

## Income Tax Planning for Financial Planners

### Basis Rules, Depreciation, and Asset Categorization Chapter 10

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### Income vs. Capital

- ▶ Tax is levied on *income*, not *capital*
- ▶ *Capital* is income that has already been taxed
- ▶ The Tax Toll-Booth

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### Realized vs. Recognized Income

- ▶ Gains must be *“realized”* before they can be taxed
- ▶ A gain is not usually realized unless
  - There is a disposition of property
  - There is a segregation of the gain
- ▶ When a gain is taxed, it is *“recognized”*

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## Calculating the Gain (IRC Section 1001)

Amount Realized  
- Adjusted Basis  
= *Realized Gain*

Cost of Property  
+ Capital Additions  
- Cost Recovery  
= *Adjusted Basis*

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## Amount Realized

- ▶ The sum of
  - Money received, plus
  - The FMV of property received in the exchange, plus
  - Liabilities shed
- ▶ Results from sale or other disposition
  - Trade-ins
  - Casualties
  - Condemnation
  - Theft

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## Basis

- Purpose
  - Keep track of after-tax dollars (capital) that is tied up in an investment
  - Allows investor to recoup capital tax-free upon sale
- Uses
  - Determine gain/loss
  - Determine depreciation deductions
  - Determine the amount an investor has "at risk" under the passive loss rules

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## Determining Basis

- ▶ **Cost Basis**
  - Initial capital used to purchase the investment
  - Includes
    - Cash
    - Cost of property given in exchange
    - Recourse debt used for financing
    - Costs necessary to acquire the asset (sales tax, freight, installation)

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## Adjustments to Basis

- ▶ **Increases to Basis**
  - Capital infusions
  - Amortization of discount bonds
  - Profit of pass-through entities
  - Liabilities assumed
- ▶ **Decreases to Basis**
  - Return of capital
    - Distributions from pass-thru entities
    - Depreciation
  - Amortization of bond premium
  - Liabilities shed

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## Basis of Personal Assets

- ▶ Initial Basis = Cost
- ▶ Basis increased by capital additions
- ▶ Capital is recovered when asset is sold
  - Depreciation is not allowed

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### Personal Residence – Basis Adjusted for Business Use Example

John is an executive with a major pharmaceutical company, and as a condition of his employment he is required to maintain an office in his home. Earlier this year, John purchased his current principal residence for \$350,000. John's expenses directly associated with his home office are \$2,650 this year, of which \$400 represents depreciation.

John's adjusted basis in his home will be \$349,600 (cost basis of \$350,000 less \$400 of depreciation) since he recovered \$400 of his capital through the depreciation deduction.

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### Basis of Property Acquired Through an Estate

- ▶ Basis = fair market value at
  - The date of death, or
  - The alternative valuation date
- ▶ Sometimes called "stepped-up" basis
- ▶ Applies to testamentary transfers of property whose value is included in the decedent's gross estate

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### Basis of Inherited Property Example

Gerald recently received an inheritance from his Uncle Frank. The inheritance consisted of a 40% ownership interest in Dunn's Funeral Home, a family business started by Gerald's father, William, and his Uncle Frank.

Uncle Frank paid \$10,000 for his 40% ownership interest in the business, and it was worth \$250,000 at the time of his death. Gerald's basis in the 40% inherited business interest he receives through Uncle Frank's estate is \$250,000.

Gerald's step-to fair market value resulted in an increase in basis of \$240,000 (\$250,000 - \$10,000).

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## Section 1014 and Joint Tenancy

- ▶ Applies to
  - Joint Tenancy with Right of Survivorship
  - Tenancy by the Entirety
- ▶ The property passes outside of probate
  - The surviving joint tenant is deemed to receive the property from the decedent
- ▶ Basis is stepped up to the extent that the value of the property is included in the gross estate of the decedent
- ▶ Results in a partial step-up in basis

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## Stepped-Up Basis Rule Exceptions

- ▶ Contemplation of Death Rule
  - Appreciated property is acquired by a decedent
    - As a gift,
    - Within one year of death, and
    - The property passes from the donee-decedent to the original donor or donor's spouse
- ▶ Income in Respect of a decedent property (IRC Section 691)
- ▶ Annuity payments transferred from the decedent to a beneficiary

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## Basis of Gifted Property

- ▶ General Rule: Carryover basis
- ▶ Changes in basis result from
  - Payment of gift tax
  - Gift of property with  $FMV < \text{adjusted basis on date of gift}$

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## Impact of Gift Tax on Basis

- ▶ Donee's basis is increased by a portion of gift taxes paid by the donor if
  - The donee sells the property
  - For more than the donor's original basis

$$\frac{\text{Appreciation in the Property}}{\text{FMV of Property at Date of Gift}} \times \text{Gift Tax Paid} = \text{Increase in Basis for Donee}$$

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## Impact of Gift Tax on Basis Example

Cathy received a gift from Darren on June 15 of this year that had a FMV of \$20,000. Darren's adjusted basis in the asset was \$15,000, and he paid a gift tax on the transfer of \$800.

- Cathy's basis in the gifted property is \$15,200
- Calculation:  $\$15,000 + (\$5,000/\$20,000 \times \$800)$

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## Gifts of Loss Property

- ▶ If FMV of gifted property < the donor's adjusted basis on the date of the gift, the **dual basis rule** applies
- ▶ To determine **Loss**, the adjusted basis of the donee is the lesser of
  - FMV of the property on the date of gift, or
  - The adjusted basis of the transferor
- ▶ To determine **Gain**, the basis of the donee is the adjusted basis of the donor (plus an adjustment for gift taxes paid, if applicable)
- ▶ If the FMV at date of gift < AR < Adjusted basis of transferor, no gain or loss is recognized

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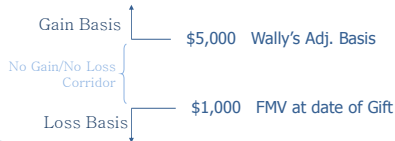
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## Gifted Property – Dual Basis Rule Example

- ▶ Wally purchased 100 shares of Hyde, Inc. five years ago for \$5,000. He just gave those shares to his son, Junior, when the value of the 100 shares was \$1,000.



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## Example (cont.)

- ▶ Junior sells the shares for \$5,500
  - Gain is \$500 (Use \$5,000 as basis)
- ▶ Junior sells the shares for \$750
  - Loss is \$250 (Use \$1,000 as basis)
- ▶ Junior sells the shares for \$3,000
  - No gain/loss corridor

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## Holding Period For Gifted Property

- ▶ **General Rule:**
  - Holding period in the hands of the donee includes the holding period in the hands of the donor
- ▶ **Exception:**
  - If dual-basis asset is sold for a loss, holding period for donee starts on date of gift

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## Basis and Spousal Transfers

- ▶ All transfers between spouses and incident to a divorce are treated as gifts
  - Basis carries over
- ▶ Husband and wife are treated as a single economic unit

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## Basis for Spousal Transfers Example

Lauren and Rob, who jointly own a house in Maryland, are in the process of getting divorced. Lauren and Rob each own 50% of the house, which has a basis of \$100,000 and a FMV of \$175,000.

As part of their divorce settlement, Lauren will receive sole ownership of the house in Maryland. Lauren's basis in the house will be \$100,000 (her \$50,000 basis plus \$50,000 of carryover basis from Rob).

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## Related Party Transactions

- ▶ **Related Party**
  - Spouse, ancestors & descendants, brothers and sisters (of the whole or half blood)
- ▶ **Sales**
  - If a gain results, normal rules apply
  - If loss results, double basis rule applies
  - Holding period resets
- ▶ **Gifts**
  - Gain property – Carryover Basis
  - Loss Property – double basis rule applies
  - Holding period resets *only* if loss basis is used

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## Depreciation

- ▶ Allows taxpayer to recover capital over useful life of asset
- ▶ May be claimed for assets
  - Used in a trade or business
  - Held for production of income
- ▶ Capital invested in personal assets is recovered when the asset is sold

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## Modified Accelerated Cost Recovery System (MACRS)

- ▶ Applies to most types of property
- ▶ Excluded Property
  - Intangible Property (Goodwill, copyrights)
  - Public utility property
  - Motion pictures and sound recordings

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## MACRS

- ▶ **Real Estate** – Straight Line
  - Residential: 27.5 yrs
  - Commercial: 39 yrs
  - Land: not depreciable
- ▶ **Personalty** – Accelerated
  - 3 year
  - 5 year
  - 7 year
  - 10 year
  - 15 year
  - 20 year

*Double Declining Balance \**

*150% Declining Balance \**

\* Switches to Straight Line (SL) when SL generates higher deduction

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### Real Estate Depreciation Deduction Example 1

Kasey purchases an 8-unit rental apartment unit for \$900,000. The value of the land is determined to be \$60,000. Since the property is used for residential rental purposes, Kasey will be able to depreciate the building (at a value of \$840,000, which equals the purchase price of \$900,000 less the land value of \$60,000) over a 27.5 year period.

Therefore Kasey's annual depreciation deduction will be \$30,545.

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### Real Estate Depreciation Deduction Example 2

Ryan purchases an office building that he plans to rent out. The building cost \$1.4 million, and \$200,000 of the purchase price is attributed to the land.

Since the property is used for commercial rental purposes, Ryan can depreciate the building (at a value of \$1.2 million, which equals the purchase price of \$1.4 million less the land value of \$200,000) on a straight-line basis over a 39 year period.

Therefore, Ryan's annual depreciation deduction will be \$30,769.23.

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### Depreciation Conventions

- ▶ **Personalty**
  - Half-year convention
  - If more than 40% placed in service in 4<sup>th</sup> Quarter, mid-quarter convention applies
- ▶ **Real Estate**
  - Mid-month convention
- ▶ **Intangible Property**
  - Straight-line
  - 15 year (180 month)
  - Referred to as "amortization"

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## Listed Property

- ▶ Property that can be used for business or personal purposes
  - Cars
  - Computers
- ▶ If used > 50% for business
  - Normal MACRS rules apply for portion that represents business use

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## 2012 Maximum Depreciation Deductions for Automobiles

Year	Passenger Auto Deduction	Truck & Van Deduction
1	\$2,960	\$3,200
2	\$4,800	\$5,200
3	\$2,850	\$3,150
4	\$1,775	\$1,875
5	\$1,775	\$1,875
6	\$1,775	\$1,875

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## IRC Section 179

- ▶ Permits business owners to expense capital acquisitions
- ▶ Requirements
  - Asset must have > 50% business use
  - Limit on deduction: \$139,000 for 2012
  - Cannot be used to generate loss
    - Excess is carried forward

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## Section 179 Phaseout

- ▶ Expense election is phased out
  - On a dollar for dollar basis
  - For depreciable property placed in service in excess of \$560,000 for 2012
- ▶ Special rule for vehicles
  - Over 6,000 pounds, less than 14,000 pounds
  - Section 179 deduction limited to \$25,000

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## Asset Categorization

- ▶ There are 3 types of assets in the Income Tax System:
  - Capital Assets
  - Ordinary Income Assets
  - Section 1231 Assets

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## Asset Categorization

- ▶ ALL assets are **Capital Assets** except:

- |                              |   |   |
|------------------------------|---|---|
| Ordinary<br>Income<br>Assets | } | ◦ <b>A</b> ccounts Receivable   |
|                              |   | ◦ <b>C</b> reative works in hands of the author   |
|                              |   | ◦ <b>I</b> nventory   |
| Section<br>1231<br>Assets    | } | ◦ <b>D</b> epreciable Real or Personal Property held for use in a trade or business or for the production of income |

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## Capital Assets Example

Reilly recently purchased a painting by Worthington, an aspiring artist, to hang in his dining room. Reilly is not an art dealer but rather a collector. The painting is a capital asset in Reilly's hands, since it was not created by Reilly, it is not being held as inventory for sale to Reilly's customers, and is not depreciable property used in a trade or a business.

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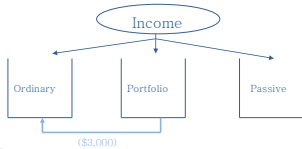
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## Taxation of Capital Assets

- ▶ Long Term gains generate lower tax rates
  - 0%/15%
  - 25% for Unrecaptured Section 1250 Depreciation
  - 28% for Collectibles
- ▶ Long Term losses are limited
  - \$3,000 maximum (against other income) per year



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## Ordinary Income Assets Example 1

Catherine is a renowned artist in New England, and her work is sought after by the rich and famous. Catherine has recently painted her newest masterpiece. The painting in Catherine's hands is inventory, and is therefore an ordinary income asset.

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## Ordinary Income Assets Example 2

George is an art dealer, and has galleries in New Orleans, New York, and San Diego. George recently purchased a painting by Wentworth, and places it in his New Orleans studio for sale to his customers. Because the painting is being held for sale to customers in the ordinary course of business, it is inventory, and, therefore is an ordinary income asset.

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## Taxation of Ordinary Income

- ▶ Gains
  - Taxed at ordinary rates
- ▶ Losses
  - Generate tax benefit at ordinary rates
  - No limitation applies

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## Section 1231 Assets Example

Homer Headshrink, a prominent psychiatrist, purchases new furniture for his office. Since the furniture is being used in Homer's trade or business, the furniture is categorized as a Section 1231 asset.

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## Taxation of Section 1231 Assets

- ▶ Gains
  - Taxed at capital gains rates
- ▶ Losses
  - Treated as ordinary losses

*Long-Term holding period is required*

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## Asset Categories

	Capital Assets	Ordinary Assets	1231 Assets
Sold for Gain	Capital Gain Treatment	Ordinary Income Treatment	Capital Gain Treatment <small>(part of all gain may require recapture)</small>
Sold for Loss	Capital Loss Treatment <small>(current loss may be limited)</small>	Ordinary Loss Treatment	Ordinary Loss Treatment

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