Unit09. Property Transactions: Capital Gains and Losses (PAK Chap. 5)

This unit examines the tax consequences of property transactions. A property transaction includes sale, exchange, or abandonment of property. Gains from property transactions are taxed, often at preferential rates. Within limits, certain types of losses from property transactions can be deducted from gross income, reducing a taxpayer's final tax bill.

Outline

1. Determination of gain or loss
2. Basis considerations
3. Definition of a capital asset
4. Tax treatment for capital gains and losses of noncorporate taxpayers
5. Tax treatment for capital gains and losses of corporate taxpayers
6. Sale or exchange
7. Holding period
8. Justification for preferential treatment of net capital gains
9. Tax planning considerations
10. Compliance and procedural considerations

1. Determination of Gain or Loss

1) Realized Gain or Loss (Ex. 5-2, 5-3, 5-4, 5-5, 5-8)

- If a realizing event occurs (normally a sale or exchange), the amount realized less the asset's adjusted basis will equal realized gain or loss.
- Amount realized consists of money and FMV of property received plus taxpayer's debt assumed by the buyer less costs of sale (i.e., commissions).
- Adjusted basis equals original basis (i.e., cost, gift, inheritance) plus additions (i.e., capital improvements) less reductions (i.e., depreciation, cost recovery, depletion, casualty loss, severance).
  - EXAMPLE: The taxpayer sells a piece of land for $20,000. Costs of sale are $1,000. The land cost the taxpayer $15,000 two years ago. Realized gain equals the amount realized of $19,000 ($20,000 sales price less $1,000 costs of sale) less the adjusted basis of $15,000 (cost) or $4,000.

1. Determination of Gain or Loss

2) Recognized Gain or Loss (Ex. 5-9)

- The amount of recognized gain or loss on disposition of an asset may be less than the realized gain or loss due to special nonrecognition or deferral of recognition statutory provisions.
  - EXAMPLE: Types of tax nonrecognition provisions are the like-kind exchange rules and the involuntary conversion rules.

2. Basic Considerations

1) Cost of Acquired Property (Ex. 5-10, 5-11, 5-14, 5-15)

- The most frequently applicable original basis is a cost basis. Cost basis includes cash, FMV of other property, debt, and transactional costs incurred in the acquisition.
- Uniform capitalization rules are mandated for certain kinds of inventory and certain other property.
- Construction period interest and taxes must be capitalized for certain "long useful life" property.
- With homogeneous property (i.e. blocks of identical common stock) specific identification of sold property may not be possible. In this case, the tax law requires a FIFO approach.
- Owners of mutual funds may use an average cost method in addition to FIFO and specific identification.

2. Basic Considerations

2) Property Received as a Gift (Ex. 5-16 through 5-18)

- The donee's adjusted basis for gain is the donor's adjusted basis plus a gift tax adjustment for the gift tax paid related to the gift property's appreciation to the date of gift.
- The donee's adjusted basis for loss is the lesser of the gain basis or the FMV at the date of gift.
- The gain basis is used for calculating any depreciation/cost recovery. The amount of depreciation /cost recovery allowed or allowable is subtracted from the applicable gain basis or loss basis in the event of a disposition.

Calculation of Donee's Basis for Gift Property

Basis for Gain = Donor's Adjusted Basis + Gift Tax Adjustment

$$\text{Gift Tax Adjustment} = \text{Gift Tax Paid} \times \frac{\text{(FMV of Gift - Donor's Adjusted Basis)}}{\text{Amount of Gift [FMV of Gift - Annual Exclusion(s)]}}$$

Basis for Loss = Lower of Basis for Gain or FMV Date of Gift

Gain basis may be used for depreciation/cost recovery calculation purposes.

2. Basic Considerations

3) Property Received from a Decedent (Ex. 5-20, 5-24, 5-25, 5-26)

- Basis of inherited property is generally fair market value at date of death or alternate valuation date. The alternate valuation date is six months after the date of death. If property owned by the decedent at the time of death is not held by the estate six months later, such property is valued at its disposition date for alternate valuation purposes. The alternate valuation can be elected by the executor only if its use lowers the value of the estate and lowers the estate tax liability.
- Both halves of community property receive a step-up in basis at the death of one of the spouses.
- Certain items (income in respect of a decedent) for which the decedent did not recognize income during her life because of accounting method or special deferral rules will not receive a step-up in basis at the date of death.
  - EXAMPLE: If a taxpayer was reporting a sale under the installment method at the time of her death, the person inheriting the installment notes would be income taxable on the unrecognized gain in the transaction on the same basis the decedent taxpayer would have been taxed.

2. Basic Considerations

4) Property Converted from Personal to Business Use (Ex. 5-27 thr. 5-29)

- Basis of personal use property converted to business use property is the lower of the personal use adjusted basis or the property's fair market value at conversion.
  - EXAMPLE: If a taxpayer converts a personal residence (cost $125,000) into rental property at the time when the residence's fair market value is $100,000, depreciation/cost recovery must be calculated on the lesser amount - $100,000.

2. Basic Considerations

5) Allocation of Basis (Ex. 5-31, 5-33, 5-34, 5-35, 5-37)

- If multiple assets are acquired for a single purchase price (i.e., basket purchase), the acquisition cost must be allocated to the individual assets on the basis of their relative FMV.
- If identical shares are received as a nontaxable stock dividend (i.e. common on common) the old adjusted basis is allocated equally to all shares.
- If different shares (i.e. preferred on common) or rights are received in a nontaxable transaction, the old adjusted basis is allocated based on the relative fair market of each different type of asset.
- Allocation of basis to a nontaxable stock right received is mandatory if the right has a fair market value of at least 15% of the FMV of the underlying stock. Allocation of basis to other nontaxable stock rights is elective.

Allocation of Basis for <u>Nontaxable</u> Stock Dividend

Identical Stock Issued:

$$\frac{\text{Adjusted Basis of Stock Before Stock Dividend}}{\text{Number of Shares Owned After Stock Dividend}} = \text{Per Share Adjusted Basis of All Shares*}$$

Different Shares Issued:

$$\text{Basis of old shares*} = \text{Adjusted Basis of Stock Before Dividend} \times \frac{\text{FMV of old shares}}{\text{FMV of old shares + new shares}}$$

$$\text{Basis of new shares*} = \frac{\text{Adjusted Basis of Stock Before Stock Dividend} \times \text{FMV of new shares}}{\text{FMV of old shares + new shares}}$$

3. Definition of a Capital Asset (Ex. 5-38, 5-39)

- Capital assets for tax purposes are defined as assets other than inventory, depreciable property or real property used in a trade or business, certain accounts or notes receivable, certain taxpayer produced works, and certain government publications.
  - EXAMPLE: A taxpayer's personal residence is a capital asset.

3. Definition of a Capital Asset

1) Influence of Courts

- Corn Products Refining Co. and Arkansas Best Corporation are two important Supreme Court cases defining capital asset treatment in trade or business situations.

3. Definition of a Capital Asset

2) Other Code Relevant Provisions (Ex. 5-40, 5-42, 5-45)

- Dealers normally treat securities as inventory which generates ordinary income. Security dealers must use the mark-to-market inventory method [yearly appreciation taxed] for tax years ending December 31, 1993, or later.
  - EXCEPTION: On acquisition, dealers may elect to treat certain securities as held for investment, thereby generating capital gain or loss on disposition.
- Certain noncorporate, nondealer taxpayers can subdivide land and sell a limited number of lots while retaining capital gain treatment.
- Nonbusiness bad debts are treated as short-term capital losses.

4. Tax Treatment for Capital Gains/Losses of Noncorporate Taxpayers (Topic Review 5-2)

1) Capital Gains (Ex. 5-46 through 5-51)

- Net capital gain results when net long-term capital gains exceed net short-term capital losses.
  - EXAMPLE: If the taxpayer has a $10,000 long-term capital gain on the sale of stock and a $5,000 short-term capital loss from the sale of land, the net capital gain is $5,000.
- For capital assets held more than one year, the maximum rate on net long-term capital gain is 15% (0% if taxpayer is otherwise in the 15% or 10% bracket). Long-term gains from collectibles are generally taxed at 28%.

4. Tax Treatment for Capital Gains/Losses of Noncorporate Taxpayers (Topic Review 5-2)
2) Capital Losses (Ex. 5-56, 5-57, 5-59, 5-60)

- Net short-term capital losses are offset against net-long term capital gains in this order: (1) 28% group, (2) 25% group, and (3) 15% group.
- Net capital losses (whether short-term or long-term) offset ordinary income to a $3,000 maximum, with an unlimited carryover to future years.
  - EXAMPLE: If the taxpayer has an $8,000 net capital loss (whether short-term or long-term), he may offset $3,000 of ordinary income in the current tax year and carryover $5,000 of net capital loss indefinitely until utilized.

5. Tax Treatment for Corporate Taxpayers (Ex. 5-63)

- Most rules for capital gains and losses are the same for noncorporate and corporate taxpayers
- Major differences:
  - The lower rate of 15%, 25% and 28% for non-corporate taxpayers do NOT apply to corporate taxpayers.
  - Unlike the noncorporate taxpayer who may deduct up to $3,000 of capital losses from ordinary income, corporations may offset capital loss only against capital gains

6. Sale or Exchange

1) Worthless Securities (Ex. 5-64, 5-65)

- Securities that become totally worthless in a tax year are treated as a capital loss on the last day of the tax year.
  - EXAMPLE: If a security becomes worthless on February 1st, a calendar-year taxpayer treats the loss as a capital loss occurring on December 31st.

6. Sale or Exchange

2) Retirement of Debt Instruments (Ex. 5-67, 5-70, 5-72)

- Amounts received on retirement of debt are treated as being received in an exchange, with original issue discount and market discount impacting the final calculation of income or loss.
- Sale or exchange of market discount bonds purchased after April 30, 1993, may result in additional ordinary income rather than capital gain.

6. Sale or Exchange

3) Options (Ex. 5-73, 5-74, 5-76)

- Options that are exercised are added to the cost basis. Options that are sold or lapse give rise to sale or exchange treatment.

6. Sale or Exchange

4) Patents (Ex. 5-78)

- Under certain conditions, the sale or exchange of patent rights may generate a capital gain.

6. Sale or Exchange

5) Franchises, Trademarks, and Trade Names (Ex. 5-81)

- Certain franchises, trademarks, and trade names may generate capital gain or loss on sale or exchange.

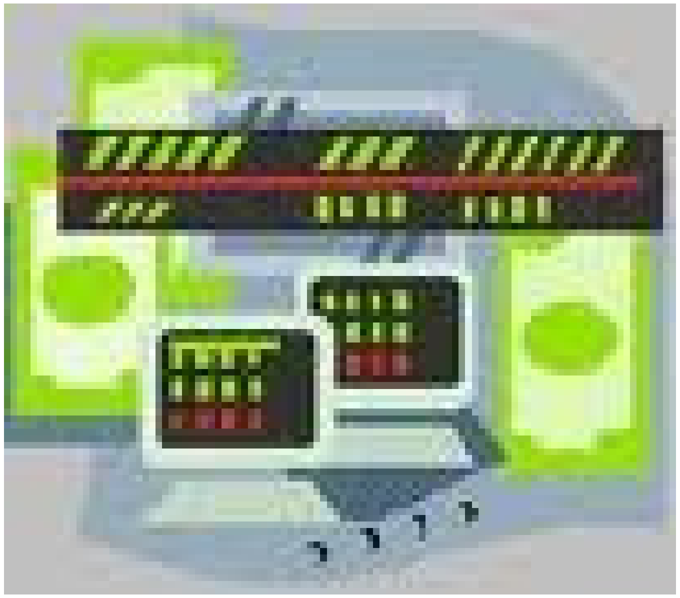
6. Sale or Exchange

6) Lease Cancellation Payments (Ex. 5-82)

- Lease cancellation payments received by the lessor are treated as ordinary income, while lease cancellation payments received by the lessee are generally treated as capital gain.

7. Holding Period (Example 5-83)

- The holding period for long-term treatment is more than one year.



7. Holding Period

1) Property Received as a Gift (Ex. 5-85, 5-86)

- If the donee's adjusted basis is determined by reference to the donor's adjusted basis, the donor's holding period is added to the donee's holding period.
- If the donee's adjusted basis is the fair market value at date of gift, the holding period begins at the date of gift.

7. Holding Period

2) Property Received from a Decedent (Ex. 5-87)

- Inherited property always receives a long-term holding period.
  - EXAMPLE: The decedent buys stock on May 1. The decedent dies on May 2. The taxpayer inherits the stock on May 3 and sells the stock on May 4. Even though only a few days are involved, the gain or loss on sale is treated as long-term.

7. Holding Period

3) Nontaxable Exchanges

- The holding period of the property given up in a tax-free exchange is added to the holding period of the property received in the exchange.
  - EXAMPLE: The taxpayer acquires an apartment building in 1990. On December 30, 2008, she exchanges the apartment building for a shopping center, qualifying under the like-kind exchange rules. The holding period of the shopping center is long-term even if it is sold on January 3, 2009.

7. Holding Period

4) Receipt of Nontaxable Stock Dividends and Stock Rights (Ex. 5-88, 5-89)

- The holding period of nontaxable stock dividends and stock rights generally includes the holding period of the underlying stock.
  - EXAMPLE: The taxpayer acquires common stock in 1998. The taxpayer receives stock rights in a nontaxable distribution in 2008. The holding period of the rights is long-term.

8. Justification for Preferential Treatment of Net Capital Gains (Ex. 5-90)

- Factors supporting preferential treatment for net capital gains are mobility of capital and the mitigation of the effects of inflation and progressive tax rates.
- While net capital gains generally receive a maximum 20% (35%-15%) rate preference for high-income taxpayers, additional special treatment for net capital gains is a continuing topic of discussion.

9. Tax Planning Considerations

1) Selection of Property to Transfer by Gift (Ex. 5-92, 5-95)

- The decision to make lifetime gifts may be influenced by available annual exclusions, a desire to reduce future estate tax, and/or a desire to shift the income tax burden.
- It is usually unwise to gift depreciated property (FMV less than adjusted basis) because the donee may be forced to take the lower FMV basis.

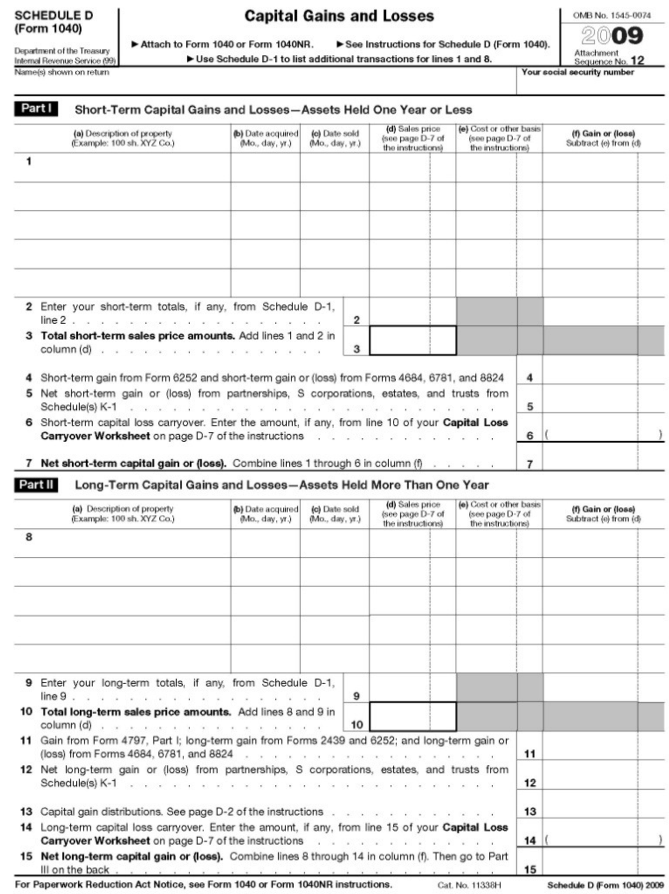
9. Tax Planning Considerations

2) Selection of Property to Transfer at Time of Death (Ex. 5-98)

- Generally, highly appreciated property should be retained until death and loss property should be sold before death.
  - EXAMPLE: A taxpayer holding property with an adjusted basis of $500,000 and a fair market value of $300,000 would want to sell the property before death to recognize the $200,000 loss. If this property was held until death, the person inheriting would receive a $300,000 adjusted basis, and the benefit of the $200,000 loss would be lost.

10. Compliance and Procedural Considerations

- Documentation of basis
- Reporting of capital gains and losses on Schedule D



SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 to list additional transactions for lines 1 and 8.

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2009
Attachment Sequence No. 12

Name(s) shown on return | **Your social security number**

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2	
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	3	
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9	
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10	
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See page D-2 of the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15	

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2009**

Addition Things to Study

- Answers to Selected Textbook Problems:
  - http://www.fcs.utah.edu/~fan/fcs5530/Answers%20to%20Selected%20Problems/AnswersSelectedUnit09.pdf
- Self-study Quizzes on Publisher's website:
  - http://wps.prenhall.com/bp_pope_fedtax_2010/120/30827/7891783.cw/index.html
- Homework Assignment for Unit09 (Graded)
  - PAK Chapter 5 Problems: 5-34, 5-37, 5-38, 5-41, 5-43, 5-49
  - Please go to Week 10 folder on course Homepage to find the link. You can also access it directly through the "Assignments" link.
- Discussion Topic for Unit09 (Graded)
  - Don't forget to post your thoughts on the discussion topic of the week.
  - Go to the Week 10 folder on course Homepage to find the link. You can also access it directly through the "Discussions" link.