Chapter 8 Capital Gains and Losses

- Define "capital asset" and holding period for long-term and short-term capital gains
- Calculate gain/loss on asset disposition
- Compute tax on capital gains and understand treatment of capital losses
- Identify treatment of 1231 assets and describe depreciation recapture rules
- Identify casualty loss treatment for personal and business purposes
- Outline gain deferral provisions on various transactions
- Identify tax treatment of voluntary conversions, sale of personal residence and like-kind exchanges

Define a Capital Asset

Capital assets are defined by exception

A capital asset is any asset *other than* inventory, receivables, copyrights, certain U.S. Government publications and depreciable or real property used in a trade or business.

Capital Gains and Losses

- Sale/exchange of capital asset results in a capital gain or loss
  - Although not defined precisely – "sale" is receipt of cash or release of debt and "exchange" requires transfer of ownership
  - Capital gains and losses receive special tax treatment
  - Tax treatment based on length of time property has been owned (called holding period)

Capital Assets - Holding Period

- Determining holding period is the first step in determining tax treatment
- The holding period for capital assets is how long the taxpayer owned the asset
  - ***Long-term*** assets are held for > 12 months
  - ***Short-term*** assets are held for ≤ 12 months

Realized Gains/Losses
vs.
Recognized Gains/Losses

Realization of gain or loss requires the "sale or exchange" of an asset.

	Amount realized*
less:	Adjusted basis of property*
	Realized gain (loss)
less:	Allowed gain deferral*
	Recognized gain (loss)

Amount Realized

Amount Realized = Gross sales price - Selling expenses

- *Gross sales price* is the amount received by the seller from the buyer and equals
  - Cash and fair market value (FMV) of property received

    plus
  - Seller’s liability assumed by or paid for by the buyer

    less
  - Selling expenses (costs paid to transfer property)

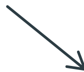
Example of Calculating Gain/Loss & Solution

Example

On 8/4/13, Juliana sold 326 shares of stock in Nanoplasma LLC that she had purchased 6/18/99. Her cost basis = $10,000; she sold it for $19,000 and paid a commission of $1,300. Calculate "amount realized" and "realized gain."

Solution

Amount realized = $17,700 ($19,000 – $1,300)



Realized gain = $7,700 ($17,700 - $10,000)

Adjusted Basis

	Original cost
plus:	Capital improvements*
less:	Accumulated depreciation
	Adjusted basis

***Items that significantly result in an increase to property value or increases the useful life**

Cost Basis for Stock

- Oftentimes difficult for taxpayers to track adjusted basis of stock
  - Depends upon whether stock was **purchased**, **inherited** or received as a **gift**
- Basis depends upon how acquired
  - If inherited, heir's basis is generally *fair market value* at time of death
  - If acquired as gift, basis depends upon whether donee sells at a gain or loss

Due to many errors in reporting security sales,

Congress now requires brokers to report basis for certain sales of stock purchased on or after 1/1/11 & mutual funds beginning in 2012.

Net Capital Gains

- There are complex capital gain rules based on type of capital gain
  - Short-term capital gains - taxed at ordinary income rates
  - Long-term capital gains - taxed at preferred rates, (see next slide) depending on which bracket a taxpayer is normally in
  - Unrecaptured 1250 gain has differing rates, depending on which bracket a taxpayer is normally in.

Tax Treatment for Net Long-term Capital Gains

- Study "Capital Gains & Applicable Tax Rates" chart on p. 8-7
- Net long-term capital gain (LTCG) rates depend upon regular tax bracket*
  - Taxed at 0% for taxpayers in 10% or 15% brackets
  - Taxed at 15% for taxpayers in 25-35% brackets
  - Taxed at 20% for taxpayers in 39.6% bracket
- Unrecaptured depreciation on real estate is taxed at a maximum rate of 25%*
- Collectibles held more than 12 months are taxed at a maximum rate of 28%*

***Additionally, a 3.8% Medicare tax on net investment income, including qualifying dividends, applies to high-income taxpayers with income over certain thresholds.**

Tax Treatment for Net Short-term Capital Gains

- Short-term capital gains result from selling capital assets held less than or equal to one year
- Net short-term capital gain (STCG) is taxed as ordinary income

Calculating Net Capital Position

Long-term gains netted against Long-term losses = **Net Long-term Gain or Loss**

Step 1: Classify each item as short-term or long-term and net by groups

Short-term gains netted against Short-term losses = **Net Short-term Gain or Loss**

Calculating
Net Capital Position

Step 2: If short-term & long-term net results are same sign:
do not net! You will have both a STC and LTC gain or loss.

If net short-term & long-term are opposite signs:

Net the short-term gain or loss against the long-term gain or loss

=

Net Capital Gain or Loss

Net Capital Losses

- Note that net capital losses (short-term and long-term) may be taken against ordinary income in amounts up to $3,000/year (with an indefinite carry forward)
- Must maintain 'nature' of capital loss (i.e. – short-term or long-term) when carrying it forward
  - In subsequent years, must deduct STCL *first*

Note: Must comply with ordering rules (on next screen)

Ordering Rules for Capital Losses

- When taxpayer has net capital loss position, must offset capital gains using ordering rules
  - Net STCL first reduce 28% gains
    - Then reduce 25% gains
    - Then reduce regular LTCG
  - Net LTCL first reduce 28% gains
    - Then reduce 25% gains
    - Then reduce regular STCG

Note: Sale of personal capital assets (like personal residence or automobile) does not generate a tax-deductible loss

Net Capital Position Example

Example

Shavril has the following capital gains and losses in the current year:

Short-term capital loss	($ 2,000)
Long-term capital gain	12,000
Long-term capital loss carryover	(7,000) *

**Carried forward from prior year*

What is Shavril's net capital position? In 2013, what are the tax implications for Shavril's capital activities, if he's in the 15% ordinary income tax bracket?

Solution

Short-term (Step 1 – net short-term activities)

Short-term capital gains	$ 0
Short-term capital loss	(2,000)
Net ST position	(2,000)

Long-term (Step 2 – net long-term activities)

Long-term capital gain	12,000
Long-term capital loss carryover	(7,000)
Net LT position	5,000

(Step 3 –first two steps go in different directions, so net the results)

Net long-term capital gain [($2,000) + $5,000]	3,000

His $3,000 LTCG will be taxed at 0% because he is in the 15% ordinary income tax bracket.

Capital Gain/Loss Example

Example

Thurber has several capital transactions in the current year as follows:

Description	Date Acquired	Date Sold	Selling Price	Cost Basis
Jet Blue Bond	5/5/08	6/1/13	41,400	39,000
Micron Stock	8/3/12	6/1/13	11,000	12,300
AP Health	9/2/99	6/1/13	19,000	24,000

What is Thurber's net capital position? If he has a carry forward, how much is it and what is the nature?

Solution

Example

Thurber has several capital transactions in the current year as follows:

Description	Date Acquired	Date Sold	Selling Price	Cost Basis
Jet Blue Bond	5/5/08	6/1/13	41,400	39,000
Micron Stock	8/3/12	6/1/13	11,000	12,300
AP Health	2/2/99	6/1/13	19,000	24,000

What is Thurber's net capital position? If he has a carry forward, how much is it and what is the nature?

Solution

Jet Blue LTCG = $2,400; Micron STCL = ($1,300); AP Health LTCL = ($5,000) .

Net long-term capital loss = $2,600. Since he has both net short-term and long-term losses, deduct net short-term loss and $1,700 of net long-term loss. Thurber will carry forward a net long-term capital loss of $900 to 2014.

Character of Gain or Loss

	Amount realized from disposition
less:	Adjusted basis of property
	Realized gain (loss)
less:	Deferred gain allowed
	Recognized gain (loss)

Character of gain (loss)

- **Ordinary**
- **§1231 (Form 4797)**
- **Capital (Schedule D)**
- **Personal Use**

Section 1231 Assets

- §1231 assets are not capital assets, but they are given special tax treatment
- Asset must be held > 12 months and used in a trade or business and include:
  - Depreciable real or personal property used in trade or business
  - Timber, coal, or domestic iron ore
  - Livestock (not poultry) held for certain purposes
  - Unharvested crops on land used in a trade or business

§1231 Netting Results

- Net all 1231 gains against losses
- Net 1231 gain is classified as LTCG
- Net 1231 loss is classified as ordinary loss
- This is the best of both worlds!
  - Lower tax rates on gains
  - No limit on losses

Depreciation Recapture

- Prevents taxpayers from receiving the dual benefits of a depreciation deduction *and* capital gain treatment upon sale of the asset
  - Requires gains to be treated as ordinary *to the extent of prior depreciation deductions*
    - §1245 recapture
    - §1250 recapture
    - "Unrecaptured depreciation" previously taken on real estate

1245 Depreciation Recapture

- 1245 applies to property such as
  - Depreciable personal property (such as furniture, machines, computers and autos)
  - Nonresidential real estate placed in service between 1981-1986 with accelerated depreciation
- Gains are treated as ordinary income to the extent of any depreciation taken
  - Any gain in excess of depreciation is netted with §1231 gains/losses and given beneficial tax treatment

Very complex rules, this is an overview only

1245 Example & Solution

Example

Francesca sells depreciable personal property used in her business on 4/1/13 for the price of $50,000. It was purchased for $60,000 four years ago and she has claimed depreciation on the property of $25,000. What is her 1245 recapture?

Solution

§1245 recapture potential	$25,000
Adjusted basis ($60,000 – $25,000)	35,000
Recomputed basis ($35,000 + $25,000)	60,000
Gain realized ($50,000 – $35,000)	15,000

Ordinary income is lesser of (a) $60,000 recomputed basis – $35,000 adjusted basis or (b) $50,000 amount realized - $35,000 adjusted basis.

The entire gain of $15,000 is ordinary income, instead of 1231 gain.

§1250 Depreciation Recapture

- 1250 applies to depreciable real property
  - Other than that identified as   1245
  - Requires partial recapture of depreciation
  - Gains are treated as ordinary income to the extent of accelerated depreciation taken over straight-line depreciation
  - Rarely occurs

Unrecaptured Depreciation on Real Estate

- Requires that portion of the gain attributable to depreciation that is not §1250 or §1245 recapture, must be taxed at a rate of 25%
  - Or 10% if taxpayer in 10% bracket
  - Or 15% if taxpayer in 15% bracket

To the extent of the remaining amount in that bracket, then 25%

- Widely seen in practice as many rentals are depreciated and then sold at gain
- Any gain not attributable to depreciation (in excess of original cost) is a §1231 gain

25% Unrecaptured Depreciation on Real Estate Example

Example

Ella purchases an apartment complex for $7,000,000 on 1/1/88. The property is depreciated straight-line and her accumulated depreciation as of the sale date is $6,100,000. She sells the property on 9/3/13 for $8,500,000. She is in the 33% bracket.

What is Ella's (a) realized gain

and

(b) how is it split between §1231 gain and 25% rate for unrecaptured depreciation?

Solution

Example

Ella purchases an apartment complex for $7,000,000 on 1/1/88. The property is depreciated straight-line and her accumulated depreciation (A/D) as of the sale date is $6,100,000. She sells the property on 9/3/13 for $8,500,000. She is in the 33% bracket.

What is Ella's (a) realized gain and

(b) how is it split between LTCG and 25% rate for unrecaptured depreciation?

Solution

Realized gain = $7,600,000 → $8,500,000 - ($900,000*)

There was $6,100,000 of depreciation taken; this will be taxed at 25%.

The remainder of the gain = $7,600,000
- 6,100,000

This is taxed as LTCG 1,500,000

*** $7,000,000 cost – $6,100,000 A/D = $900,000 adjusted basis**

Casualty Gains & Losses: Personal

- Casualty loss is the lesser of
  - Property's adjusted basis

    or
  - Decline in the value of the property (repair cost)
  - Deductible loss is reduced by
    - Insurance proceeds received
    - $100 floor (per event)
    - 10% of AGI per year
  - Shown as an itemized deduction on Schedule A
- Casualty gain occurs when insurance reimbursement > adjusted basis of property

Casualty Gains & Losses: Business

- Business casualty and theft losses result from damage caused by a sudden, unexpected and/or unusual event
  - For property fully destroyed, deduct adjusted basis
  - For property partially destroyed, deduct the lesser of the property's adjusted basis or the decline in the value
    - Any insurance reimbursement reduces loss
    - May cause gain

Casualty Gains & Losses: Business

- Treatment of gains and losses depends on holding period
  - Property held one year or less
    - Net gains and losses are treated as ordinary
    - Losses from investment property separately calculated
  - Property held more than one year
    - Net gains treated like §1231
    - Net losses must have components analyzed separately

Interaction of 1231 and casualty gains/losses from business or investment property is complex.
See instructions for Forms 4684 and 4797

Casualty Gains & Losses Example

Example

Sherry incurred the following casualty gains/losses and insurance reimbursements in one year, all of the assets are personal property. The fences were destroyed by a hurricane and the boat and trailer by a windstorm. *This was all due to the same storm and is same casualty loss.*

		Adjusted	*Insurance*	*Holding*
Asset	*FMV change*	*Basis*	*Received*	*Period*
Fences	$15,000	$8,000	$15,000	5 years
Boat	$44,000	$50,000	$10,000	6 months
Trailer	$8,000	$10,000	$0	6 months

Solution

Example

Sherry incurred the following casualty gains/losses and insurance reimbursements in one year, all personal. The fences were destroyed by a hurricane & the boat and trailer by a windstorm*. This was all due to the same storm and is the same casualty loss.*

Asset	FMV change	Adjusted Basis	Insurance Received	Holding Period
Fences	$15,000	$8,000	$15,000	5 years
Boat	$44,000	$50,000	$10,000	6 months
Trailer	$8,000	$10,000	$0	6 months

Solution

Hurricane results in a casualty gain = $ 7,000 ← *$8,000 - $15,000*

Windstorm results in a casualty loss = (41,900) ← *($44,000 - $10,000) + ($8,000 - $0)] - $100 floor*

Net casualty loss = 34,900

The total net casualty loss of $34,900 is further reduced by 10% of AGI.

Installment Sales - Form 6252

- An installment sale occurs when
  - Real or personal property or business/rental property is sold

    and
  - Note is signed and payments are collected over time
- Congress allows taxable gain to be reported as cash received, not when sale completed
  - However, can elect to report all the gain in the year of sale
- Otherwise, use Form 6252, Installment Sale Income
  - Must recapture any §1245 or §1250 first
  - Then calculate gross profit percentage
  - Then multiply percentage by cash received each year

Installment Sales Computations

Taxable Gain = $\frac{\text{Realized Gain}^{*}}{\text{Contract Price}^{**}} \times \$\text{ Received}$

***Realized Gain** = Sales Price
Less Selling Expenses
Less §1245 or §1250 Recapture
Less Adjusted Basis

****Contract Price** = Sales Price – Assumed Liabilities

Complex installment sale rules apply to taxpayers who regularly sell real/personal property or business/rental property

§1031 Like-Kind Exchanges

- No gain/loss recognized when an exchange of like-kind property occurs (deferred gain/loss)
  - Like-kind property transactions occur when
    - Exchanging real property for real property

      or

    - Exchanging personal property for personal property of the same asset class
  - Rules only apply to business or investment property
- May have some recognized gain if “boot” is received
  - Boot is defined as cash received in an exchange or any property (inventory, stocks, bonds, or other securities) that is not like-kind
  - Relief from a liability is also treated as boot received

Like Kind Exchange Models

Realized Gain = FMV of property received – Adjusted basis of property given up

Recognized Gain = Lesser of realized gain or boot received

Basis of New Property = Adjusted basis of property given up + Boot paid – Boot received + Gain recognized

Like Kind Exchange Example

Example

Barry exchanges his marina in Alabama for Adolph's Missouri land. The marina has a fair market value of $250,000 and an adjusted basis of $175,000. The land has a FMV of $305,000. Barry also gives Adolph $25,000 cash.

What is Barry's realized gain, recognized gain, and new basis in the land?

Solution

Example

Barry exchanges his marina in Alabama for Adolph's Missouri land. The marina has a FMV of $250,000 and an adjusted basis of $175,000. The land has a FMV of $305,000. Barry also gives Adolph $25,000 cash. What is Barry's realized gain, recognized gain, and new basis in the land?

Solution

Realized gain = $105,000 $305,000 – ($175,000 + $25,000)

Recognized gain =$0 since *no boot was received*

Basis of land $175,000 + 25,000 - 0 + 0 = $200,000

Involuntary Conversions

- Gain recognition may be deferred if involuntary disposal of property
  - Due to an act of God, theft, condemnation, etc.
    and
  - Insurance proceeds are reinvested in qualified replacement property within two years after close of tax year in which conversion occurred
- Must recognize gain if insurance proceeds exceed adjusted basis of property
- Losses are not deferred

Sale of Personal Residence

- Exclusion on gain of personal home allowed on sale of home
  - For sales 5/6/97 or later
  - If owned and used as principal residence for two of the last five years
- Gain exclusion is up to $500,000 (MFJ) or $250,000 (S)

Sale of Personal Residence

- Sales before 5/7/97 were treated very differently
- Taxpayers didn't have to recognize gain on sale of house if 'bought up' when purchasing new residence
  - Therefore, many taxpayers who had sold one or more principal residences over a period of years have a principal residence with a basis that is far lower than the cost of that residence
  - These taxpayers get 'fresh basis' equal to purchase price of newly purchased residence

Beginning in 2009, can't use 'loophole' of moving into previously rented properties every two years and exclude gain – if you rent your residence prior to 2 years of personal use, generally limited to a lesser exclusion