**Chapter Eight**

**Capital Gains and Losses**

**Learning Objective 8.1 Capital Assets**

Tax law defines a capital asset by exception – it is everything e3xcept:

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
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

* Classified as either short-term (for assets held up to a year in length) or
* Long-term (for assets held longer than a year).

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

The gain or loss realized is

Amount realized\* - Adjusted basis of the property\*\* = Realized Gain

\*Amount realized = Sales Price (cash and the fair market value of property plus liabilities relieved)

- Costs incurred to transfer the property.

\*\*Adjusted basis = Original cost

+ Capital improvements

* Accumulated depreciation allowed or allowable.

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. Classify all capital gains and losses as either short-term or long-term
2. Long-term capital gains are offset by long-term capital losses = net long-term capital gain or net long-term capital loss
3. Short-term capital gains are offset by short-term capital losses, = 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.

It is necessary to order capital gains included in taxable income. They are ordered as follows

1. Short-term capital gains 2. Unrecaptured Section 1250 gains on real estate 3. Gains on collectibles and 4. Long-term capital gains

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 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% | 25 - 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.

* Can 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% gains, then 25% gains, then regular long-term gains.
2. Net long-term capital losses first reduce 28% gains, then 25% gains, then any short-term capital gains.

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

§1231 assets, although NOT capital assets, are given special treatment. They include

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

To calculate §1231 gains and losses, net all §1231 gains and losses.

* If the gains exceed the losses, the excess is a long-term capital gain.
* If 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 §1245 property, §1250 property and unrecaptured depreciation previously taken on real estate.

§1245 property includes the following:

* Depreciable personal property
* Livestock
* Amortizable personal property such as patents, copyrights, leaseholds and professional sports contracts
* Elevators and escalators
* Pollution control facilities
* Nonresidential real property

Gains from sale of §1245 property is ordinary income up to an amount equal to the depreciation claimed

* Any amount over the ordinary income amount is considered §1231 gain

§1250 applies to real property other than §1245 property.

* If the property was depreciated using SL - no recapture is necessary.
* Must pay 25% for real property gains attributable to depreciation previously taken and not already recaptured under the §1250 rules
  + This means that gains on the sale of real estate may be taxed at several different rates ranging from 0 percent to 28.8% depending upon the taxpayer’s regular tax bracket.
    - The ACA imposed an additional 3.8% Medicare tax on net investment income for high-income taxpayers and that increases the special 25% tax to 28.8% (See LO 1.9 and LO 8.4)

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

Casualty gains and losses must be netted for tax purposes

* Casualty gains are the result of receiving an insurance reimbursement in an amount in excess of the basis of the property.
* 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% 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.

* Use Forms 4686 and Form 4797 to record casualty gains/losses gains and losses

*Note:*  *the issue becomes very complex, depending on classification of the asset*

**Learning Objective 8.9 Installment Sales**

When taxpayers sell property but do not receive the entire payment, an *installment sale* is created.

* Can spread 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.
* The calculation to determine taxable gain reported each year equals

*Total gain realized on the sale/Contract price x Cash collections during the year*

**Learning Objective 8.10 Like-Kind Exchanges**

Exchange like kind property can result in a gain or loss

* 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, for example, to be a like-kind exchange.
* Gains/losses may be deferred for tax purposes
* 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 involves *only 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.

The basis of the like-kind property received equals:

*The basis of the like-kind property given up*

*Plus any boot paid*

*Less any boot received*

*Plus any gain recognized*

**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. *Note: only gains – not losses*
* Replacement property must be similar in use and service.
* A realized gain on the involuntary conversion occurs when insurance settlement > adjusted basis

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

* Gain on sale of a principal residence can be excluded from income up to $250,000 (S), $500,000 (MFJ) on the sale of the residence.
  + Have to have lived in it for two of the last 5 years.
  + 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.