Chapter 13

Property Transactions: Capital Gains and Losses, §1231 and Recapture Provisions

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Taxation of Capital Gains And 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
  - A net capital loss is only deductible up to $3,000 per year

Proper Classification of Gains and Losses

- Depends on three characteristics:
  - The tax status of the property
    - Capital asset, §1231 asset, or ordinary asset
  - The manner of the property's disposition
    - By sale, exchange, casualty, theft, or condemnation
  - The holding period of the property
    - Short term and long term

Capital Assets (slide 1 of 6)

- §1221 defines capital assets as everything except:
  - Inventory (stock in trade)
  - Notes and accounts receivables acquired from the sale of inventory or performance of services
  - Realty and depreciable property used in trade or business (§1231 assets)

Capital Assets (slide 2 of 6)

- §1221 defines capital assets as everything except (cont'd):
  - Creative works (e.g., art, music, copyrights) when created by taxpayer (or for which taxpayer takes a carryover basis from the creator)
  - Certain publications of U.S. government

Capital Assets (slide 3 of 6)

- Thus, capital assets are:
  - Assets held for investment (e.g., stocks, bonds, land)
  - Personal use assets (e.g., residence, car)
  - Miscellaneous assets selected by Congress

Capital Assets (slide 4 of 6)

- Dealers in securities
  - In general, investment assets are the inventory of securities dealers, thus ordinary assets
  - However, a dealer can identify securities as an investment and receive capital gain treatment
    - Clear identification must be made on the day of acquisition

Capital Assets (slide 5 of 6)

- Real property subdivided for sale
  - Taxpayer may receive capital gain treatment on the subdivision of real estate if the following requirements are met:
    - Taxpayer is not a corporation
    - Taxpayer is not a real estate dealer
    - No substantial improvements made to the lots
    - Taxpayer held the lots for at least 5 years
    - Capital gain treatment occurs until the year in which the sixth lot is sold

Capital Assets (slide 6 of 6)

- Nonbusiness bad debts
  - A nonbusiness bad debt is treated as a short-term capital loss in the year it becomes worthless

Sale or Exchange
(slide 1 of 9)

- Recognition of capital gains and losses generally requires a sale or exchange of assets
- Sale or exchange is not defined in the Code
- There are some exceptions to the sale or exchange requirement

Sale or Exchange

(slide 2 of 9)

- Worthless securities
  - A security that becomes worthless creates a deductible capital loss without being sold or exchanged
  - The Code sets an artificial sale date for the securities on the last day of the year in which worthlessness occurs

Sale or Exchange
(slide 3 of 9)

- Worthless securities example:
  - Calendar year taxpayer purchased stock on December 5, 2002
  - The stock becomes worthless on April 5, 2003
  - The loss is deemed to have occurred on December 31, 2003
    - The result is a long-term capital loss

Sale or Exchange
(slide 4 of 9)

- Retirement of corporate obligations
  - Collection of the redemption value of corporate obligations (e.g., bonds payable) is treated as a sale or exchange and may result in a capital gain or loss
    - OID amortization increases basis and reduces gain on disposition or retirement

Sale or Exchange
(slide 5 of 9)

- Options
  - Sale of an option by grantee results in capital gain or loss if the option property is a capital asset to the grantee
  - Lapse of an option on a capital asset is considered a sale or exchange resulting in a capital loss for the grantee of the option
  - For the grantor of an option, the lapse creates
    - Short-term capital gain, if the option was on stocks, securities, commodities or futures
    - Otherwise, ordinary income

Sale or Exchange

(slide 6 of 9)

- Options (cont'd)
  - Exercise of an option by a grantee increases the gain (or reduces the loss) to the grantor from the sale of the property
    - Gain is ordinary or capital depending on the tax status of the property
  - Grantee adds the cost of the option to the basis of the property acquired

Sale or Exchange

(slide 7 of 9)

- Patents
  - When all substantial rights to a patent are transferred by a *holder* to another, the transfer produces long-term capital gain or loss
    - The holder of a patent must be an individual, usually the creator, or an individual who purchases the patent from the creator before the patented invention is reduced to practice

Sale or Exchange
(slide 8 of 9)

- Franchises, trademarks, and trade names
  - The licensing of trade names, trademarks, and other intangibles is generally not considered a sale or exchange of a capital asset
  - Therefore, ordinary income results to transferor
    - Exception: Capital gain (loss) may result if the transferor does not retain any significant power, right, or continuing interest

Sale or Exchange
(slide 9 of 9)

- Lease cancellation payments
  - Lessee treatment
    - Treated as received in exchange for underlying leased property
      - Capital gain results if asset leased was a capital asset (e.g., personal use)
      - Ordinary income results if asset leased was an ordinary asset (e.g., used in lessee's business)
  - Lessor treatment
    - Payments received are ordinary income (rents)

Holding Period
(slide 1 of 3)

- Short-term
  – Asset held for 1 year or less
- Long-term
  – Asset held for more than 1 year
- Holding period starts on the day after the property is acquired and includes the day of disposition

Holding Period
(slide 2 of 3)

- Nontaxable Exchanges
  - Holding period of property received includes holding period of former asset if a capital or §1231 asset
- Transactions involving a carryover basis
  - Former owner's holding period tacks on to present owner's holding period if a nontaxable transaction and basis carries over
- Inherited property is always treated as long term no matter how long it is held by the heir

Holding Period
(slide 3 of 3)

- Short sales
  - Taxpayer sells borrowed securities and then repays the lender with substantially identical securities
  - Gain or loss is not recognized until the short sale is closed
  - The holding period for a short sale is determined by how long the property used for repayment is held

Tax Treatment of Capital Gains and Losses (slide 1 of 5)

- 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 capital loss deduction is limited to a maximum deduction of $3,000
    - Unused amounts retain their character and carryforward indefinitely

Tax Treatment of Capital Gains and Losses (slide 2 of 5)

- Noncorporate taxpayers (cont'd)
  - If net from capital transactions is a gain, tax treatment depends on holding period
    - Short-term (assets held 12 months or less)
      - Taxed at ordinary income tax rates
    - Long-term (assets held more than 12 months)
      - An alternative tax calculation is available using preferential tax rates

Tax Treatment of Capital Gains and Losses (slide 3 of 5)

- Noncorporate taxpayers (cont'd)
  - Net long-term capital gain is eligible for one or more of five alternative tax rates: 8%, 10%, 20%, 25%, and 28%
    - The 25% rate applies to unrecaptured §1250 gain and is related to gain from disposition of §1231 assets
    - The 28% rate applies to collectibles
    - The 8%/10%/20% rate applies to any remaining net long-term capital gain

Tax Treatment of Capital Gains and Losses (slide 4 of 5)

- When there are both short and long-term capital gains and losses, a complicated ordering procedure is required because the long-term capital gains may be taxed at various rates

Tax Treatment of Capital Gains and Losses (slide 5 of 5)

- Corporate taxpayers
  - Differences in corporate capital treatment
    - There is a NCG alternative tax rate of 35 %
      - Since the max corporate tax rate is 35 %, the alternative tax is not beneficial
    - Net capital losses can only offset capital gains (i.e., no $3,000 deduction in excess of capital gains)
    - Net capital losses are carried back 3 years and carried forward 5 years as short-term losses

§1231 Assets
(slide 1 of 3)

- §1231 assets defined
  - Depreciable and real property used in a business or for production of income and held greater than 1 year
  - Includes timber, coal, iron, livestock, unharvested crops
  - Certain purchased intangibles

§1231 Assets
(slide 2 of 3)

- If transactions involving §1231 assets result in:
  - Net §1231 loss = ordinary loss
  - Net §1231 gain = long-term capital gain

§1231 Assets
(slide 3 of 3)

- Provides the best of potential results for the taxpayer
  - Ordinary loss that is fully deductible FOR AGI
  - Gains subject to the lower capital gains tax rates

§1231 Netting Procedure
(slide 1 of 2)

§1231 asset and long-term nonpersonal use capital asset casualty gains
minus
§1231 asset and long-term nonpersonal use capital asset casualty losses

Net Gain

Net Loss

Net Gain

(add to §1231 gains)

Items treated separately: Gains are ordinary income, §1231 asset losses are deductible *for* AGI, Other losses deductible *from* AGI

§1231 gains
minus
§1231 losses

Net Loss

Net Gain

§1231 Netting Procedure

(slide 2 of 2)

Lookback Provision:

Net gain is offset against nonrecaptured net §1231 losses from 5 prior tax years

Gain offset by lookback losses is ordinary gain

Remaining gain is LTCG

Lookback Provision For Net §1231 Gain

- There would be an advantage to having all §1231 losses (ordinary losses) in a different year from gains (long-term capital gains)
- To control manipulation, net §1231 gains are treated as ordinary income to the extent that the taxpayer has nonrecaptured net §1231 losses in the prior 5 year period

Lookback Provision Example

- Taxpayer had the following §1231 gains and losses:

2001	$ 4,000 loss
2002	10,000 loss
2003	16,000 gain

  - In 2003, taxpayer's net §1231 gain of $16,000 will be treated as $14,000 of ordinary income and $2,000 of long-term capital gain

Depreciation Recapture
(slide 1 of 3)

- Assets subject to depreciation or cost recovery are subject to depreciation recapture when disposed of at a gain
  – Losses on depreciable assets receive §1231 treatment; no recapture occurs in loss situations

Depreciation Recapture

(slide 2 of 3)

- Depreciation recapture characterizes gains that would otherwise be capital or §1231 as ordinary income

Depreciation Recapture
(slide 3 of 3)

- Depreciation recapture provisions generally override all other Code Sections
  – There are exceptions to depreciation recapture rules in those dispositions where all gain is not otherwise recognized currently (e.g., like-kind exchanges, involuntary conversions) or where gain is not recognized at all (e.g., gifts and inheritances)

§1245 Recapture
(slide 1 of 3)

- Depreciation recapture for §1245 property
  - Applies to tangible and intangible personalty, and nonresidential realty using accelerated methods of ACRS (placed in service 1981-86)
    - Recapture potential is entire amount of accumulated depreciation for asset
    - Method of depreciation does not matter

§1245 Recapture
(slide 2 of 3)

- When gain on the disposition of a §1245 asset is less than the total amount of accumulated depreciation:
  - The total gain will be treated as depreciation recapture (i.e., ordinary income)

§1245 Recapture
(slide 3 of 3)

- When the gain on the disposition of a §1245 asset is greater than the total amount of accumulated depreciation:
  - Total accumulated depreciation will be recaptured (as ordinary income), and
  - The gain in excess of depreciation recapture will be §1231 gain or capital gain

§1250 Recapture
(slide 1 of 3)

- Depreciation recapture for §1250 property
  - Applies to depreciable real property
    - Exception: Nonresidential realty classified as §1245 property (i.e., placed in service after 1980 and before 1987, and accelerated depreciation used)

§1250 Recapture

(slide 2 of 3)

- Depreciation recapture for §1250 property
  - Recapture potential is limited to excess of accelerated depreciation taken on asset over depreciation that would have been deductible if straight-line depreciation had been used

§1250 Recapture
(slide 3 of 3)

- Straight-line depreciation on real property
  - If straight-line depreciation has been taken on real property, no depreciation recapture potential exists under §1250
  - All real property acquired after 1986 must use straight-line depreciation
    - Therefore, no depreciation recapture potential for such property

Real Estate 25% Gain
(slide 1 of 2)

- Also called unrecaptured §1250 gain or 25% gain
  - 25% gain is some or all of the §1231 gain treated as long-term capital gain
  - Used in the alternative tax computation for net capital gain

Real Estate 25% Gain
(slide 2 of 2)

- Maximum amount of 25% gain is depreciation taken on real property reduced by:
  - Certain §1250 and §1245 depreciation recapture
  - Losses from other §1231 assets
  - §1231 lookback losses
- Limited to recognized gain when total gain is less than depreciation taken

Related Effects of Recapture
(slide 1 of 8)

- Gifts
  - The carryover basis of gifts, from donor to donee, also carries over depreciation recapture potential associated with asset
  - That is, donee steps into shoes of donor with regard to depreciation recapture potential

Related Effects of Recapture
(slide 2 of 8)

- Inheritance
  - Death is only way to eliminate recapture potential
  - That is, depreciation recapture potential does not carry over from decedent to heir

Related Effects of Recapture
(slide 3 of 8)

- Charitable contributions
  - Recapture potential reduces the amount of charitable contributions that are based on FMV

Related Effects of Recapture
(slide 4 of 8)

- Nontaxable transactions
  - When the transferee carries over the basis of the transferor, the recapture potential also carries over

Related Effects of Recapture

(slide 5 of 8)

- Like-kind exchanges and involuntary conversions
  - Property received in these transactions have a substituted basis
    - Basis of former property and its recapture potential is substituted for basis of new property
  - Any gain recognized on the transaction will first be treated as depreciation recapture, then as §1231 or capital gain
    - Any remaining recapture potential carries over

Related Effects of Recapture
(slide 6 of 8)

- Installment sales
  - Recapture gain is recognized in year of sale regardless of whether gain is otherwise recognized under the installment method

Related Effects of Recapture
(slide 7 of 8)

- Property Dividends
  - A corporation generally recognizes gain on the distribution of appreciated property to shareholders
  - Recapture applies to the extent of the lower of the recapture potential or the excess of the property's FMV over its adjusted basis

Related Effects of Recapture
(slide 8 of 8)

- Sales between related parties
  - Sales of depreciable assets between related parties can cause the total gain to be recognized as ordinary income
    - Applies to related party sales or exchanges of property that is depreciable in hands of transferee

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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