

Holding period rules for preferential capital gains treatment

What a difference a day makes! We've all heard that expression more often than we care to remember. But when it comes to selling appreciated-in-value capital assets such as stocks, the expression isn't a cliché. One less day of ownership can be the difference between having your gain taxed at your regular tax rate (which can be as high as 35%) instead of at the preferential 15% top tax rate that applies to *long-term* capital gain from most capital assets (and a 5% capital gains rate for those who would pay regular tax at a rate below 25% on the gain if it were treated as ordinary income instead of capital gain). The tax term involved is called the *holding period*, the minimum period of time you must hold a capital asset for gain to be favorably taxed as long-term capital gain.

Here's an introduction to some of the more common holding period rules that apply to capital assets. It will help you avoid making a tax mistake that can't be undone once your trade is made. Keep in mind, however, that the tax payable on your gain is only one of the factors to take into account in deciding when to sell a capital asset. For example, if you expect a stock's value to decline substantially before the long-term holding period is met, you may very well be better off by selling that stock immediately and paying tax at the higher rate for short-term gains.

General holding period rule. To yield "long term" capital gain, an asset must be held for more than one year, in other words, for at least a year and a day. The holding period begins on the day *after* you buy an asset, and ends *on* the day you sell it. For example, suppose you bought stock on Jan. 3 of Year 1. Your holding period began on Jan. 4 (the day after you bought). If you sell at a profit on or after Jan. 4 of Year 2, your gain will be long-term capital gain. If you sell on Jan. 3, Year 2 (or sooner), any gain will be short-term, taxed at the same rate as ordinary income. Keep in mind that for publicly traded securities, the holding period begins on the day after the trading date you bought the securities, and ends on the trading date you sold them.

Special holding periods. There are a number of special holding periods that must be met for certain types of gains to be favorably taxed. Here are a few of them:

- If you inherit a capital asset, you are automatically treated as having held it for more than one year. Thus, for example, if you inherit an asset and sell it six months later at a gain, your gain is taxed as long-term capital gain. This rule applies regardless of how long the decedent owned the asset.
- A dual holding period applies if you have been granted an incentive stock option (ISO) by your employer and you exercise the option and buy stock. To qualify for full long-term capital gain treatment on the stock you buy, you must hold the stock for (1) at least one year after the shares were transferred to you, and (2) at least two years from the date that the ISO was granted.
- Up to one-half of the gain on the sale of qualified small business stock (up to 60% if the stock is in an empowerment zone business) is tax free (with the balance generally taxed at a special 28% capital gains rate) if the stock was originally issued after Aug. 10, 1993 by a qualifying corporation, and the stock is held for more than five years.
- If you invest in commodity futures, gain on the sale of those futures qualifies as long-term capital gain as long as you held them for at least six months and a day before the sale.
- A capital gain dividend from a mutual fund automatically is treated as long-term capital gain, regardless of how long you held the mutual fund shares generating the dividend.

Adding on someone else's holding period. There are instances where your holding period includes someone else's. For example, if someone gives you stock, your holding period includes the donor's holding period. Similarly, if you acquire property from your spouse (or your ex-spouse, in the case of a divorce), your holding period includes your spouse (or ex-spouse's) holding period.

Adding on another property's holding period. Where you defer gain on property by exchanging it for other property, the holding period of the new property includes the holding period for the old property. Thus, for example, if you swap an apartment building for an office building, your holding period for the office building includes the period of time you held the apartment building.

Dividends taxed at long-term capital gains rates. As you may be aware, dividends that you receive from domestic corporations and "qualified foreign corporations" are taxed at the 5% and 15% rates applicable to long-term capital gains. To qualify for such treatment, you must hold the stock on which the dividend is paid for more than 60 days during the 120-day period beginning 60 days before the ex-dividend date. In the case of dividends with respect to preferred stock which are attributable to a period or periods aggregating more than 366 days, you must hold the stock for more than 90 days during the 180-day period beginning 90 days before the ex-dividend date.

Where holding period doesn't matter. In the case of assets held in an IRA or qualified retirement account, it doesn't matter how long the stocks, bonds, or other assets were held. That's because all your withdrawals will be treated as ordinary income. And if the assets are held within a Roth IRA, your withdrawals will be 100% tax-free if they are qualified distributions (made after you've had a Roth IRA for five tax years and paid out after you are 59-1/2, or if you are disabled, or for certain first-time homebuyer expenses, or after your death).