**Chapter 7 Notes**

**Investments**

**I. Portfolio vs. Passive Investments**

Portfolio Investments: investments that produce dividends, interest, royalties, annuities, or capital gains

Most people own these (e.g., stocks, bonds, annuities)

Some are taxed on an annual basis; CG are deferred (taxed when sold).

Potentially taxed at preferential tax rates (LTCGs and qualified dividends are taxed 15%).

Deductibility of losses from selling the investment is often subject to limitations.

Passive Investments: generate ordinary income, and the ability to deduct losses is limited

Owned by very wealthy individuals (e.g., limited partnerships, REITs, rental property)

Generate **operating** income and operating losses; you do not actually participate in these activities.

Can only deduct losses to the extent you have passive activity income.

Operating income is taxed at ordinary income tax rates.

Deductibility of losses from selling the investment is also subject to limitations.

**Portfolio Investments**

*Interest*: Taxed at ordinary income rates (includes interest from: savings account, certificate of deposits (CDs), money market accounts, and bonds)

Corporate Bonds

- Not exempt from state income taxes and federal income taxes.

- May or may not pay interest periodically.

U.S. Treasury Bonds

- Exempt from state income taxes, but not federal income taxes.

- Pay interest periodically.

- Usually the safest investment in the world.

*Dividends*

Dividends are either qualified or non-qualified.

Qualified dividends are taxed at preferential rates (0, 15, or 20%) depending on the taxpayer’s filing status and amount of taxable income, while non-qualified dividends are taxed at ordinary income tax rates

Most people own qualified dividends, but if you own a mutual fund, then you will likely have non-qualified dividends

Requirements for a qualified dividend:

1. (dividends paid by a) Domestic (corporation, i.e. ,U.S. corp.) or qualified foreign corporation

2. Investor must own the dividend-paying stock for **more than** 60 days during the 121 day period before the ex-dividend date (date where you are entitled to receive the dividend if you owned the stock before this date – so if buyer bought the stock on this day, the buyer is not entitled to receive the dividend declared by the corp.)

Calculate ATRR on the investment as we have discussed before.

*Capital Gains and Losses*

Typically investment-type assets and personal-use assets

Occurs when investors buy and hold assets with appreciation potential; these are capital assets: e.g., stocks, collectibles, business assets, personal residence, and car.

(capital gain/capital loss is computed when a TP sells a capital asset)

Gain (Loss) = Amount realized (sale proceeds less selling expenses (broker fees, sales commission) – Adjusted tax basis (i.e. tax basis) (cost of acquiring the asset plus other costs incurred to purchase or improve the asset – e.g. improvements done on personal residence is included in the tax basis; brokerage fees paid by the TP to acquire the stock is included in the tax basis – so these additional costs are “capitalized” and added to the initial cost of acquiring the asset – so adjusted tax basis = initial cost of acquisition + capitalized costs.

Losses on personal-use assets are **not** deductible (so if TP sells her personal residence at a loss, the loss is non-deductible)

Advantages of investing in capital assets are:

1. Gains are deferred until you dispose of the assets

Makes sure that investors have the wherewithal to pay the tax on the sale.

2. Gains are taxed at preferential rates

Incentivizes investors to invest and stimulate the economy.

Loss deductibility is subject to limitations.

What is **not** a capital asset? (IRC defines a capital asset in the negative, i.e., what it isn’t…e.g. depreciable property or real property used in a trade or business is ordinary income property; accounts or notes receivable; and inventory)

Types of Capital Gains and Losses

1. Short-term – capital assets that do not qualify for preferential tax rates and are held **for one year or less**

a. Taxed at ordinary income tax rate

2. Long-term – capital assets that qualify for preferential tax rates and are held for **more than** **one year**

a. Taxed at preferential tax rates – 0, 15, or 20% (just like qualified dividends)

3. Net Section 1231 Gains – assets (depreciable property) used in business that are held for more than one year

a. Taxed at preferential tax rates – generally 15%

b. Unrecaptured Section 1250 Gain is taxed at 25% (discuss in Ch. 11)

c. Must be a result of the Section 1231 Netting Process

4. Collectibles – works of art, rugs, antiques, gems, metals, stamps, etc. that are held for more than one year

a. Taxed at 28%

5. Qualified small business stock (IRC Section 1202) – C corporations with no more than $50 million of assets (TP must hold stock for more than 5 years)

a. Taxed at 28%

**II. Determining Tax Treatment of Assets**

Whether an asset qualifies as a capital asset depends on the purpose for which the taxpayer uses the asset.

* Example: piece of land
  + if held as an investment (e.g., for expected appreciation potential): capital asset
    - LTCG/LTCL
  + if held as inventory (e.g., by a real estate developer): ordinary asset
    - ordinary income
  + if held for more than one year and used in a trade or business (e.g., as a parking lot): §1231 asset.
    - LTCG/LTCL
      * ordinary income if held one year or less

**III. Netting Process for Short-Term and Long-Term Capital Gains and Losses**

There may be situations where a TP recognizes capital gains and capital losses during the year. If so, taxpayers must complete the netting process to determine the appropriate tax treatment for capital gains and losses recognized during the year.

Works in favor of the taxpayer.

Occurs when taxpayers sell multiple capital assets during the year

**Situation 1:** Taxpayers only sell stock or personal use assets (i.e., no collectibles or Section 1231 assets) (i.e., no 25% or 28% LTCGs)

85-90% of people find themselves here.

1. Determine the net long-term and net short-term gains and losses separately

2. If **all** sales are either for losses or gains, then no more netting needed.

If there are both net short-term and net long-term losses, apply net short-term loss against ordinary income first up to the $3,000 limit.

For individuals, the maximum net capital loss that is deductible against ordinary income is $3,000.

Using the short-term loss first makes sense because it gets rid of ordinary income. If the loss is greater than $3,000, carryforward indefinitely (i.e., they never expire) until you use it up. When a loss is carried forward, its character remains (i.e., STCL/LTCL).

3. If one is a gain and another is a loss, then net short-term and long-term items to yield a final net gain or net loss.

If net short-term capital gain, tax at ordinary income rate.

If net long-term capital gain, tax at preferential rate (0%, 15%, or 20%).

If net loss – deduct up to $3,000 and carry excess forward (character remains).

Example 1: Assume you sell the following stocks during the year with these results: $8,000 STCG; $9,000 STCL; $4,000 LTCL; and $10,000 LTCG. What is your tax liability on the sale of the assets? Assume a preferential tax rate of 15%.

Short-Term Long-Term

$8,000 STCG ($4,000) LTCL

($9,000) STCL $10,000 LTCG

($1,000) STCL $6,000 LTCG

$5,000 net LTCG $5,000\*.15 = $750

Example 2: Now assume you sell the following stocks with these results: $4,000 STCG; $7,000 STCL; $5,000 LTCL; and $4,000 LTCG. How much tax do you owe (save) on the sale of the assets assuming your marginal tax rate is 24%?

Short-Term Long-Term

$4,000 STCG ($5,000) LTCL

($7,000) STCL $4,000 LTCG

($3,000) STCL ($1,000) LTCL

Deduct the $3,000 STCL against ordinary income to save: ($3,000)\*.24 = ($720) saved in taxes.

Carry forward the $1,000 LTCL.

Example 3: Now assume that you sell the following stocks in Year 1 with these results: $3,000 STCL and $5,000 LTCL. The next year, you sell the following assets with these results: $5,000 STCG and $5,000 LTCG. How much tax do you owe (save) on the sale of the assets in Year 1 and Year 2 assuming your marginal tax rate is 24% in both years?

Year 1

Short-Term Long-Term

($3,000) STCL ($5,000) LTCL

Deduct the $3,000 STCL against ordinary income to save: ($3,000)\*.24 = ($720) saved in taxes.

$5,000 LTCL carryforward.

Year 2

Short-Term Long-Term

$5,000 STCG ($5,000) LTCL CF from Year 1

$5,000 LTCG

$5,000 STCG $0

$5,000 \* .24 = $1,200 owed in taxes

Example 4: Assume you are planning on selling the following stocks:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Stock | FMV | Basis | Purchase Date | Gain (Loss) |
| A | $12,000 | $9,000 | 1/1/2001 | $3,000 LTCG |
| B | $5,000 | $8,000 | 1/1/2001 | ($3,000) LTCL |
| C | $15,000 | $12,000 | 2/1/2018 | $3,000 STCG |
| D | $17,000 | $20,000 | 2/1/2018 | ($3,000) STCL |

Today is 12/31/2018 and you need to sell all of the stocks by 1/15/2019. Your marginal tax rate is 24%. When should you sell each stock?

If we sold everything on 12/31, we would not owe any taxes, but we can manipulate the timing to save taxes. What do we want to look at? (1) Tax rate and whether it will change, (2) After-tax rate of return (will the FMV change), (3) Do you need the cash immediately, (4) Evaluate whether the ST stocks could become LT stocks, (5) Accelerate losses and defer gains, and (6) Get rid of income taxed at higher rates.

We want to split LT up and sell ST together. C and D, it doesn’t matter when we sell them, but we want to sell them **together**.

Year 1

Short-Term Long-Term

$3,000 STCG (C) ($3,000) LTCL (B)

($3,000) STCL (D) x.24

$0 ($720) tax savings

Year 2

Short-Term Long-Term

$0 $3,000 LTCG (A)

x.15

$450 tax owed in Year 2

Example 5: Assume you are planning on selling the following stocks:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Stock | FMV | Basis | Purchase Date | Gain (Loss) |
| A | $12,000 | $9,000 | 1/1/2001 | $3,000 LTCG |
| B | $5,000 | $8,000 | 1/1/2001 | ($3,000) LTCL |

Today is 12/31/2018 and you need to sell all of the stocks by 1/15/2019. Your marginal tax rate is 24% in 2018 and will be 40% in 2019. When should you sell each stock?

**Scenario 1: Sell A in year 1 and sell B in year 2**

Year 1 (2018) Year 2 (2019)

Short-Term Long-Term Short-Term Long-Term

$0 A $3,000 $0 B ($3,000)

x.15 x.40\_\_

$450 tax owed Year 1 ($1,200) tax savings Yr 2

tax savings: ($1,200) + 450 = ($750)

**Scenario 2: Sell B in year 1 and sell A in year 2**

Year 1 (2018) Year 2 (2019)

Short-Term Long-Term Short-Term Long-Term

$0 B ($3,000) $0 A $3,000

x.24 x.20

($720) tax savings Year 1 $600 tax owed Year 2

tax savings: ($720) + $600 = ($120) tax savings

**Sell A now and sell B in Year 2.**

**Situation 2:** Taxpayer sells a wide variety of long-term capital property that is taxed at various rates. This process is designed to maximize losses and carryforwards in the different tax rate buckets [(0/15/20, 25% and 28%].

Before you do any of this, you need to do the Section 1231 netting process.

If you have a net Section 1231 loss, it reduces ordinary income and does not go into the capital gain netting process.

1. Determine net long-term and net short-term gains and losses separately.

Note: long-term includes collectibles, Section 1231, etc.

2. If result is a net long-term capital gain (REGARDLESS of whether or not there is a short-term capital gain or loss), follow the process below.

If the result is a net long-term capital loss, see the remainder of the steps outlined in Situation 1.

3. Separate long-term capital gains and losses into groups by tax rate (i.e., 28%, 25%, and 15%).

Initially, the 25% group will only have gains because of Unrecaptured Section 1250.

4. Place all long-term capital losses carried forward from prior years into the 28% group (works in the taxpayer’s favor).

5. Net the gains and losses in the 15% group.

If the result is a loss, move the loss to the 28% group.

If the result is a gain, leave it in the 15% group.

6. If there is a net short-term loss from Step 1, place it in the 28% group.

7. Net the gains and losses in the 28% group.

If the result is a net gain, tax at 28%.

If the result is a net loss, then transfer it to the 25% group.

8. Net 25% gains with losses (if any) from the 28% group.

If the result is a net gain, tax at 25%.

If the result is a net loss, transfer to the 15% group.

9. Net 15% gains with losses from the 25% group.

This amount is taxed at 15%.

Example 6: On December 15, 2018, you sell the following assets (assume that these are all collectibles, stocks, or used in trade or business). How much tax will you pay on the sale of these assets?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Asset** | **FMV** | **Basis** | **Purchase Date** | **Gain (Loss)** |
| Stock | $15,000 | $10,000 | 1/1/2018 | $5,000 STCG |
| Stock | $30,000 | $41,000 | 5/15/2018 | ($11,000) STCL |
| Stock | $35,000 | $20,000 | 11/05/2016 | $15,000 LTCG |
| Rug | $50,000 | $80,000 | 3/15/2012 | ($30,000) LTCL |
| Painting | $18,000 | $11,000 | 4/15/2008 | $7,000 LTCG |
| Machine | $10,000 | $26,000 | 3/20/2007 | ($16,000) 1231 Loss |
| Building | $150,000 | $100,000 (include $25,000 of depr.) | 2/22/2003 | $50,000 1231 Gain  ($25,000 U/R 1250) |
| Stock | $22,000 | $24,000 | 2/22/2014 | ($2,000) LTCL |

(1) Section 1231 Netting Process

|  |  |  |
| --- | --- | --- |
| **25%** |  | **15%** |
| $25,000 U/R 1250 |  | ($16,000) 1231 loss |
|  |  | $25,000 1231 gain |
| $25,000 |  | $9,000 |

$34,000 in total

(2) Separate out into short-term and long-term.

|  |  |  |
| --- | --- | --- |
| **Short-term** |  | **Long-term** |
| $5,000 |  | $15,000 |
| ($11,000) |  | ($30,000) |
|  |  | $7,000 |
|  |  | $9,000 1231 gain (15%) |
|  |  | $25,000 U/R 1250 (25%) |
|  |  | ($2,000) |
| ($6,000) |  | $24,000 |

(3) Separate the LTCGs into tax rate buckets.

|  |  |  |
| --- | --- | --- |
| **28%** | **25%** | **15%** |
| ($30,000) | $25,000 | $15,000 |
| $7,000 | ($29,000) (8) net 28% loss w/ 25% | $9,000 |
| (4) $0 carryforward losses | ($4,000) | ($2,000) |
| (6) ($6,000) STCL |  | $22,000 (5) net g/l in 15% |
| ($29,000) (7) net g/l in 28% |  | ($4,000) (9) net 25% loss w/ 15% |
|  |  | $18,000 |
|  |  | x0.15 |
|  |  | $2,700 tax owed |

**IV. Tax-Exempt Portfolio Income** (skim this section in the book)

*Portfolio Investment Expenses*

Expenses incurred by TP to acquire or maintain investments.

Beginning in 2018, the only expense associated with investment expenses that is deductible is investment interest expense.

Prior to 2018, regular investment expenses were classified as miscellaneous itemized deductions and deductible subject to the 2% AGI floor.

(e.g., investment advisory fees from e.g. attorneys or accountants, periodical subscription fees (WSJ), safety deposit box rental fees)

Investment interest expense (From AGI deduction; not subject to a floor) (different from **investment expenses**)

Interest paid on loans used to acquire investments.

Interest is deductible as an itemized deduction **up to** the amount of net investment income.

Net investment income is also referred to as gross investment income (prior TCJA NII was calculated by subtracting deductible investment expense, which is no longer deductible)

Gross investment income includes all types of taxable income **except** that which qualifies for the preferential rate (e.g., qualified dividends, LTCG, and tax-exempt assets).

Taxpayer can elect to include qualified dividends and LTCG in gross investment income calculation, but this income will be taxed at ordinary tax rates.

Only people with a really small amount or with an ordinary tax rate is less than 15% would make this election; practically speaking this is a non-issue.

Unlimited carryover is allowed (never expires – of the investment interest expenses).

Example 7: In the current year, Daly has an investment interest expense of $13,000, investment expenses of $3,000, and an AGI of $50,000. In figuring her AGI, she considered the following items: interest income from a CD of $1,400, qualified dividends from Coca Cola stock of $2,300, and a gain of $5,200 from selling 20 shares of Google (purchased on 2/1 of the current year and sold on 10/15). What is her deductible investment interest for this year?

Coca Cola dividends ($2,300) – qualified, taxed at a preferential tax rate, so they are not included in the calculation of gross taxable investment income.

Google gain ($5,200) – STCG taxed as ordinary income

Gross investment income = $1,400 + 0 + $5,200 = $6,600

Deductible investment expense = $0

Daly can deduct $6,600 of the $13,000 now (carryforward $6,400)

Not covering Passive Activity Income