed at the regular 10% or 15% tax rates.

If a non-corporate taxpayer has a net capital gain (excess of net long-term capital gains over net short-term losses, subject to certain netting rules, and increased by qualified dividend income for a tax year, ²⁷ a tax of 5% (0% for tax years beginning after 2007, see below) applies to so much of the adjusted net capital gain (this is net capital gain reduced [but not below zero] by unreaptured section 1250 gain and by "28% rate gain," and then increased by qualified dividend income, (or, if less, taxable income) that doesn't exceed the excess (if any) of: ²⁸

- (1) the amount of taxable income that would be taxed at a rate below 25% (without taking the special capital gains rates into account), ²⁹ over
- (2) taxable income reduced by the adjusted net capital gain. ³⁰

RIA observation: The amount of taxable income that would be taxed at the regular tax rate below 25% (in (1), above) is the amount that would be taxed at 10% or 15%, since the 10% and 15% rates are the only regular tax rates that are below 25%. This means that, effectively, the amount at (1) is the "top" of the 15% rate bracket for each of the classes of individual taxpayers. For 2007, those amounts are as follows:

... single taxpayers and married taxpayers filing separate returns, \$31,850;
... married taxpayers filing joint returns and surviving spouses, \$63,700;
... heads of households, \$42,650.

The amount at (2) is taxable income other than adjusted net capital gain—that is:

... "ordinary" income; plus
... net short-term capital gain; plus
... unreaptured section 1250 gain; plus
... collectibles gain; plus
... section 1202 gain.

As discussed above, the 5%/0% rate only applies to adjusted net capital gain. Because unreaptured section 1250 gain, collectibles gain, and section 1202 gain (from the sale of qualified small business stock), are specifically excluded from the definition of adjusted net capital gain, the 5%/0% rate does not apply to those types of capital gains.

Thus, the 5% maximum capital gains rate applies to gain that would otherwise be taxed at the regular 15% rate ³¹ and/or the regular 10% rate.

RIA observation: Since, as noted above, the regular 15% rate bracket for a single taxpayer in 2007 stops at taxable income of \$31,850 (see Tables & Rates ¶ TBL-1001), the maximum amount of any single taxpayer's adjusted net capital gain that could be taxed at the 5% capital gains rate in 2007 is \$31,850.

RIA illustration : If, in 2007, a single taxpayer had taxable income of \$35,000, all of which consisted of adjusted net capital gain, the 5% capital gains tax rate could apply to no more than \$31,850 of the gain, as follows:

(1) Amount of taxable income that would (ignoring the special capital gains tax rates) be taxed below 25% (i.e., that would be taxed in the 10% and 15% brackets)	\$31,850
minus:	
(2) Taxable income minus adjusted net capital gain (\$35,000 - 35,000)	-0-

Maximum amount of gain taxed at 5%	\$31,850

But if, as is more likely, a taxpayer also has other taxable income that isn't adjusted net capital gain, the maximum amount of the adjusted net capital gain to which the 5% capital gains tax could apply would be reduced as a result of the application of the rule in (2).

RIA illustration : Assume the single taxpayer in *RIA illustration (1)* above had taxable income of \$45,000 in 2007, \$10,000 of which was ordinary income and \$35,000 of which was adjusted net capital gain. The 5% tax would apply to only \$21,850 of the adjusted net capital gain, determined as follows:

(1) Amount of taxable income that would (ignoring the special capital gains tax rates) be taxed below 25% (i.e., that would be taxed in the 10% and 15% brackets)	\$31,850
minus:	
(2) Taxable income minus adjusted net capital gain (\$45,000 - \$35,000)	10,000

Maximum amount of gain taxed at 5%	\$21,850

The above rules result in the application of the two lowest tax rates (the 10% and 15% rates), against the types of income making up the item (2) amount—ordinary income, short-term capital gain, etc.—before the 5%/0% rate can be applied to adjusted net capital gain (not exceeding the item (1) amount). In other words, those types of income effectively “absorb” the 5%/0% rate before it can actually be applied to adjusted net capital gain. See *RIA Illustration (2)* above.

But where the taxpayer's item (1) amount—the maximum amount of the taxpayer's taxable income subject to the 15% rate—exceeds the taxpayer's item (2) amount, the 5%/0% rate applies to the taxpayer's adjusted net capital gain to the extent of that excess, regardless of whether the taxpayer has additional income taxable at higher rates (or not taxable at all), and regardless of whether the taxpayer's taxable income has been achieved as a result of allowable deductions. In other words, the 5%/0% rate is potentially available to all taxpayers with adjusted net capital gain, and not exclusively to taxpayers who are taxable *only* at the lowest tax rates.

RIA illustration : For 2007, H and W, married taxpayers who file a joint return, have adjusted gross income (AGI) of \$255,000, consisting of \$115,000 of wages and taxable interest, plus \$140,000 of long-term capital gain from the sale of stock. This gain qualifies as adjusted net capital gain. H and W also have tax-exempt interest income of \$75,000. Assume that, for the year, H and W are entitled to personal exemptions of \$5,000, and \$90,000 of itemized deductions for real estate taxes, mortgage interest, and charitable donations, resulting in taxable income for the year of \$160,000 (\$255,000 AGI – \$5,000 personal exemptions – \$90,000 itemized deductions). Under these circumstances, the 5% rate would apply to \$43,700 of H's and W's adjusted net capital gain, computed as follows:

(1) Amount of taxable income that would (ignoring the special capital gains tax rates) be taxed below 25% (i.e., that would be taxed in the 10% and 15% brackets)	\$63,700
minus:	
(2) Taxable income minus adjusted net capital gain (\$160,000 - \$140,000)	20,000

Maximum amount of gain taxed at 5%	\$43,700

For tax years beginning after 2007, the 5% rate at footnote 28 above will be reduced to 0%.