**Chapter Four**

**Additional Income and the Qualified Business Income Deduction**

**2020**

**Learning Objective 4.1 What Is a Capital Asset?**

When taxpayers dispose of property, they must calculate any gain or loss on the transaction and report the gain or loss on their tax returns.

* The gain or loss realized is equal to the difference between the amount realized on the sale or exchange of the property and the taxpayer’s adjusted basis in the property.
* How gains and losses are reported depends on the nature of the property and the length of time the property has been owned.

Tax law defines a capital asset by exception. It is everything except:

* Stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business
* Depreciable property or real property used in a trade or business (Section 1231 assets)
* A patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, if the property is created by the taxpayer
* Accounts or notes receivable
* Certain U.S. government publications

**Learning Objective 4.2 Holding Period**

Gains and losses from the sale of capital assets are called capital gains and losses and are classified as one of these:

* Short-term (for assets held up to a year in length)
* Long-term (for assets held longer than a year)

**Learning Objective 4.3 Calculation of Gain or Loss**

The gain or loss realized is calculated as:

Gain or lossrealized = Amount realized\* – Adjusted basis\*\*

\*Amount realized = Sales price (Cash and fair market value of property + Liabilities relieved) – Costs incurred to transfer property

* If taxpayer is relieved of a liability, amount of liability is added to amount realized.

\*\*Adjusted basis = Original cost + Capital improvements – Accumulated depreciation allowed or allowable

* Oftentimes, it is difficult for taxpayers to track the adjusted basis of stock.
	+ Depends on whether stock was purchased, inherited, or received as a gift
* Basis depends on how acquired:
	+ If inherited, heir’s basis is generally FMV at time of death.
	+ If acquired as gift, basis depends on whether the donee sells at a gain or loss.

Closing costs included in adjusted basis of real property:

* Charges for installing utility services
* Legal fees
* Recording and survey fees, transfer taxes
* Owner’s title insurance
* Any amounts seller agrees to pay

Closing costs not included in adjusted basis of real property:

* Amount put in escrow for future payments (taxes, etc.)
* Casualty insurance premiums
* Rent for occupancy
* Utility charges related to occupancy
* Charges connected with getting a loan, such as points (discount points), mortgage insurance premiums, loan assumption fees, credit report cost, and appraisal fees

**Learning Objective 4.4 Net Capital Gains**

It is necessary to order capital gains included in taxable income.

Capital gains are ordered as follows:

* Short-term capital gains
* Unrecaptured Section 1250 gains on real estate
* Gains on collectibles
* Long-term capital gains

*Note:* The TCJA did not construct long-term capital gains tax rates that align with existing ordinary income tax rates.

For 2019, typical long-term capital gains are taxed as follows:

| **Income Level** | **Long-Term Capital Gains Rates\*** |
| --- | --- |
| Married filing jointly: $0–$78,750 | 0% |
|  $78,751–$488,850 | 15% |
|  > $488,850 | 20% |
| Single: $0–$39,375 | 0% |
|  $39,376–$434,550 | 15% |
|  > $434,550  | 20% |
| Head of household: $0–$52,750 | 0% |
|  $52,751–$461,700 | 15% |
|  > $461,700 | 20% |
| \*An additional 3.8% Medicare surtax on net investment income, including qualifying dividends, applies to high-income taxpayers. |

To calculate net capital gain or capital loss (“net capital position”), the following procedures must be followed:

1. Classify all capital gains and losses as either short-term or long-term.
2. Long-term capital gains are offset by long-term capital losses, resulting in either a net long-term capital gain or a net long-term capital loss.
3. Short-term capital gains are offset by short-term capital losses, resulting in a net short-term capital gain or a net short-term capital loss.
4. If Step 2 results in a net long-term capital gain, it may be offset by any net short-term capital loss. If Step 2 results in a net long-term capital loss, it may offset a net short-term capital gain.

**Learning Objective 4.5 Net Capital Losses**

Net capital losses occur when the total capital losses for the period exceed the total capital gains for a period.

* Taxpayers can deduct net capital losses against ordinary income up to $3,000 per year.
* Unused portions are carried forward until completely used.

Loss on sale of personal assets is never deductible.

The following ordering rules must be followed:

* Net short-term capital losses first reduce 28% gains, then 25% gains, then regular long-term capital gains.
* Net long-term capital losses first reduce 28% gains, then 25% gains, then any short-term capital gains.

**Learning Objective 4.6 Sale of a Personal Residence**

Gain on sale of a principal residence can be excluded from income up to $250,000 (S) or $500,000 (MFJ) on the sale of the residence.

* + Taxpayer must have lived in it for two of the last five years.
	+ Generally, this exclusion may only be used once every two years.
	+ There are limits if personal residence used to be rental property.

Rules are different for sale of homes before May 7, 1997.

**Learning Objective 4.7 Rental Income and Expenses**

Net income from rental property is taxable to the taxpayer.

* Most rental income is reported on Schedule E, Supplemental Income and Loss.
* Allowable deductions for rental property include real estate taxes, mortgage interest, insurance, commissions, repairs, miscellaneous expenses, and depreciation.

Vacation homes defined as property used by the taxpayer part of the year and rented out for part of the year are subject to three possible special tax treatments.

* Primarily personal use: Rented out < 15 days per year.
	+ Rental income is not taxable.
	+ Mortgage interest and real estate taxes are itemized deductions.
	+ Other expenses associated with the renting of the property are not deductible.
* Primarily rental use: Rented 15+ days and used for personal purposes for not more than 14 days or 10% of the days rented, whichever is greater.
	+ All expenses must be divided between personal and rental; this allows for expenses to exceed income and result in a loss that can reduce other income, subject to passive loss limitations.
* Rental/personal use: Rented 15+ days and used for personal purposes for more than 14 days or 10% of the days rented, whichever is greater.
	+ Expenses must be allocated between personal and rental with this property type.
	+ Most allowable expenses can be deducted up to the amount of income the property generates.

**Learning Objective 4.8 Passive Loss Limitations**

Passive losses, from investments such as limited partnership tax shelters and losses from rental activities, are limited.

* Passive losses may not be used to reduce active or portfolio income (wages, salaries, dividends, interest, etc.).
* Unused passive losses may be carried forward.
* *Note:* Rental real estate is specifically defined as passive.
	+ However, individual taxpayers may deduct up to $25,000 of rental property losses against other income if they actively participate in the management of the property.
		- Phase-out = $0.50 per $1.00 of MAGI > $100,0000
		- Essentially, ability to deduct rental losses phases out completely when MAGI = $150,000
* Taxpayers with real estate rental activities as substantial part of total income are determined to be in a trade or business if they meet two criteria (i.e., no limitations on loss).
	+ If > 50% of individual’s personal service income is derived from real property trades or businesses
	+ If 750+ hours of service are conducted in real property trade or business (material participation)

**Learning Objective 4.9 Net Operating Losses**

* Net operating loss (NOL) provisions are designed to provide relief from losses from trade/businesses, casualty/theft losses, and confiscation losses.
	+ Therefore, all income, deductions, and gains/losses must be categorized as either business or nonbusiness.
* NOLs generated after December 31, 2017, are limited to 80% of current year’s taxable income.
	+ Prior NOLs continue to be used 100% necessitating tracking of different NOL periods.
	+ Carryback provisions are repealed and NOLs may only be carried forward.
* Tax law places a $510,000 (MFJ) and $255,000 (all other others) annual limitation on noncorporate business losses. Any excess business loss limited under these rules becomes part of the NOL for future years.

**Learning Objective 4.10 Qualified Business Income (QBI) Deduction**

Qualified business income (QBI) is defined as the net amount of qualified items of income, gain, deduction, and loss relating to any qualified trade or business of the taxpayer in the United States.

* QBI excludes the following:
* Short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss
* Dividend income
* Interest income other than properly allocable to a trade or business
* Commodity transaction income or foreign currency gain or loss
* Any item of income, gain, deduction, or loss relating to certain notional principal contracts
* Amounts received from an unrelated annuity
* The tax law provides a safe-harbor under which income from rental real estate (even if treated as passive) can qualify as qualified business income. The requirements are:
	+ 250 hours or more are spent by the taxpayer with respect to the rental activity.
	+ Contemporaneous records of the time are maintained.
* Separate books and records for the rental activity are maintained.
* The QBI deduction is subject to a number of limitations and exceptions.
	+ QBI deductions cannot exceed 20% of taxpayer’s taxable income (excluding net long-term capital gains and qualifying dividend income).
* For taxpayers with taxable income above certain thresholds ($321,400 MFJ, $160,725 MFS, and $160,700 others), a phase-out occurs. For such taxpayers, two additional limitations apply. The wage limit is the greater of :
* 50% of the allocable share of W-2 wages with respect to the business
* 25% of the allocable share of W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified business property.
	+ - * + To calculate phase-out, taxpayer must determine QBI deduction “with and without” wage limitation.
* The excess of the QBI deduction with no limitation over the QBI deduction with limitation is known as the “excess amount.”
* The excess amount is subject to a pro rata phase-out based on the taxpayer’s income over the threshold amount.