Chapter 5
Capital Gains and Losses

Issues in this Chapter:
1) Meshing capital gains and losses
2) Capital gains policy issues
3) The “sale or exchange” requirement
4) The “capital asset” definition
5) Depreciation recapture
6) Code §1231 property defined
7) Hedging transactions
Mechanics of the Treatment of Capital Gains & Losses

§1001(a) – determine the amount of the gain realized;
How determine tax basis (e.g., §1012)?
See §6045(g) re brokers to report basis re securities transactions.

§1001(c) - gain which is realized is to be “recognized” - unless otherwise provided in the Code.
Tax Benefits and Planning Objectives re Capital Gains

1. Beneficial rate treatment - §1(h) provides for a 15% tax rate for long term capital gains, subject to certain exceptions (e.g., collectibles @ 28% rate), through 2011 (& 20% rate after 2011?).

2. Capital losses cannot be used to offset ordinary income (except for individuals to the extent of $3,000 per year). How maximize the use of realized capital losses? Harvest gains?

3. Definitional consideration: what is a capital asset?
When Capital Gains Exceed Capital Losses

Long term capital gains - §1(h) - lower tax rates. Code §1222(11) - the excess of net long-term capital gain over net short-term capital loss is “net capital gain”.

Meshing of (i) long term capital gains and losses and (ii) short term capital gains and losses is required to preclude arbitraging the tax rate structure.
Capital **Losses Exceed Capital Gains**

1) Deductible losses are available only to the extent of aggregate capital gains, but each year individuals can deduct $3,000 excess capital losses against ordinary income.

2) Code §1212(b) allows an **indefinite carryover** of capital losses for **individuals**. Code §1212(a) provides a **five year capital loss carryover limit** for **corporations**, but a **carryback** is available for three years.
Problem - Applicability of Capital Loss Rules

Year 1 – Assume total losses of 9,000 exceed total gains of 8,000; deduction for 8,000 gains against 9,000 losses, plus 1,000 extra loss which can be used against ordinary income.

Year 2 – Assume total losses of 12,000 exceed total gains of 8,000; can deduct (i) losses in an amount equal to gains, and (ii) lesser of the excess 4,000 or 3,000. Current deduction of 11,000 (8,000 & 3,000); 1,000 is carried over.
Problem, continued

Year 3 – Assume total current losses of 14,000 plus 1,000 short term loss carryover equals 15,000. And 15,000 exceeds assumed gains of 8,000.

Therefore, 8,000 (equal to gain amount), plus 3,000 additional, can be used as losses.

4,000 (15,000 less 11,000) is carried over and consists of long-term (?) capital loss. See Code §1212.
Planning considerations - “Harvesting losses”

Sell gain and loss assets in the same year?

No (except for those individuals regularly having significant capital gains and losses).

Alternative: stash gains and losses so as to (a) first use capital losses against $3,000 of ordinary income, and (b) then have long term gains taxed at the preferable 15% tax rate (or in reverse chronological order).
1) Will lowering the capital gains tax rate increase tax revenues by unlocking gains and encourage gain recognition for income tax purposes?

2) Should relief be available for possible income bunching effect (because multiple years’ value accrual is taxed in one year)?

*continued*
3) Relief of the impact of inflation (but compare treatment of assets held either for (i) one year+ or (ii) 10 years)?

Is an option the indexation of tax basis (impacted by holding period) to reflect inflation?

But, then also must debt (1) owed by borrowers and (2) owned by lenders be indexed?

continued
Capital Gains Tax Rate Policy Considerations, cont

4) Consider the “lock-in” effect of the impact of capital gains tax rates & Code §1014 (basis step-up at death). Avoid this by eliminating the realization concept? Some Code provisions have “mark to market,” e.g., §475.

5) The “realization” concept itself does enable (i) tax deferral (cf., Haig-Simons) & (ii) income tax benefits.
Capital Gains Tax Rate As Enabling Tax Regressivity?

Who owns most capital assets which produce capital gains? Probably the highest income individuals?

Should capital gain income be subject to the same tax rate as wage income? Or, should risk-taking concerning capital be more rewarded through the income tax system?

Does the lower rate represent implementation of a quasi-consumption tax approach?
Why the limit on capital loss utilization?

Taxpayer cannot (1) realize losses to offset against ordinary income, while (2) not realizing economically accrued gains.

The limited $3,000 deduction for individuals does permit low level “cherry picking” for loss utilization.

See §1211(b) re the $3,000 capital loss allowance.
Note the discussion concerning compensation paid to hedge fund & private equity fund managers: i.e., the “2 & 20” formula.

The 2% of amount invested does constitute ordinary income/compensation.

But, what about the 20% participation in the upside gains? Particularly, when no cash investment has been made by the managers.

Cf., tax characterization of the growth of the capital value of a private company, e.g., corporate shares/founders’ shares with value derived from “sweat equity.”
Defining the Term “Capital Asset” - Code § 1221

Code §1221 provides a definition of “capital asset” – but not including (for example):

1) inventory, and

2) property used in a trade or business (i.e., Code §1231 property).

What is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"? Inventory?
Impact of Code §1231 p.552

Code §1221(a)(2) provides a definition of property identified in §1231 – depreciable or real property used in a trade or business. Sale of this property produces capital gain or ordinary loss (after various netting procedures). Further subject to possible “depreciation recapture” – under Code § 1245.
§1221(a)(1) provides for the exclusion from capital asset status of property held for sale. Here: Taxpayer held property for development or for sale (i.e. dual purpose property). Was property held “primarily for sale” to customers in ordinary course of trade? The term “primarily” means “of first importance” or “principally.” Remanded for further consideration. Is this a “change in purpose” case? Cf., sales of equipment by rental agencies.
Parallel ownership in a partnership and a corporation. Partnership sold investment land to corp. for development by the corp. Sale for promissory notes from the corp.

Was the partnership involved in selling the land?

Holding: **Partnership was not** in the business of **selling** land & not an agent of the corp.

See the seven factors on p.558.

Appeals Court rejects a “substance over form” analysis and the agency issues raised by IRS.
Factors Impacting Dealer
Status – Fact Issues - p.561-4

1) Frequency and substantiality of sales
2) Development activities for the land (e.g., lots, streets, utilities and sewers)
3) Seller’s activities/non-activities in sales
4) Relative earnings – property sales income vs. earned income
5) Bulk sale or multiple sales
6) Liquidation of investments?

Cf., Code §1237 re bifurcated treatment of the proceeds received by land developers.

Page 565.
Cf., Sellers of Stock and Debt Securities  p.564

Investors are entitled to capital gains treatment (but gain may be short-term gain).

1) Dealers - sellers to customers & ordinary income (or loss) treatment. See Code §1236 – enabling dealers to earmark securities as investment assets (producing cap. gains/losses).

2) Traders – numerous transactions – but not sales to “customers”; “day trader” treatment?

3) Investor – purchasing for capital appreciation and longer term holding. Never a “business.”
Cf., Code §1221(a)(2) capital gains exclusion & Section 1231 asset treatment ("quasi-capital"). Aggregate Code §1231 gains are treated as long term capital gain. Compare: Aggregate Code §1231 losses are treated as ordinary losses. A five year meshing rule applies to preclude staggering of these gains and losses to enable arbitraging the tax rate differential - Code §1231(c).
Depreciation Recapture
§1245 - Personal Property

See p. 568.

1) An asset’s tax basis is reduced (below FMV?) by tax depreciation (including §168, §179 & §197). Code §1016(a)(2). By depreciation owner’s tax basis is recovered in portions, not at only one time.

2) All disposition gain equal to prior total tax depreciation deductions is ordinary income.

§1221 > §1221(a)(2) > §1231 > §1245

This avoids tax arbitraging (except for timing).
Depreciation Recapture
§1245

Sale of office equipment held for two years:

original cost basis  30,000
depreciation claimed  8,000
sales price  25,000

Amount realized of 25,000 less 22,000 adjusted tax basis (30-8=22); this 3,000 gain is recaptured under §1245 as ordinary income (up to the amount of the prior tax depreciation).
Depreciation Recapture
Code Section 1250

Sale of rental real property acquired three years ago:

- cost: 100,000
- straight line depreciation: 9,000
- sales price: 110,000

Code §1231 gain is $19,000 (110,000 less 91,000 basis). SL depreciation & real property so no §1250 recapture occurs.

If §1245 property - $9,000 recapture (not 19,000).
§1235 provides capital gain treatment on the sale of a patent by an individual inventor. Capital gains treatment is available even where the consideration received is based on royalties. All “substantial rights” in the patent are to be transferred to enable capital gains treatment. §§1221(a)(3) and 1231 exclusively apply to other types of patent transfers (e.g., not by individual inventors).

Inventors tax treatment extended to songwriters – see §1221(b)(3).
Corn Products case p.572

Tax Common Law?

Were the purchases and sales of the corn futures contracts “capital asset” transactions? What is a “futures contract”? Protection on both sides?

Taxpayer says futures trading was separate from its manufacturing operations. And, therefore, capital gains (and losses) realized from the futures contracts were capital.

Sup. Ct. says futures contracts are equivalent to inventory and, therefore, ordinary income (and loss) realized on disposition of futures contract.

Futures contract losses as therefore ordinary?
"Corn Products" Doctrine
Arkansas Best case  p.575

Was corporate stock a capital asset or a §1231 asset? Taxpayer acquired stock in a Dallas bank. The stock was sold at a loss after the bank became a problem bank (& ordinary loss realized?). Tax Court held the stock purchases during the bank's "problem phase" were made exclusively for business purposes. Reversed by 8th Cir. and Supreme Court affirmed. Acquisition purpose is not deemed relevant. A "capital asset" was sold.
Sequels to Arkansas Best

No tax “common law” definition of a capital asset exists – but this concept assumed after the Corn Products case. But, a broad construction of §1221(a)(1) applies.

Regulatory response: Reg. §1.1221-2 which limits non-capital asset treatment to hedging transactions/“risk reduction” arrangements.

Consider the “source of supply” stock ownership cases (not hedging cases).
Changes to IRC §1221 (1999) p.581

Special exceptions to the capital asset definition:
§1221(a)(6) – commodities derivative financial instruments
§1221(a)(7) – hedging transactions (timely identification is required)
§1221(a)(8) – supplies of a type consumed by the taxpayer in the ordinary course of business (e.g., airlines purchase of fuel).
Qualified small business stock - §1202
- 50% exclusion
- special 75% exclusion through 2010
(even more – 100% - for small business stock purchases in late 2010 and for 2011 - §1202(a)(3))

Dividends – taxed at the capital gains rate - §1(h)(11) (but what rate is applicable in 2012 - 39.6%?).
Hort, p.586 – lump sum payment received by owner upon the cancellation of a lease treated as a substitute for future rent. **Ordinary income.**

**P.G. Lake, p.587** – corporation transferred a 600x “oil payment” to its officer to pay a loan. Treatment of the assignment as a capital asset transfer. Held: taxable to employer as **ordinary income**, since a substitute for ordinary income.

Response is Code §636 – treating the transaction as a loan. Seller is taxable on the income when produced, subject to depletion deduction.
Transfer by the life tenant of a life interest to the remainderman – ordinary or capital gain?

Held: Not a sale of “naked rights” to receive income, but the sale of the life interest in the property. The consideration received is to be characterized as capital gain.

What is the life tenant’s tax basis? See §1001(e).

Cf., the Blair case re assignment of income.
The Meaning of “Property”

1) Surrender of the lease of the play is not excluded from capital gains treatment.

2) Negative power to prevent disposition or motion picture rights until after play production – capital gain proceeds.

3) Right to receive a portion of the motion picture proceeds – not a capital asset disposition.
Sale of rare blood: Sale of property? If so, what is character of the income? Ordinary income if regularly selling blood? See Green case.

Charitable contribution of blood to a “blood bank” – contribution for fmv of blood (as property) or a service (and no charitable deduction for value of services)? See Code §170(e)(1)(A).

Other body parts? What tax basis in a body part?
Lottery winner

Taxpayer sold for a lump sum the right to the remaining lottery winning payments (why sell?), and reported sales proceeds as capital gains, and tax basis of zero (except cost for lottery ticket?). Annual payments are treated as ordinary income, but different when a lump sum sale occurs? Held: this payment is a substitute for the regular receipt of ordinary income and, therefore, is ordinary income. Equivalent to earned income? Are all capital assets essentially substitutes for a stream of ordinary income?
What tax character for the sale of a going business (i.e., (1) one asset or (2) the various assets of a sole proprietorship).

Prior partnership, and loss on sale of the 2/3\textsuperscript{rd} interest and gain on the 1/3\textsuperscript{rd} interest.

Sale of an entity interest? Or (as suggested by Code §1221) is an allocation of the total price to the various assets required, since some assets sold are capital and some ordinary.

The allocation of the sales price is to be based on the §1060 rules.
Allocation of Price - §1060
Asset Classes

Class 1 assets: Cash & cash equivalents.
Class 2 assets: Marketable securities.
Class 3 assets: Accounts receivable.
Class 4 assets: Inventory.
Class 5 assets: Tangible property.
Class 6 assets: Intangibles (§197).
Class 7 assets: Goodwill & going concern value (also §197 assets).
Cummings v. Commr. P.616

Insider short swing stock profits (within Securities 1933 Act, §16(b)), i.e., sold for gain and then purchase same stock within six months for a lesser price. Gain (automatically) required to be disgorged by the taxpayer to the employer.

Held: capital loss treatment, not ordinary expense for the payment required.

Other option: Treat the payment of profits as an additional purchase cost for the new stock?

See Arrowsmith case, U.S. Supreme Court (next slide).
Shareholder/taxpayer liquidated a corporation. Gain was reported by shareholder on the stock redemption (i.e., liquidation proceeds) as capital gain.

Later the taxpayer was required personally to pay a judgment against the corporation (i.e., transferee liability).

This subsequent payment was treated as a capital loss, not as an ordinary and necessary business expense, since a restoration of earlier cap. gain.
Gain or loss arises on the “sale or exchange of a capital asset.” See Code §1222.

How postpone this sale/gain recognition event?

- “Short sale against the box”: (1) owning securities, (2) borrow similar securities, (3) sell the borrowed securities (short), thereby terminating the risk on the investment; (4) then subsequently close the transaction – delivering original shares.

Alternative types of gain realization postponement arrangements:

1) Buy a put option – i.e., the right to sell security at a price equal to its present value;

2) Variable prepaid forward contract – receiving up-front payment (up to 85% of fair market value) in exchange for delivery of a variable amount of shares or cash in the future.

Are these gain realization events? Should § 1259 reg. authority be exercised here? See p.626.
Abandonment or Terminating Property Rights

The abandonment of property can constitute a “sale or exchange” (e.g., where nonrecourse mortgage exceeds FMV of property; i.e., an “underwater” property).

Remember the Tufts case (debt in excess of tax basis) with realization to extent of the debt relief.

The termination of a contract can constitute a sale or exchange – but not where merely terminating a right to receive ordinary employment income.

Note Code §1241 re capital gain treatment to the lessee for receiving a payment to terminate a lease (p. 629).
Gift of property is made subject to an obligation assumed by donee to pay gift tax arising from the transfer. Is this a satisfaction of the taxpayer’s (gift tax) liability by a 3rd party?

Does the donor have (capital gain) income to the extent (1) gift tax amount (62x) exceeds (2) the donor’s tax basis (51x) for the transferred property? A discharge of donor’s legal gift tax obligation has occurred in a “deal.”

Note the interrelated computation required here.

Cf., §1011(b) in charitable bargain sale context.
**Problem re “Net Gift” Transaction**

Gift transfer of stock: Basis - 10x; fmv - 100x. Condition that donee pay 25x gift tax liability. **Gain of 15x (25x tax less 10x basis)?**

Is the donee’s tax basis for the property 25x? Reg. §1.1015-4.

Or, is the sale made of 1/4 of the property? (25/100; approx tax basis of 2.5x – 1/4th of 10x) for the 25x portion deemed received and, therefore, gain to donor of 22.5x (25x less 2.5x)?

Cf., the “bargain sale to charity” rule. §1011(b).
Under Code §1001(c) gain is to be recognized – except as otherwise provided.

“Like-kind” exchanges can enable gain recognition postponement - Code §1031.

No gain recognition is required on a “like-kind” property exchange, except for the receipt by the taxpayer of “boot” - §1001(b).

What is the rationale for this provision enabling gain recognition postponement? A valuation difficulty? lack of liquidity?

Basis shifted to the replacement property. §1031(d).
Identifying “Like Kind” Property p.640

Like-kind exchange treatment permitted:

1) Different types of real estate? Cf, TICs; sale-leasebacks (Marsh case – how long a lease?).

2) Auto trade-ins?

3) Professional athlete contract swaps?

4) Partnership interests swaps? No, but the separate assets of a partnership? Note: Williams v. McGowan case

See the limits in §1031(a)(2). Liquid securities and inventory are not eligible. Coins?
Like-kind Exchange - Deferred Property Receipt

“Starker” exchange – p. 638

Delayed receipt of the exchange property – by relying on the creditworthiness of the exchanging party. Does this qualify as a §1031 exchange?

See §1031(a)(3) specifying 45 day and 180 day limits for completing the exchange.

What if an interest charge equivalent is credited to the replacement property purchase?
Deferred?
How Assure “Exchange” Status Exists?

§1031 does not permit deferral upon the receipt of cash and then the reinvestment of the cash proceeds in a new property.

How arrange a tax-free exchange when one party is providing cash?

- multi-party transactions (p. 637);
- §1031 exchange facilities

Cf., tenancy in common (“TIC”) ownership arrangements.
How is the Gain Potential Retained for Tax Purposes?

Tax **basis** for the replacement property is:
1) same as the tax basis for property transferred;
2) decreased by the boot received;
3) increased by the gain recognized on the exchange.

See §1031(d) providing the rules for a transferred tax basis for the replacement property.
Like Kind Exchanges with No “Boot” Received

**Example 1:** Client owns Property A. Exchange of Property A worth 10x, basis 4x, for like-kind Property B, also fmv 10x.

Taxable inclusion of gain of 6x is postponed. Tax basis for the replacement property is 4x (to preserve the income tax potential on the 6x deferred gain). Code §1031(d).
Example Two: Transfer of Property A worth 10x (basis 4x, accrued gain is 6x) in exchange for replacement Property B, fmv 8x, and additional 2x cash is received (i.e., “boot”) by transferor. Code §1031(b) - 6x gain is realized. Gain is to be recognized to the extent of the 2x “boot.” Tax basis for replacement Property B (fmv 8x) is 4x (2x has been recognized; 4x is not recognized). Tax basis for 2x cash received is (obviously) 2x.
Like-kind Exchanges, cont.

Boot *Exceeds* the Gain

**Example Three:** Transfer of Property A worth 10x (basis 4x; 6x appreciation) for replacement Property B, fmv 3x, plus cash (boot) received in the amount of 7x.

Code §1031(b) - 6x gain (not the 7x cash amount) is to be recognized (i.e., recognition is only to the extent of the gain actually realized).

Basis for Property B is 3x (all the gain has been recognized). Basis for the cash is 7x.
Loss - Like-kind Exchange Provision Is Not Elective

Example Four: Transfer made of Property A worth 10x (basis 12x, i.e., loss property) for replacement Property B, fmv 10x (i.e., same FMV).

No loss can be recognized. Code §1031(a).

Basis for Property B received is 12x (i.e., the 2x loss potential is retained in the replacement property for future loss recognition when sold, unless subsequent appreciation occurs).
Loss - Like-kind Exchange Provision is Not Elective

Example Five (& boot received): Transfer of Property A worth 10x (basis 12x, i.e., loss property) for (1) replacement Property B, fmv 8x, and (2) 2x cash boot received by the “seller.” No loss can be recognized. Code §1031(c).

Tax basis for Property B is 10x (the basis of the transferred property, as reduced by the 2x cash); the 2x loss potential is retained in replacement property (8x fmv for Property B with 10x basis); and, 2x tax basis applies for the cash received.
Example Six: Transfer of Property A worth 10x (tax basis is 4x, 6x appreciation) for (1) replacement Property B, fmv 8x and (2) other property (e.g., listed stock) worth 2x.

Code §1031(b) - 6x gain is realized, but recognition applies only to extent of the “boot.” Basis for Property B (fmv 8x) is 4x (2x of the 6x appreciation is recognized (& 4x gain potential) & 2x is the tax basis for the boot (listed stock).
Like-kind Exchange - Taxpayer *Adds* Cash Boot

**Example Seven:** Transfer of both (1) Property A worth 10x (basis 4x, with 6x appreciation) and (2) 5x cash for acquiring replacement Property B with a 15x fmv.

Code §1031(a) - 6x gain is realized but no gain is to be recognized.

Basis for (15x fmv) Property B is 9x (4x old basis plus the 5x new cash paid to the purchaser).
Postponement of realized gain occurs if:

1) A gain is derived from an involuntary conversion, e.g., theft, casualty, seizure, or eminent domain (or a taking “threat”?); proceeds received from insurance?

2) An acquisition occurs within the required time period (before the close of the 2nd taxable year of gain) of a replacement property “similar or related in service or use.” Cf., the more expansive §1031 “like kind” property concept.
Business Property Burned Example

Building burned down is business property. Receive 350x insurance proceeds; 200x basis for the old property & 325x reinvestment in new property. Under §1033(a)(2)(A) the 150x of realized gain is included in GI only to extent of 25x (350x insurance proceeds less the lesser 325x reinvestment).

The 125x of unrecognized gain reduces the tax basis for the replacement property to 200x.

The unrecognized gain is preserved in the replacement property through this tax basis adjustment.
Permanent exclusion provision – for the gain on the sale of a personal residence:

$250,000 for a single return

$500,000 for a joint return.

No reinvestment requirement (prior law: §1034).

How relate to the involuntary conversion provision if the personal residence is destroyed and insurance proceeds are received? Gross income exclusion or only postponement?
Code §121 – GI Exclusion

Problem

Sale of residence for 350x in Year 4 of ownership; tax basis is 200x; realization of 150x gain occurs.

Satisfy the 2 of 5 year principal residence requirement? 150x gain is excluded from GI under §121. Buys new house for 400x.

No downward basis adjustment for the new residence (because of the unrecognized gain); the tax basis for the new residence is 400x.

What is the “tax expenditure” cost for §121?
Example 2 - §121
& Involuntary Conversion

House is destroyed by fire when the value of the principal residence is 300x. Reproduction cost (enabling an insurance recovery) is 350x, paid in a subsequent year. Reconstruction is completed in the next year for 325x amount.

Basis of old residence is 200x, and the realized gain is 150x, but (assuming no limit) this is excluded under §121 (even though an involuntary conversion has occurred).

The basis for the new residence is 325x.
First Time Homebuyer’s Refundable Tax Credit

2008 - $7,500 credit, subject to recapture over a 15 year period; 2009 – $8,000 credit.

“Worker, Homeownership, and Business Assistance Act of 2009,” H.R.3548, 11-6-09

1) Extend the 1st homebuyer credit to 5-1-10;
2) 2nd time homebuyer’s credit - if in the current residence 5 of last 8 years - $6,500 credit.

Purchase price limit of $800,000.

Provision expired?