Answers to Selected PAK Problems for Unit09
Chapter 5. Property Transactions - Capital Gains and Losses

Discussion Questions

I:0-1

Cost of the house	$60,000
Cost of the room added to the house	10,000
Cost of built-in bookshelves	800
Basis for the house p. I:5-4.	$70,800

I:0-2 a. David's holding period starts on October 22 of the current year (the day after the date of the gift) if David uses the FMV at the date of the gift to determine his basis.

b. His holding period starts on January 20, 1995, if he uses his grandfather's basis. pp. I:5-28 and I:5-29.

I:0-3 a. The value of the taxable estate would be $200,000 less and the estate tax is reduced by electing to use the alternate valuation date.

b. Jim's basis for the property would be $200,000 higher, and he might have a smaller gain or larger loss when he sells or exchanges the land.

c. The potential savings in estate tax is $90,000 (45% x $200,000). If the property is subsequently sold at a gain, the tax savings will be $30,000 (15% x $200,000), thus the alternate valuation date should be elected. The holding period for an inherited asset is long-term. Another factor to consider is whether Jim plans to sell the property in the near future since the income tax savings would not occur until Jim sells or exchanges the property while the estate tax savings are realized currently. p. I:5-8.

I:0-4 $150 ($82,500/550 shares). pp. I:5-10 and I:5-11.

I:0-25 The gain on the sale of A is a LTCG of $12,000; the loss on the sale of B is a STCL of $3,000; and the gain on the sale of C is a LTCG of $7,400. Phil's NLTCG is $19,400 and his NSTCL is $3,000. The net capital gain is $16,400 ($19,400 - $3,000). Because there is no collectibles gain, Sec. 1202 gain or unrecaptured Sec. 1250 gain, the NLTCG is ANCG. p. I:5-28.

Problems

I:0-35 a.

Amount realized	$784,000	($800,000 - $16,000)
Minus: Basis*	(118,000)	
Gain Realized	($666,000)	

*$110,000 + ($200,000/$300,000 x $12,000)

b.

Amount realized	$784,000
Minus: Basis	(110,000)
Gain realized	$674,000

pp. I:5-6 and I:5-7.

I:0-46 a. $29,000 [$16,750 + 28% x ($126,000 - $82,250)]
b. $30,715 [$16,750 + 28% x ($126,232* - $82,250) + (15% x $11,000)]

pp. I:5-17 and I:5-18.

*The $11,000 addition to his AGI results in a $110 (3% x $11,000) (1/3) reduction of itemized deductions and a $122 (1/3 x 2% x 5 x $3,650) reduction in the personal exemption deduction, thus his taxable income is increased by $11,232 [$11,000 + ($110 + $122)] and his tax liability is increased by $1,715. Note to instructor: This problem illustrates how ANCG may be subject to a tax rate greater than 15%. The marginal tax rate on the $11,000 NCG amounts to 15.59% ($1,715 ÷ $11,000).

I:0-48

	Situation 1	**Situation 2**	**Situation 3**	**Situation 4**
AGI after considering capital gains and losses	$45,000	$58,000	$59,000	$67,000*
NSTCG (NSTCL)	4,000	(3,000)	1,000	(9,000)
NLTCG (NLTCL)	1,000	11,000	(2,000)	5,000

*$1,000 STCL is a carryforward.

pp. I:5-16 through I:5-18.

I:5-59 a. Taxable income is $185,000 ($140,000 + $10,000 + $15,000 + $20,000)
Tax liability increases by $11,350 [35% ($10,000) + 15% (15,000) + 28% ($20,000)]

The stock held for nine months is a STCG and taxed at Charlene's ordinary income rate of 35%. The stock held for three years is a LTCG and taxed at 15%. The collectible asset is taxed at 28%.

b. Taxable income is $171,000
Tax liability increases by $6,730 [15% ($15,000) + 28% ($16,000)]

The $14,000 STCL first reduces the $10,000 STCG and the remaining $4,000 NSTCL reduces the $20,000 collectible gain.

c. Taxable income is $158,000 ($185,000 - $27,000)
Tax liability increases by $4,700 [35% ($10,000) + 15% ($8,000)]
p. I:5-19.

Case Study Problems

I:5-68 a. Taxpayers who own appreciated capital assets often have the ability to determine when or if the asset will be sold (i.e., the taxpayer has control over determining when the tax will be paid). Proponents of preferential treatment for capital gains often argue that tax revenue will substantially increase in the year the law is changed to allow for preferential treatment. They maintain that many taxpayers with appreciated assets are holding appreciated capital assets waiting for more favorable tax treatment. Most revenue estimates do show an expected increase in tax revenue during the year of change.

For older taxpayers, the voluntary nature of the tax is affected by the basis rules. Taxpayers may avoid the tax on the capital gain by passing the property to an heir, since the heir is allowed a basis equal to the property's FMV at the date of decedent's death.

b. During late 1986, many taxpayers owning appreciated capital assets decided to sell or exchange those assets and utilize the 60% deduction. Since AGI or taxable income reported on the federal return is used to determine state income tax liability for many states, the increased AGI or taxable income created higher taxable income for purposes of determining state tax liabilities. Thus, states experienced a significant increase in 1986 state income tax revenue. The significant increase in sales and exchanges of capital assets during 1986 is additional support for the notion that the tax on capital gain is a voluntary tax (see statement a).

In a September 14, 1990, article in **The Wall Street Journal** entitled "High Capital-Gains Tax Busts State Budgets," realized capital gains for the five states (New York, California, Florida, Texas, and Illinois) that account for nearly half the capital gains in the entire nation are shown for the four-year period 1985-1988. For all five states, 1986 realized gains are significantly higher than 1985 realized capital gains. Furthermore, realized capital gains in 1987 and 1988 are significantly lower than 1986 realized capital gains, a fact that leads the author to conclude that state income tax revenue is being negatively affected by the lack of preferential treatment on capital gain income.

c. Since high-income taxpayers are more likely to have capital gain income and be subject to higher tax rates on non-capital gain income, high-income taxpayers are likely to receive greater benefit from preferential treatment on capital gain income than low-income taxpayers. Based on the Internal Revenue Service's 1986 data, one-third of all NLTCGs are earned by those who earn more than $1 million annually which is less than .5% of all taxpayers. More than 80% of all capital gains are recognized by the richest 10% of taxpayers, those who earned more than $50,000 per year. (**The Wall Street Journal,** "Democrats to Challenge Gains-Tax Cut With Amendments During Panel Vote," July 24, 1989, p. A3). Prior to 1987, noncorporate taxpayers were able to deduct 60% of their net capital gain when determining AGI. That deduction benefited both high and low-income taxpayers but benefited high-income taxpayers more because a deduction is more valuable if one's tax rate is higher. The preferential rates for tax years beginning after 1990 (i.e., the 28% maximum rate on net capital gain) favored high-income taxpayers. Today, low-income and high-income taxpayers receive benefit by having income classified as long-term capital gain. Low-income taxpayers could have a rate as low as 5% and a rate of zero for tax years after 2007.

Proponents of preferential treatment of capital gain income maintain that preferential treatment stimulates economic growth thus benefiting low-income taxpayers and small businesses. They also maintain that numbers such as the above often include moderate-income taxpayers with large, one-time gains. pp. I:5-34 and I:5-35.