

# The Taxation of Capital Assets

## Chapter 11

©2011 Money Education

---

---

---

---

---

---

---

---

### Asset Categorization

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

Ordinary  
Income  
Assets

- Accounts Receivable
- Creative works in hands of the author
- Inventory

Section  
1231  
Assets

- Depreciable Real or Personal Property held for use in a trade or business or for the production of income

©2011 Money Education

11-2

---

---

---

---

---

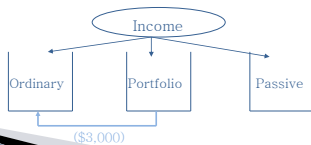
---

---

---

### Taxation of Capital Assets

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



©2011 Money Education

11-3

---

---

---

---

---

---

---

---

## Sale or Exchange Requirements

- ▶ **Realization**
  - Sale
  - Casualty or theft
  - Corporate bankruptcy (Worthless Security)
  
- ▶ **Recognition**
  - Realized gains must be recognized unless Congress defers/excludes the gain from income

©2011 Money Education

11-4

---

---

---

---

---

---

---

---

## Realization and Recognition Example

After conducting a thorough investment portfolio analysis, Colin decides that MNL, Inc. stock no longer fits into his asset allocation and sells the shares of MNL that he owns on the open market.

The sale constitutes a realization event. Colin will calculate gain or loss and, absent a special Code provision deferring or exempting any gain, will be required to recognize any gain on his individual income tax return.

©2011 Money Education

11-5

---

---

---

---

---

---

---

---

## Recognition Event Worthless Securities Example

On December 28 of last year, Kasey purchased 1,000 shares in Heidi Industries, Inc. This investment was not one of Kasey's best investments, the company declared bankruptcy on January 5 of the current year, and the security became worthless.

For federal income tax purposes, when a security becomes worthless, a constructive sale occurs on December 31 of that year. Therefore, Kasey will have a recognition event due to the bankruptcy of Heidi Industries, Inc. as of December 31 of the current year.

©2011 Money Education

11-6

---

---

---

---

---

---

---

---

## Calculating the Gain (IRC Section 1001)

Amount Realized  
- Adjusted Basis  
= *Realized Gain (or loss)*

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

©2011 Money Education

11-7

---

---

---

---

---

---

---

---

## Gain Recognition Personal Asset Example

Brendan purchased a Ferrari 10 years ago for \$80,000. He used the car for personal purposes and sold it earlier this year. Because the model he purchased was a limited edition, he was able to sell the car for \$90,000 even though he used it for over 10 years. Brendan's gain is calculated as follows:

Amount Realized	\$90,000
Less: Adjusted Basis	- \$80,000
Equals: Gain or (Loss)	\$10,000

The realized gain of \$10,000 must be recognized on his income tax return this year.

©2011 Money Education

11-8

---

---

---

---

---

---

---

---

## Disallowed Losses

- Losses on sale or conversion of personal assets
- Losses on gift or sale of property to a related party
- Wash sales
  - Purchase and sale within 30 days
  - Results in 61-day window
  - Unrecognized loss added to basis of replacement securities

©2011 Money Education

11-9

---

---

---

---

---

---

---

---

## Personal Asset Losses

Helen purchased her personal residence sixteen months ago for \$290,000. She lives in a city that has been heavily effected by the current recession and she needs to sell her home and relocate due to a lucrative job offer.

The best offer Helen receives on her home is \$265,000. She sells her home and suffers an economic loss of \$25,000. Helen's loss on her personal asset is not tax deductible.

©2011 Money Education

11-10

---

---

---

---

---

---

---

---

## Losses on Related Party Transactions

Maxine purchased Triton stock three years ago for \$30 a share. The stock is currently valued at \$25 a share. Maxine decides to gift her shares of Triton to her son, Justin. Justin immediately sells the shares of stock for \$26.

The \$5 loss that occurred during Maxine's holding period will never be recognized (disallowed loss). Justin has an economic gain of \$1 per share and no taxable gain (double basis rule).

©2011 Money Education

11-11

---

---

---

---

---

---

---

---

## Wash Sales

Michael reviews his portfolio and decides to sell 100 shares of Bear stock on November 1<sup>st</sup> for \$20,000 to offset some of his annual gains. Michael purchased the stock two years ago for \$30,000. Michael subsequently reads an investor report that indicates Bear stock has a new patent for a potentially high revenue product.

On November 20<sup>th</sup>, Michael purchases 100 shares of Bear stock for \$15,000. Michael will not be able to recognize the \$10,000 loss on the original sale due to the wash sale transaction (sale and purchase within 30 days). The loss will be added to his new basis. (\$15,000 + \$10,000 = \$25,000 new basis)

©2011 Money Education

11-12

---

---

---

---

---

---

---

---

## Capital Gains Holding Periods (HP)

Capital Gain/Loss	Holding Period
Long-Term Capital Gain/Loss	>1 year
Short-Term Capital Gain/Loss	≤1 year

©2011 Money Education

11-13

---

---

---

---

---

---

---

---

## Long Term Capital Gain Example

Chris purchased 100 shares of Dowling Novelties, Inc. stock on March 17 for \$10,000. On March 18 of the following year, he sold the stock for \$12,000.

Chris' \$2,000 gain on the stock (\$12,000 amount realized less \$10,000 adjusted basis) will be treated as a long-term capital gain, since Chris held the stock for more than one year.

©2011 Money Education

11-14

---

---

---

---

---

---

---

---

## Special Holding Period Rules

- Property received from a decedent
  - Death is long-term
- Gifts
  - FMV > basis on date of gift
    - Add holding period of donor and donee
  - FMV < basis on date of gift
    - Gain basis used on sale
      - Add holding period of donor and donee
    - Loss basis used on sale
      - Holding period starts on date of gift

©2011 Money Education

11-15

---

---

---

---

---

---

---

---

## Special Holding Period Rules

- ▶ **Related Party Sale Transaction**
  - HP begins on date of sale
- ▶ **Nonbusiness bad debts**
  - *Always* short-term
- ▶ **Non-Taxable Exchange**
  - HP of replacement asset includes HP of original asset

©2011 Money Education

11-16

---

---

---

---

---

---

---

---

## Summary – Special HP Rules

Property Acquired By...	Will have the following holding period...
Inheritance	Long-term holding period
Gift	Holding period will tack to donor's holding period if gain basis is used. If loss basis is used, the donee's holding period begins on the date of the gift
Related Party Transaction	Holding period starts on sale date
Nonbusiness Bad Debts	Short-term capital losses

©2011 Money Education

11-17

---

---

---

---

---

---

---

---

## Capital Gains Tax Rate

- ▶ **General Rule:**
  - Maximum capital gain rate of 15% for long-term gains
  - For individuals in 15% or lower income tax bracket – 0%
- ▶ **Exceptions:**
  - Collectibles – 28%
  - Unrecaptured Section 1250 Gain – 25%
- ▶ The effective rate may be more than the maximum rate
  - Capital gains increase a taxpayer's AGI
  - Increased AGI may lead to phaseouts

©2011 Money Education

11-18

---

---

---

---

---

---

---

---

## Taxation of Capital Gains & Losses

- ▶ Capital gains and losses must be separated from other types of gains and losses for two reasons:
  - Long-term capital gains may be taxed at a lower rate than ordinary gains
  - Net capital losses are only deductible up to \$3,000 per year

©2011 Money Education

11-19

---

---

---

---

---

---

---

---

## Determining Net Capital Gain

- ▶ Noncorporate taxpayers
  - Capital gains and losses must be netted by holding period
    - Short-term capital gains and losses are netted
    - Long-term capital gains and losses are netted
    - If possible, long-term gains or losses are then netted with short-term gains or losses
  - If the result is a loss:
    - The net capital loss deduction is limited to a maximum deduction of \$3,000 per year
    - Unused losses retain their character (as to short or long term) and are carried forward indefinitely

©2011 Money Education

11-20

---

---

---

---

---

---

---

---

## Net Capital Gains and Losses Example

	<u>Short-Term</u>	<u>Long-Term</u>
Gains	\$15,000	\$3,000
Losses	<u>&lt;\$10,000&gt;</u>	<u>&lt;\$5,000&gt;</u>
	\$5,000 NSTCG	<\$2,000> NLTCL

↓  
Result: Net \$3,000 NSTCG

NSTCG	\$5,000
NLTCL	<u>(2,000)</u>
NSTCG	\$3,000

©2011 Money Education

11-21

---

---

---

---

---

---

---

---

## Determining Net Capital Gain

- ▶ Corporate taxpayers
  - Net capital gain alternative tax rate is 35%
    - Since the maximum corporate tax rate is 35%, the alternative tax is not beneficial
  - Net capital losses can only offset capital gains
    - May not be used as a deduction against other sources of income

---

---

---

---

---

---

---

---