# Chapter Objectives

The following objectives are addressed in this chapter:

4.1 Define the term “capital asset.”

4.2 Apply the holding period for long-term and short-term capital gains and losses.

4.3 Calculate the gain or loss on the disposition of an asset.

4.4 Compute the tax on capital gains.

4.5 Describe the treatment of capital losses.

4.6 Apply the exclusion of gain from personal residence sales.

4.7 Apply the tax rules for rental property and vacation homes.

4.8 Explain the treatment of passive income and losses.

4.9 Describe the basic tax treatment of deductions for net operating losses.

4.10 Compute the qualified business income (QBI) deduction.

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# Chapter Outline

*In the outline below, each element includes references (in parentheses) to related content. “CH.##” refers to the chapter objective; “PPT Slide #” refers to the slide number in the PowerPoint deck for this chapter (provided in the PowerPoints section of the Instructor Resource Center); and, as applicable for each discipline, accreditation or certification standards (“BL 1.3.3”). Introduce the chapter and use the Ice Breaker in the PPT if desired, and if one is provided for this chapter. Review learning objectives for Chapter 4. (PPT Slides 2–3).*

I. Learning Objectives (PPT Slides 2*–*3)

1. The Learning Objectives provide students with a brief overview of what they will learn in this chapter.

II. What Is a Capital Asset? (4.1, PPT Slides 4*–*5)

1. 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.
   * 1. 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.
     2. How gains and losses are reported depends on the nature of the property and the length of time the property has been owned.
2. Tax law defines a capital asset by exception. It is everything except:
   * 1. Stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business
     2. Depreciable property or real property used in a trade or business (Section 1231 assets)
     3. 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
     4. Accounts or notes receivable
     5. Certain U.S. government publications
3. The Knowledge Check on Slide 5 asks student to identify which property is a capital asset. The correct answer is b. The other three choices—inventory, property held by the creator, and accounts receivable—are all excluded from the definition of a capital asset.

III. Holding Period (4.2, PPT Slide 6)

1. Gains and losses from the sale of capital assets are called capital gains and losses and are classified as one of these:
   * 1. Short-term (for assets held up to a year in length)
     2. Long-term (for assets held longer than a year)

IV. Calculation of Gain or Loss (4.3, PPT Slides 7*–*16)

1. The gain or loss realized is calculated as:

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

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

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

* + 1. If taxpayer is relieved of a liability, amount of liability is added to amount realized.
    2. 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
    3. 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.

1. Closing costs included in adjusted basis of real property:
   * 1. Charges for installing utility services
     2. Legal fees
     3. Recording and survey fees, transfer taxes
     4. Owner’s title insurance
     5. Any amounts seller agrees to pay
2. Closing costs not included in adjusted basis of real property:
   * 1. Amount put in escrow for future payments (taxes, etc.)
     2. Casualty insurance premiums
     3. Rent for occupancy
     4. Utility charges related to occupancy
     5. Charges connected with getting a loan, such as points (discount points), mortgage insurance premiums, loan assumption fees, credit report cost, and appraisal fees
3. The example on Slides 13*–*14 walks students through the calculation of a gain or loss for someone who sold shares of stock. The example considers the stockholder’s purchase price, selling price, and commission.
4. The discussion on Slides 15*–*16 asks student to compare two cases in which a taxpayer received stock. One case is an inheritance, while the other was a gift. Students are asked to explain the difference between the two cases and determine the cost basis for each.

V. Net Capital Gains (4.4, PPT Slides 17*–*22)

1. It is necessary to order capital gains included in taxable income.
2. The 2021 capital gains tax rates are as follows:

|  |  |
| --- | --- |
| **Type of Gains** | **Tax Rate\*** |
| Short-Term Capital Gains | Taxed at ordinary income rates consistent with filing status |
| Typical Long-Term Capital Gains | Taxed at 0, 15, or 20 percent depending on level of other taxable income |
| Long-Term Unrecaptured Section 1250 Gain | Capped at 25 percent |
| Long-Term Collectibles Gains (Art, Gems, Coins, Stamps, etc.) | Capped at 28 percent |
| \*An additional 3.8% Medicare surtax on net investment income, including qualifying dividends, applies to high-income taxpayers. | |

1. Capital gains are ordered as follows:
   * 1. Short-term capital gains
     2. Unrecaptured Section 1250 gains on real estate
     3. Gains on collectibles
     4. Long-term capital gains
2. For 2021, typical long-term capital gains are taxed as follows:

| **Income Level** | **Long-Term Capital  Gains Rates\*** |
| --- | --- |
| Married filing jointly: $0–$80,800 | 0% |
| $80,801–$501,600 | 15% |
| > $501,600 | 20% |
| Single: $0–$40,400 | 0% |
| $40,401–$445,850 | 15% |
| > $445,850 | 20% |
| Head of household: $0–$54,100 | 0% |
| $54,101–$473,750 | 15% |
| > $473,750 | 20% |
| \*An additional 3.8% Medicare surtax on net investment income, including qualifying dividends, applies to high-income taxpayers. | |

1. 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.
2. Slides 21*–*22 walk students through an example of a taxpayer who has capital gains and losses in the current year. The example examines the taxpayer’s net capital position and tax implications.

VI. Net Capital Losses (4.5, PPT Slides 23*–*25)

1. Net capital losses occur when the total capital losses for the period exceed the total capital gains for a period.
   * 1. Taxpayers can deduct net capital losses against ordinary income up to $3,000 per year.
     2. Unused portions are carried forward until completely used.
2. Loss on sale of personal assets is never deductible.
3. The following ordering rules must be followed:
   * 1. Net short-term capital losses first reduce 28% gains, then 25% gains, then regular long-term capital gains.
     2. Net long-term capital losses first reduce 28% gains, then 25% gains, then any short-term capital gains.
4. The poll on Slide 25 asks students whether or not a taxpayer should sell appreciated investments in order to offset a large capital loss. There is no correct answer. While taxpayers with a large capital loss might want to generate enough capital gains to use up all but $3,000 of the capital loss, it does not necessarily make sense to sell off a strong property just to accomplish this. The taxpayer’s entire investment strategy should probably be examined before making this decision.

VII. Sale of a Personal Residence (4.6, PPT Slides 26*–*28)

1. 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.
   * 1. Taxpayer must have lived in it for two of the last five years.
     2. Generally, this exclusion may only be used once every two years.
     3. There are limits if personal residence used to be rental property.
2. Rules are different for sale of homes before May 7, 1997.
3. The Knowledge Check on Slide 28 asks students to determine the taxable gain for a couple who sells their house. The correct answer is “a,” $0. The $500,000 exclusion for joint filers exceeds the $320,000 realized gain. $30,000 is the cost basis, $70,000 is the recognized gain for a single taxpayer, and $320,000 is the realized gain.

VIII. Rental Income and Expenses (4.7, PPT Slides 29*–*37)

1. Net income from rental property is taxable to the taxpayer.
   * 1. Most rental income is reported on Schedule E, Supplemental Income and Loss.
     2. Allowable deductions for rental property include real estate taxes, personal portion of mortgage interest, insurance, commissions, repairs, miscellaneous expenses, and depreciation.
2. 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.
   * 1. 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.
     2. 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 results in a loss that can reduce other income, subject to passive loss limitations.
     3. 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.
3. Slides 33*–*35 take students through an example of a family that owns a property that they both use and rent out. The solution first determines the category of the property and then allocates the expenses accordingly, before determining the amounts to report on Schedules A and E.
4. The discussion on Slides 36*–*37 then asks students to consider another property. Students need to determine the category, as well as the income and deductions. Finally, students are asked to make specific changes to the details to alter the category of the property to each of the other two choices.

IX. Passive Loss Limitations (4.8, PPT Slides 38*–*43)

1. The three classifications of individual income are active income, portfolio income, and passive. Passive losses, from investments such as limited partnership tax shelters and losses from rental activities, are limited.
   * 1. Passive losses may not be used to reduce active or portfolio income (wages, salaries, dividends, interest, etc.).
     2. Unused passive losses may be carried forward.
     3. 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
     4. Taxpayers with real estate rental activities as a 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)
2. Slides 42*–*43 walk students through an example determining how much of a rental loss can be claimed by a taxpayer who owns a rental duplex that shows a loss.

X. Net Operating Losses (4.9, PPT Slides 44*–*47)

1. Net operating loss (NOL) provisions are designed to provide relief from losses from trade/businesses, casualty/theft losses, and confiscation losses.
   * 1. Therefore, all income, deductions, and gains/losses must be categorized as either business or nonbusiness.
2. Rules related to NOLs fall into three categories:
   * 1. Pre-2018 period
        + NOLs eligible to be carried back two years and forward for 20 years.
        + Carryover or carryback can offset 100 percent of income generated.
        + NOLs generated in this period can be used in the same manner.
     2. COVID-19 pandemic period (2018*–*2020)
        + NOLs generated in 2018–2020 have a 5-year carryback and indefinite carryforward.
        + 80 percent income limitation suspended on NOLs generated and used in those years.
     3. Pre-COVID but post-2018 NOL rules will become effective again after 2020.
3. Tax law places an annual limitation on noncorporate business losses.
   * 1. After adjusting for inflation, the 2021 limits are $564,000 (for married filing jointly taxpayers) and $262,000 (for all other taxpayers).
     2. The CARES Act suspended the excess loss limitation provisions through the end of 2020.
     3. The business loss limitation is in place for 2021 through the end of 2026.
4. The poll on Slide 47 examines the case of a taxpayer who has a credit card for his business. He gave cards to his family members for their gasoline purchases, and wants to include that amount in his deductions on Schedule C. The students are asked if they, as a paid preparer, would sign the return. It seems questionable to sign this return, it most students would probably refuse to do so. But it would be informative to hear the reasoning of any students who would agree to sign it.

XI. Qualified Business Income (QBI) Deduction (4.10 PPT Slides 48*–*52)

1. 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.
   * 1. 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
     2. 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.
     3. 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).
     4. For taxpayers with taxable income above certain thresholds ($326,600 MFJ and $163,300 all 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
2. To calculate phase-out, taxpayer must determine QBI deduction “with and without” wage limitation.
   * 1. The excess of the QBI deduction with no limitation over the QBI deduction with limitation is known as the “excess amount.”
     2. The excess amount is subject to a pro rata phase-out based on the taxpayer’s income over the threshold amount.
3. QBI from a service-related trade or business may also be subject to limitation if income is in excess of the threshold.

XII. Case Study (PPT Slide 53)

1. The Case Study considers a taxpayer who won $3,000 at a casino earlier in the year and used it to buy stock. The stock has appreciated significantly, and the taxpayer wants advice on whether or not to sell before the end of the year. Students are asked to reply to the taxpayer, including estimates of the different after-tax outcomes that she suggests.

XIII. Summary (PPT Slides 54*–*55)

1. The Summary slides review the ten Learning Objectives, covering what the students should have learned in this lesson.

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