

Treat Capital Gains as Investment Income

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Jane is in the 33% tax bracket for 2006. Her income includes \$2,000 of interest income and \$6,500 of net long-term capital gain from sale of gold. She also has \$5,000 of investment interest expense from broker margin accounts. She expects her 2007 income and deductions to be similar to 2006.

Generally, investment interest is only deductible, as an itemized deduction, to the extent of investment income. If Jane were to prepare her return without considering her available options, she would probably just deduct \$2,000 of her 2006 investment interest expense and carryforward the remaining \$3,000 indefinitely.

Many taxpayers are surprised to hear that Gold is considered a "collectible" and is subject to the 28% capital gains rate, not the more common 15% long-term capital gains rate. Because of this, Jane would be better off if she made an election on her 2006 tax return to include part of her net capital gains in investment income.

Making this election would cause Jane to treat \$3,000 of the net capital gain as investment income. In doing so, this \$3,000 is taxed as ordinary income at her 33% tax rate instead of at the 28% collectibles long-term capital gains rate. This results in an additional \$150 [$\$3,000 \times (33\% - 28\%)$] of tax paid on the net capital gain, but she is now entitled to an additional \$3,000 of investment interest expense deduction. This results in a tax savings of \$990 ($\$3,000 \times 33\%$). **The net result is a tax savings of \$840!**

This election should not be made without first considering your entire tax situation and expected future tax situation. If the gain was instead taxed at the 15% capital gains rate or if Jane expected her 2007 investment income to increase or if she expected her 2007 taxable income to increase enough to push her into a higher tax bracket, this deduction may not be as beneficial. There are other issues that may also need to be considered, such as whether there are any other capital gains before making a decision such as this. As always, it is best to consult with your tax advisor in situations such as this.

Gina L. Gwozdz is a CPA who has chosen to specialize in taxes. Visit her website at <http://GLGcpa.com> to view more Tax Tip Articles.