**Chapter Eight**

**Capital Gains and Losses**

**Learning Objective 8.1 Capital Assets**

Tax law defines a capital asset as any property, whether or not used in a trade of business, other than:

1. Stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business
2. Depreciable property or real property used in a trade or business
3. Copyrights, literary, musical or artistic compositions, letters or memorandums, or similar property if the property is created by the taxpayer
4. Accounts or notes receivable and
5. Certain U.S. Government publications.

**Learning Objective 8.2 Holding Period**

Gains and losses from the sale of capital assets are called capital gains and losses and are classified as either short-term (held up to a year) or long-term (held longer than a year).

**Learning Objective 8.3 Calculation of Gain or Loss**

The gain or loss realized is the difference between the amounts received from the sale of the property (including cash and the fair market value of any other property) and any costs paid to transfer the property. The adjusted basis of property is the original basis adjusted by adding capital (major) improvements and deducting depreciation allowed or allowable. The original basis is usually the cost of the property, including costs incidental to the purchase. Capital improvements are expenditures for permanent improvements to or restoration of the property. These expenditures help increase the useful life or the value of the property. Property received as an inheritance has a basis equal to the fair market value at the decedent’s date of death.

**Learning Objective 8.4 Net Capital Gains**

To calculate a taxpayer’s net capital gain or capital loss, the following procedures must be followed:

1. Capital gains and losses are classified as short-term or long-term
2. Long-term capital gains are offset by long-term capital losses, resulting in either a net long-term capital gain or net long-term capital loss
3. Short-term capital gains are offset by short-term capital losses, resulting in either a net short-term capital gain or net short-term capital loss
4. If Step 2 results in a net long-term capital gain, it may be offset by any net short-term capital loss. If Step 2 results in a net long-term capital loss, it may offset net short-term capital gain.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Ordinary Tax Rate | Short-Term Capital Gains | Long-Term Capital Gains | Unrecaptured Section 1250 Gain (See LO 8.7) | Collectibles Gain (Art, Gems, Coins, Stamps, etc.) |
| 10% to 15% | 10% to 15% | 0% | 10% to 15% | 10% to 15% |
| 25% to 35% | 25% to 35% | Capped at 15% | Capped at 25% | Capped at 28% |
| 39.6% | 39.6% | Capped at 20% | Capped at 25% | Capped at 28% |
| 3.8% ACA Medicare Surtax\* | 3.8% added for “high-income” taxpayers | 3.8% added for “high-income” taxpayers | 3.8% added for “high-income” taxpayers | 3.8% added for “high-income” taxpayers |
| Top Total Rate | 43.4% | 23.8% | 28.8% | 31.8% |
| \*The 3.8% Medicare tax on net investment income including qualifying dividends applies to high-income taxpayers with income over certain limits. | | | | |

**Learning Objective 8.5 Net Capital Losses**

Net capital losses occur when the total capital losses for the period exceed the total capital gains for a period. Taxpayers may deduct net capital losses against ordinary income up to $3,000 per year. Unused portions are carried forward until completely used. The following order rules must be followed:

1. Net short-term capital losses first reduce 28 percent gains, then 25 percent gains, then regular long-term gains.
2. Net long-term capital losses first reduce 28 percent gains, then 25 percent gains, then any short-term capital gains.

**Learning Objective 8.6 Section 1231 Gains and Losses**

Section 1231 assets include:

1. Depreciable or real property used in a trade or business,
2. Timber, coal or domestic iron ore
3. Livestock (not including poultry) held for draft, breeding, dairy or sporting purposes
4. Unharvested crops on land used in a trade or business.

To calculate Section 1231 gains and losses, net all Section 1231 gains and losses. If the gains exceed the losses, the excess is a long-term capital gain. When the losses exceed the gains, all gains are treated as ordinary income and all losses are fully deductible as ordinary losses.

**Learning Objective 8.7 Depreciation Recapture**

Three main depreciation recapture rules exists for Section 1245 property, Section 1250 property and unrecaptured depreciation on real estate taxed at the 25 percent rate. Section 1245 property includes the following:

1. Depreciable personal property
2. Livestock
3. Amortizable personal property such as patents, copyrights, leaseholds and professional sports contracts
4. Elevators and escalators
5. Pollution control facilities
6. Nonresidential real property

Any gain recognized from the disposition of Section 1245 property will be classified as ordinary income up to an amount equal to the depreciation claimed after 1961. Any amount over the ordinary income amount is considered Section 1231 gain. Section 1250 applies to real property other than Section 1245 property. If the property was depreciated using the straight-line method, no recapture is necessary. A special 25 percent tax rate was implemented for real property gains attributable to depreciation previously taken and not already recaptured under the Section 1250 rules. The result of the rule is that the gains on the sale of real estate may be taxed at several different ratesranging from 0 percent to 28.8% depending upon the taxpayers regular tax bracket. The ACA imposed an additional 3.8 percent Medicare tax on net investment income for high-income taxpayers increasing the special 25 percent tax to 28.8 percent. (see table LO 1.9 and LO 8.4)

**Learning Objective 8.8 Capital Gains and Casualty Gains and Losses**

Casualty gains are the result of receiving an insurance reimbursement in an amount in excess of the basis of the property. Casualty gains and losses must be netted for tax purposes. If the losses exceed gains, the excess loss is treated as an itemized deduction. When casualty gains exceed casualty losses for the year, none of the casualty losses are subject to the 10 percent of adjusted gross income limitation. Casualty gains and losses from property used in a business or for investment must be classified as a capital asset, trade or business property subject to an allowance for deprecation, or ordinary income property. Clearly, the issue becomes very complex, depending on classification of the asset. Form 4686 and Form 4797 assists taxpayers with the instructions for treatment of the gains and losses.

**Learning Objective 8.9 Installment Sales**

When taxpayers sell property but do not receive the entire payment, an installment sale is created. The taxpayer may spread the gain from the sale over the tax periods in which the payments will be received, or elect to report all the gain in the year of sale.

**Learning Objective 8.10 Like-Kind Exchanges**

Recognition of gains or losses may be deferred for tax purposes, even if the gain or loss has been realized. To qualify as a nontaxable exchange, the property exchanged must be held for productive use in a trade or business or for investment. When an exchange only involves qualified like-kind property, no gain or loss is recognized. If the exchange included cash or other property (boot), the tax consequences can be limited. Gain is recognized in an amount equal to the lesser of the gain realized or the boot received. Relief from liability is the same as receiving cash and is treated as boot. A like-kind exchange must involve real property for real property or personal property for personal property. Also, property classifications must be identical. Office equipment must be exchanged for office equipment, not computers, to be a like-kind exchange.

**Learning Objective 8.11 Involuntary Conversions**

Taxpayers are sometimes forced to dispose of property as a result of circumstances beyond their control, such as natural disasters. Gains on these conversions may be deferred. Replacement property must be similar in use and service. A realized gain on the involuntary conversion occurs when a taxpayer receives an insurance settlement or other payment for the property in excess of the adjusted basis in the property. The involuntary conversion provision applies only to gains, not losses.

**Learning Objective 8.12 Sale of a Personal Residence**

A seller of any age who has owned and used a home as a principal residence for at least two of the last five years can exclude from income up to $250,000 of gain ($500,000 for joint filers) on the sale of the residence. Generally, this exclusion may only be used once every two years. Personal residences include single-family homes, mobile homes, houseboats, condominiums, cooperative apartments, duplexes or row houses. Married taxpayers can exclude the full $500,000 if either spouse owned the home for at least two of the last five years, both spouses used the home as a principal residence of at least two of the last five years and neither spouse has used the exclusion during the prior two years.