

# **Advanced Individual Income Tax**

**Documents for  
Lecture on Chapter 7**

## **Investments**

**UNC Charlotte MACC Program**

**May 31, 2017**

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**33.** Dana intends to invest \$30,000 in either a Treasury bond or a corporate bond. The Treasury bond yields 5 percent before tax and the corporate bond yields 6 percent before tax. Assuming Dana's federal marginal rate is 25 percent and her marginal state rate is 5 percent which of the two options should she choose? If she were to move to another state where her marginal state rate would be 10 percent, would her choice be any different? Assume that Dana itemizes deductions.

**34** At the beginning of his current tax year David invests \$12,000 in original issue U.S. Treasury bonds with a \$10,000 face value that mature in exactly 10 years. David receives \$700 in interest (\$350 every six months) from the Treasury bonds during the current year and the yield to maturity on the bonds is 5 percent.

- How much interest income will he report this year if he elects to amortize the bond premium?
- How much interest will he report this year if he does not elect to amortize the bond premium?

**36.** At the beginning of her current tax year, Angela purchased a zero-coupon corporate bond at original issue for \$30,000 with a yield to maturity of 6 percent. Given that she will not actually receive any interest payments until the bond matures in 10 years, how much interest income will she report this year assuming semiannual compounding of interest?

**37.** At the beginning of his current tax year, Eric bought a corporate bond with a maturity value of \$50,000 from the secondary market for \$45,000. The bond has a stated annual interest rate of 5 percent payable on June 30 and December 31, and it matures in five years on December 31. Absent any special tax elections, how much interest income will Eric report from the bond this year and in the year the bond matures?

**40** John bought 1,000 shares of Intel stock on October 18, 2013 for \$30 per share plus a \$750 commission he paid to his broker. On December 12, 2016, he sells the shares for \$42.50 per share. He also incurs a \$1,000 fee for this transaction.

- What is John's adjusted basis in the 1,000 shares of Intel stock?
- What amount does John realize when he sells the 1,000 shares?
- What is the gain/loss for John on the sale of his Intel stock? What is the character of the gain/loss?

**46** George bought the following amounts of Stock A over the years:

	Date Purchased	Number of Shares	Adjusted Basis
Stock A	11/21/1990	1,000	\$24,000
Stock A	3/18/1996	500	9,000
Stock A	5/22/2005	750	27,000

On October 12, 2016, he sold 1,200 of his shares of Stock A for \$38 per share.

- How much gain/loss will George have to recognize if he uses the FIFO method of accounting for the shares sold?
- How much gain/loss will George have to recognize if he specifically identifies the shares to be sold by telling his broker to sell all 750 shares from the 5/22/2005 purchase and 450 shares from the 11/21/1990 purchase?

**58** On January 1 of year 1, Nick and Rachel Sutton purchased a parcel of undeveloped land as an investment. The purchase price of the land was \$150,000. They paid for the property by making a down payment of \$50,000 and borrowing \$100,000 from the bank at an interest rate of 6 percent per year. At the end of the first year, the Suttons paid \$6,000 of interest to the bank. During year 1, the Suttons only source of income was salary. On December 31 of year 2, the Suttons paid \$6,000 of interest to the bank and sold the land for \$210,000. They used \$100,000 of the sale proceeds to pay off the \$100,000 loan. The Suttons itemize deductions and are subject to a marginal ordinary income tax rate of 35 percent.

## Capital gains and losses for Susan and John (joint return)

Started investing in stock in 2014

	2014	2015	2016	2017
<b>Information</b>				
<b>Salaries</b>	<b>\$100,000</b>	<b>\$100,000</b>	<b>\$100,000</b>	<b>\$100,000</b>
S.T. gain (loss) sale of stock	(14,000)		(3,000)	
L.T. gain (loss) sale of stock		1,000	2,000	9,000
<b>Subtotal for income or loss</b>	<b>86,000</b>	<b>101,000</b>	<b>99,000</b>	<b>109,000</b>
<b>Analysis</b>				
Net capital gain (loss) current year	(14,000)			
Capital loss brought forward				
Subtotal	(14,000)			
Net gain included (or loss deducted)	(3,000)			
Adjusted Gross Income- Form 1040	<b>\$97,000</b>			

**What is the amount federal income tax before credits on a joint return for 2017?**

Assume they have deductions totaling \$20,000 (exemptions and itemized deductions).

Description	Income	Tax Rates	Tax
Ordinary income	<b>\$100,000</b>		
Exemptions and deductions	<b>(20,000)</b>		
Income taxed at ordinary rates	<b>\$80,000</b>		
Top full layer			
Top partial layer			
Income subject to tax at ordinary rates			
Income tax at ordinary rates			
Net Capital Gains, Tax Rate & Tax			
Total federal income tax before credits			

## Investment income and Investment Interest Deduction

On January 1 of year 1, Nick and Rachel Sutton purchased a parcel of undeveloped land as an investment. The purchase price of the land was \$150,000. They paid for the property by making a down payment of \$50,000 and borrowing \$100,000 from the bank at an interest rate of 6 percent per year. At the end of the first year, the Suttons paid \$6,000 of interest to the bank. During year 1, the Suttons only source of income was salary. On December 31 of year 2, the Suttons paid \$6,000 of interest to the bank and sold the land for \$210,000. They used \$100,000 of the sale proceeds to pay off the \$100,000 loan. The Suttons itemize deductions and are subject to a marginal ordinary income tax rate of 35 percent.

Do not make election		Make election	
<b>Ordinary rates</b>		<b>Ordinary rates</b>	
Salary	XXXX	Salary	XXXX
Gain		Gain	
Tax rate		Tax rate	
Tax		Tax	
Investment interest Exp.		Investment interest Exp.	
Tax rate		Tax rate	
Tax saving		Tax saving	
<b>Capital gain rates</b>		<b>Capital gain rates</b>	
Gain		Gain	
Tax rate		Tax rate	
Tax		Tax	
<b>Remaining suspended investment interest</b>		<b>Remaining suspended investment interest</b>	

Reporting Monica's Gains & Losses on Stock Transactions. 2017			
	Monica Money works for Big Corporation at a salary of	\$120,000	61
	Monica is single (no dependent). Exemption	(4,050)	151 b
	State income tax	(6,100)	164 a 3
	Property tax on home	(3,850)	164 a 1
	Home mortgage interest	(6,000)	163 h 2 D
	Taxable income [before stock transactions]	<u>\$100,000</u>	63
1	What is Monica's marginal income tax rate?		1
2	If Monica paid interest on a loan to buy corporate stock, is that interest expense deductible, subject to a limit?		163 d 1
3	Can excess investment interest expense be carried over?		163 d 2
<b>Part 1. Tax Impact of Monica's Gain</b>			
	Monica bought Bank of America stock in 2015 for	<b>\$240,000</b>	1012
	Monica sold that stock on 12-31-2017 at a net price of	<b>\$540,000</b>	1001 b
4	Is she required to include a \$300,000 gain in income?		61
5	Suppose she traded the stock for a \$540,000 home.		1001 b
6	Is the bank stock a capital asset?		1221
7	Did this sale generate a long-term capital gain?		1222 3
8	What is the special tax rate for this gain for her?		1 h
	What is the rate for gain on sale of a stamp collecton?		1 h 4
9	What marginal rate applies to the gain if she bought the Bank of America stock in February, 2017?		1222 2
10	May she use installment sales method to report gain on sale of Bank of America Stock?		453 k
11	Does she a report gain, if stock is traded for IBM Stock? [Special rule for stock-for-stock corporate reorganizansions.]		1031 a 2 B 354, 368
12	She bought home for \$240,000, lived there for 5 years, sold for \$540,000. How much gain does she recognize?		121
<b>Part 2. Assume Monica had a Loss</b>			
	Monica bought ABC stock in 2015 for	<b>\$240,000</b>	
	Monica sold that stock this year at a net price of	<b>\$40,000</b>	
13	Is she able to deduct a loss?		165 a & c, b
14	How much capital loss does she deduct in 2017? (Assume this is her only asset sale in 2017.)		1211 b
15	Can she carry the excess loss to another year? [Note: Sec. 165 is the gateway for loss deductions.]		1212 b
	[Any special rules for stock that becomes worthless?]		165 g
	[Are loss deduction rules different for corporations?]		1211 a
<b>ABC Stock above is Sec. 1244 Small Business Stock</b>			
16	How much ordinary loss does she deduct in 2017?		1244
17	How much capital loss does she deduct in 2017?		1211 b
<b>ABC stock is Sec. 1202 Small Business Stock</b>			
18	May you exclude gain under Sec. 1202?		1202

<b>Betty is CEO of Huge Corporation</b>	<b>Date</b>	<b>Amount</b>	<b>Code</b>
Her primary income is from her job with a salary per year:	2017	\$500,000	
She is single, with no dependent. All cases are independent.			
Her only asset transactions are shown below.			
<b>Case I. Gains &amp; Losses: Stock Transactions</b>			
She purchased IBM stock (1,000 shares)-Date, Cost	11/2/2016	\$300,000	
She sold same IBM stock (1,000 shares)-Date, Selling Price	9/6/2017	\$400,000	
<b>Is this gain subject to tax? Yes or No</b>			61
<b>What is basis of the property that has been sold?</b>			1011, 1012
<b>How much gain is recognized?</b>			1001
<b>Is this a capital gain?</b>			1221
<b>What is the tax rate on this gain? [tax year 2017]</b>			1(h)
<b>Case II. Gains &amp; Losses: Stock Transactions</b>			
She purchased IBM stock (1,000 shares)-Date, Cost	4/2/2016	\$300,000	
She sold same IBM stock (1,000 shares)-Date, Selling Price	9/6/2017	\$400,000	
<b>How much gain is recognized?</b>			1001
<b>What is the tax rate on this gain? [tax year 2017]</b>			1(h)
<b>Case III. Gains &amp; Losses: Stock Transactions</b>			
She purchased IBM stock (1,000 shares)-Date, Cost	4/2/2016	\$300,000	
She sold same IBM stock (1,000 shares)-Date, Selling Price	9/6/2017	\$180,000	
<b>How much loss is realized?</b>			165( c), (f)
<b>How much loss is deducted this year?</b>			1211
<b>How much loss is carried back to preceding year?</b>			1212
<b>How much loss is carried forward to a future year?</b>			
<b>Case IV. Gains &amp; Losses: Stock Transactions</b>			
She purchased stock (1000 shares)-Date, Cost	1/2/2016	\$300,000	
She sold same stock (1000 shares)-Date, Selling Price	9/6/2017	\$180,000	
<b>The stock was issued by a section 1244 small business corp.</b>			
<b>How much loss is realized?</b>			165( c), (f)
<b>How much ordinary loss is recognized on 2017 return?</b>			
<b>How much capital loss is recognized on the 2017 return?</b>			
<b>How much capital loss is carried over to a future return?</b>			
<b>What is the nature of the loss carryforward? (Ord. or Cap)</b>			
<b>Case V. Speculation</b>			
	<b>Date</b>	<b>Amount</b>	
There is a rumor there is gold in caves in the mountains.			
Betty rushed to the mountains to buy a cave.			
She found a mountain farm (with cave) & bought the cave for:	9/6/2017	\$200,000	
Rumor was false. She has no hope of selling the property.			
She abandoned the property on	12/6/2017		
<b>How much loss is deducted on the 2017 return?</b>			165, 1211

Code/Reg	<b>Mr. and Ms. Bum are wealthy investors. They file a joint return.</b>	
	<b>Mr. and Ms. Bum each earn a salary of \$500,000. They take Stand. Ded.</b>	
	Mr. Bum paid \$100 per share for 1,000 shares of stock- cost of:	100,000
	The market price of his investment in the stock on Dec. 31, 2017 was:	40,000
<b>61</b>	<b>Case 1. Deducting a capital loss.</b>	
<b>1001</b>	Mr. Bum sold 1,000 shares of ABC Corp. stock on December 31, 2017 for	40,000
<b>165</b>	The sale of ABC stock is their only transaction in 2017.	
<b>1211, 12</b>	How much loss from ABC stock sale will be deducted for 2017?	
	<b>Assume they will also have capital gain of \$200,000 on sale of IBM Stock.</b>	
	How much loss from ABC stock sale will be deducted for 2017?	
	<b>Case 2. Wash sale rules. Stock of DEF Corporation</b>	
	Mr. Bum Bought 1,000 shares of DEF stock on October 1, 2016 for:	100,000
<b>1091(a)</b>	Mr. Bum sold the 1,000 shares of DEF stock on December 29, 2017 for:	40,000
1.1091-1	Mr. Bum bought 1,000 new shares of DEF stock on January 2, 2018, for	42,000
<b>1091(d)</b>	How much loss will they deduct on their 2017 Form 1040?	
<b>1.1091-2</b>	What is the basis of the stock purchased on January 2, 2018?	
	Assume he bought only 250 shares of DEF (at \$40/sh) on Jan. 2, 2018, for:	12,000
	How much loss is deductible for 2017?	
	What is the basis of the DEF stock bought on January 2, 2018?	
	<b>Case 3. Sale to a related party. Stock of NOP Corporation.</b>	
	Mr. Bum paid \$100 per share for 1,000 shares of NOP stock- cost of:	100,000
	Mr. Bum sold the NOP stock to their son (Bubba) on Dec. 31, 2017 for	40,000
<b>267(a)</b>	How much loss will the parents deduct on their 2017 joint return	0
1.267(b)-6	In 2019, Bubba sells the stock the 1,000 shares of NOP for	25,000
267(d)	How much gain (loss) does Bubba report on this sale of NOP stock?	
	How much gain (loss) does Bubba report if he sells it for \$80,000.	
	How much gain (loss) does Bubba report if he sells it for \$114,000.	
	<b>Case 4. Sale to related party on the installment basis.</b>	
	Ms. Bum owned land. Her basis in the land was:	100,000
	The market value of the land on December 29, 2017 was:	500,000
	Ms. Bum sold the land to their son (Bubba) on December 29, 2017 for:	500,000
	Bubba Bum will sell the land in 2018 for:	600,000
	Bubba Bum will have a cost for the land of :	
	Bubba will pay Ms. Bum for the land on December 31, 2019:	
	How much gain will Ms. Bum recognize in 2017?	
453(e)(1)	How much gain will Ms. Bum recognize in 2018?	
	How much gain will Ms. Bum recognize in 2019?	
<b>453(k)</b>	<b>Can you use installment method for the sale of marketable stock?</b>	
<b>453(g)</b>	<b>Suppose the asset is an apartment building?</b>	
	<b>Case 5. Sale to unrelated party on the installment basis.</b>	
	Ms. Bum owned land that cost her:	200,000
<b>453(a)</b>	She sold the land to an unrelated investor on December 29, 2017 for:	500,000
<b>453(b)(1)</b>	She will receive annual payments of \$100,000 (plus interest) starting in 2018.	
<b>453( c)</b>	How much gain will Ms. Bum recognize in 2017?	
<b>453( c)</b>	How much gain will Ms. Bum recognize in 2018?	



References Code: Section 267

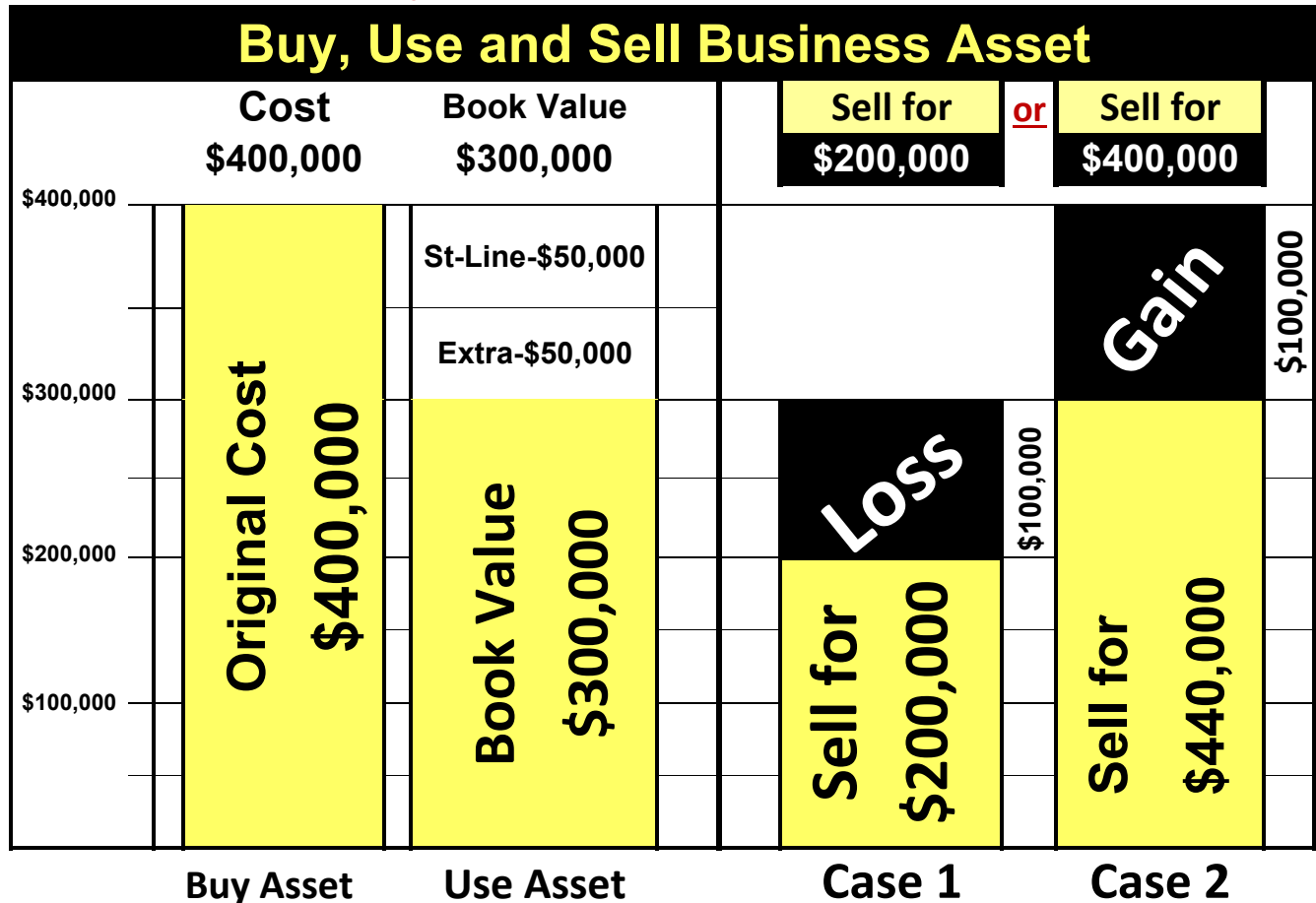
## Transactions Between Related Parties

	Sec. 267(a)(1), (d). Reg. 1.267(d)-(1)(a)(4)	Case 1	Case 2	Case 3	Case 4
<b>1</b>	<b>Ann</b>				
	Bought Stock for:	<b>\$500</b>	<b>\$500</b>	<b>\$500</b>	<b>\$500</b>
<b>2</b>	<b>Ann sells stock to Betty</b>				
	<b>(Betty is Ann's sister)</b>				
	Ann sold stock to Betty for:	<b>\$600</b>	<b>\$300</b>	<b>\$300</b>	<b>\$300</b>
	Gain or loss on <b>Ann's</b> Tax Return				
	Gain				
	Loss				
<b>3</b>	<b>Betty sells to Carla (unrelated)</b>				
	Betty sold stock to Carla for:	<b>\$800</b>	<b>\$180</b>	<b>\$450</b>	<b>\$600</b>
	Gain or loss on <b>Betty's</b> Tax Return				
	Gain				
	Loss				

**What other deduction limits are found in Sec. 267?**

**Depreciation recapture is in Chapter 11 (not covered in Acct. 6160).**

**We focus now on Unrecaptured 1250 Gain (Part 2 below).**



In each case, assume the asset (machine) was held over one year before being sold, and assume the asset is used in a proprietorship owned by a top tax bracket taxpayer (40%).

**Part 1. Analyze the sale in Case 1, using the following code sections.**

- Sec. 63
- Sec. 165
- Sec. 1001(a), Sec. 1211(b)
- Sec. 1221(a)(1), and (2)
- Sec. 1231(a)(3), 1231(a)(1), and (2)

**Analyze the sale in Case 2, using the following code sections.**

- Sec. 165
- Sec. 1001(a), Sec. 1211(b)
- Sec. 1221(a)(1), and (2)
- Sec. 1231(a)(3), 1231(a)(1), and (2)
- Sec. 1245(a)(1), 1245(a)(2)(A), 1245(a)(3)(A)
- Sec. 1(h)

**Part 2. assume this is a building is used in a proprietorship.**

**Accelerated depreciation is not allowed for building. Straight-line deprec was \$100,000.**

**Analyze the sale in Case 1. Analyze the sale in Case 2.**

**Part 3. Assume this is a parking lot is used in a proprietorship.**

**Depreciation is not allowed for land, so assume the land had cost \$300,000.**

**Assume Case 1 involves one parcel of land, and Case 2 involves another parcel of land.**

**Would you want to sell both in the same year? Section 1231( c)(1) and (2).**

### **Sec. 1221. Capital Asset Defined.**

**(a) In General.** For purposes of this subtitle, “capital asset” means **property held by the taxpayer** (whether or not connected with his trade or business), but does not include-

- (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the **inventory**..., or property held by the taxpayer primarily for sale to customers...;
  - (2) property, used in business, of a character which is **subject to depreciation** (section 167), or **real property** used in business;
- (Also, a letter or memorandum, accounts or notes receivable, a government publication, etc.)

### **Sec. 1211. Limit on Capital Losses.**

**(a) Corporations.** In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

**(b) Other Taxpayers.** In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of (1) \$3,000 (\$1,500 on a separate return), or (2) the excess of such losses over such gains.

### **Sec. 1231. Property Used in the Business and Involuntary Conversions.**

**(a) General Rule.**

**(1) Gains exceed losses.** If the section 1231 gains for any taxable year **exceed** section 1231 losses for such taxable year, such gains and losses shall be treated as **long-term capital gains or long-term capital losses**....

**(2) Gains do not exceed losses.** If the section 1231 gains for any taxable year do not exceed the section 1231 losses for such taxable year, such gains and losses shall **not be treated as gains and losses from sales or exchanges of capital assets**.

**(3) Section 1231 gains and losses.** “Section 1231 gain” means—

- (i) any recognized gain on the sale or exchange of property used in the trade or business, and
- (ii) any recognized gain from the compulsory or involuntary conversion into other property or money of—

- (I) property used in the trade or business, or (II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.

**Section 1231 loss.** The term “section 1231 loss” means any recognized loss from a sale or exchange or conversion [of such assets].

### **(c) Recapture of Net Ordinary Losses.**

**(1) The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.**

**(2) Non-recaptured net section 1231 losses.** For purposes of this subsection, the term “non-recaptured net section 1231 losses” means the excess of (A) the aggregate amount of the net section 1231 losses for the 5 most recent preceding taxable years beginning after December 31, 1981, over (B) the portion of such losses taken into account under paragraph (1) for such preceding taxable years.

### **Sec. 1245. Gain from Disposition of Depreciable Property.**

**(a) General Rule.** Except as otherwise provided in this section, if section 1245 property is disposed of the **amount** by which the lower of—

- (A) the **recomputed basis** of the property, or
- (B) (i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or
- (ii) in the case of any other disposition, the **fair market value** of such property,

**exceeds the adjusted basis** of such property **shall be treated as ordinary income**. Such gain shall be recognized notwithstanding any other provision of this subtitle.

**(2) Recomputed basis.** “Recomputed basis” means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization.

### **Sec. 1250. Gain from Dispositions of Depreciable Realty.**

**(a) General Rule.** Except as otherwise provided in this section-

**(A) In general.** If section 1250 property is disposed of, then the applicable percentage of **the lower of—**

- (i) the **additional depreciation** (depreciation in excess of straight-line depreciation), or
- (ii) the excess of the **amount realized** (in the case of a sale, exchange, or involuntary conversion), or the FMV of such property (in the case of any other disposition),

**over the adjusted basis** of such property, **shall be treated as gain which is ordinary income**. Such gain shall be recognized notwithstanding any other provision of this subtitle.

### Test Questions from the Past

1 An individual is single and has no dependent. She has this information.

Description	Amounts	Tax Return
Salary income	\$240,000	\$240,000
Interest earned on a savings account	\$4,000	\$4,000
Deductions for AGI	\$40,000	(\$40,000)
<b>AGI</b>		\$204,000
<b>Amounts paid</b>		
Interest on mortgage (loan of \$400,000)	\$20,000	
Interest on loan to buy stock investments	\$7,000	
State income tax	\$30,000	
State and federal gasoline tax	\$1,000	
Property tax on home	\$9,000	
Personal exemption	\$4,050	
<b>Taxable income</b>		

What is the taxpayer's taxable income?

- a. \$133,950      b. \$136,950      c. \$24,000      d. \$23,000

2 Continue preceding question. Assume the financial results above are typical and no significant change is expected in the future. The rate of interest being earned on the savings account is 6%. Taxpayer is considering withdrawing the funds in the savings account (would not incur a penalty) and investing those funds in bonds issued by the state of North Carolina.

What interest rate on the North Carolina bonds would provide the same after-tax return as the savings account (nearest answer)? (Ignore the impact of state income tax.)

- a. 4%      b. 4.32%      c. 4.96%      d. 8.33%

3 George bought the following amounts of Stock A over the years:

Bought	Mo/Day/Year	No of Shares	Unit Basis	Total Basis
Stock A	11/21/1986	1,000	\$24	\$24,000
Stock A	3/18/1992	500	\$18	9,000
Stock A	5/22/2001	750	\$36	27,000

On October 12, 2017, he sold 1,000 of his shares of Stock A for \$38 per share.

With optimum planning of the sale, how much gain/loss will George have to recognize?

- a. \$5,000      b. \$7,000      c. \$6,200      d. \$4,900

4 Anna (an owner of a proprietorship) sold the following assets which had been used exclusively in the business. Anna did not sell a business asset in the first two years of business operation.

Sold	Asset	Date acquired	Original Cost	Acc. Deprec.	Sell. Price
Year 3	Machine	Year 1	\$200,000	\$40,000	\$170,000
Year 4	Land	Year 1	\$200,000	\$0	\$190,000
Year 5	Land	Year 1	\$300,000	\$0	\$325,000

How does the taxpayer report the sale in Year 3?

- |                        |                     |                        |                  |
|------------------------|---------------------|------------------------|------------------|
| <b>Ordinary Income</b> | <b>Capital Gain</b> | <b>Ordinary Income</b> | <b>Cap. Gain</b> |
| a. \$10,000            | \$0                 | c. \$0                 | \$10,000         |
| b. \$30,000            | \$10,000            | d. \$0                 | \$30,000         |

5 Continue preceding question. How does the taxpayer report the sale in Year 5?

- |                        |                     |                        |                  |
|------------------------|---------------------|------------------------|------------------|
| <b>Ordinary Income</b> | <b>Capital Gain</b> | <b>Ordinary Income</b> | <b>Cap. Gain</b> |
| a. \$25,000            | \$0                 | c. \$15,000            | \$10,000         |
| b. \$0                 | \$25,000            | d. \$10,000            | \$15,000         |

1	Single Person-independent cases	Case A	Case B	Case C
	1. Gross Income	\$100,000	\$100,000	\$100,000
	2. Deductions	(\$60,000)	(\$60,000)	(\$60,000)
	3. Taxable income- before capital gains & losses	\$40,000	\$40,000	\$40,000
	4. Long-term capital gain	\$4,000		\$3,000
	5. Short-term capital gain		\$4,000	
	6. Short-term capital loss	(\$9,000)	(\$1,000)	(\$1,000)
	7. Taxable income? Line 3, adjusted for capital gain & loss	\$37,000		
	8. Amount of income taxed at ordinary rates	\$37,000		
	9. Amount of income computed with capital gains rates			
	10. Capital loss carryover to future	\$2,000		

2	Barb-2	4 Buckets	2 Buckets	1 Bucket		
	Stock Transactions		Net Short-Term	Net Long-Term	Net Gain (Loss)	Tax Return
	Short-term Capital Gain	\$0				
	Short-term Capital Loss	(2,400)	(2,400)			
	Long-term Capital Gain	400				
	Long-term Capital Loss	(3,500)		(3,100)		
					(5,500)	
	Deduct Short-Term Capital Loss					
	Deduct Long-Term Capital Loss					
	Deduction limit this year					
	Loss Carryover to next year					

3	Jill (an individual)	Case A	Case B
	Salary income (AGI before gains & losses)	\$100,000	\$100,000
	Long-term capital gain	\$3,000	\$3,000
	Short-term capital loss	(7,000)	(9,000)
	Gain (Loss) on sale of business land (owned 2 years)	(4,000)	\$4,000
	Adjusted gross income?		

4	Apartments owned by an individual		Case A	Case B
	Selling Price		\$390,000	\$410,000
	Cost	\$400,000		\$400,000
	Accumulated Depreciation (Straight-Line)	(60,000)		(60,000)
	Extra depreciation			
	Adjusted Basis			
	Total Gain			
	Section 1245 Gain	Ordinary Income		
	Section 1250 Gain	Ordinary Income		
	Section 1231 gain	UnRecaptured Sec. 1250 gain 25%		
	Section 1231 gain	Capital Gain-20% max. rate		

**TAX BRIEF****INDIVIDUAL**

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**Capital Loss vs. Ordinary Loss** – Journal of Accountancy - February 1999.

When taxpayers realize losses, they generally prefer to classify them as ordinary business losses rather than capital losses. In the case of the financial misadventures of Richard L. Matz, this was not to be.

Matz claimed ordinary business losses and interest deductions totaling over \$4 million for failed start-up companies and real estate ventures. The IRS denied the business deductions and determined instead that he underpaid his taxes by approximately \$900,000 (*Richard L. Matz, et ux. v. Commissioner*, TC Memo 1998-334).

Matz was primarily a real estate broker, but he also invested in real estate, from which he reported losses of several million dollars. He had bought and sold 45 real estate properties over a period of three decades. Matz claimed that he was in the business of acquiring, developing and selling real estate for profit and that he held the real estate for sale to customers in the ordinary course of business. This reasoning would support the classification of his current real estate losses as ordinary business losses rather than capital losses.

The Tax Court, however, disagreed. It determined that the sales were not frequent and substantial enough to qualify the activity as a trade or business. Accordingly, the court deemed Matz's real estate losses capital losses.

In its decision, the court listed seven factors that determine whether a sale of land is considered to be a sale of a capital asset or a sale of property held primarily for sale to customers in the ordinary course of business. The frequency and substantiality of sales are the most important factors. No precise number of sales is needed to be in a trade or business, and one court held that a single real estate transaction could qualify an activity as a trade or business.

Matz also invested in six start-up businesses, including a commuter airline, from the 1960s through the late 1980s. He asked for a refund of his investment in the airline stock and received a \$325,000 note, which became worthless. He deducted the loss as an ordinary loss under IRC section 165(a) and (c)(1) and as a business bad debt under IRC section 166(a). He claimed he was in the business of promoting, developing, organizing and financing start-up businesses.

To be engaged in a trade or business, an individual must be involved in an activity with continuity and regularity and for the primary purpose of earning income or profit. The Tax Court determined that Matz's business development activity was sporadic and not a regular trade or business that would generate an ordinary loss under section 165(c)(1). The loss was a nonbusiness bad debt treated as a capital loss under section 166(d) rather than a fully deductible business bad debt under section 166(a).

**Observation:** When an entrepreneur or real estate developer seeks to deduct a loss from a small business or a real estate venture, it is critically important to have documentation that supports classifying the activity as a trade or business.

—Howard Godfrey, CPA, PhD,  
*professor of accounting, University  
of North Carolina at Charlotte.*

# CaseStudy

## MAXIMIZING THE USE OF THE SPECIAL \$25,000 RENTAL REAL ESTATE LOSS ALLOWANCE



EVEN THOUGH RENTAL INCOME OR LOSS is generally passive, a special rule allows qualifying individuals and estates to offset up to \$25,000 of nonpassive income with rental real estate losses and credits. To qualify for the \$25,000 deduction, the taxpayer must own at least 10% of the value of all interests in the activity at all times during the tax year and must actively participate in the operations of the

rental property in both the year the loss is incurred and the year recognition is sought, if different (under the carryover provisions).

### Ownership and Active Participation

A taxpayer will not be considered an active participant in a rental real estate activity if, at any time during the tax year, his or her ownership in the activity drops below 10% of the value of all interests in the activity (Sec. 469(i)(6)(A)). When measuring an individual's ownership in a rental real estate activity, any spousal interest is also included.

Active participation is a less stringent standard than material participation and does not require regular, continuous, and substantial involvement in the operations. Rather, the taxpayer must participate in a significant way, such as making management decisions or arranging for others to provide services (S. Rep't No. 313, 99th Cong., 2d Sess. 737, 1986-3 C.B. 737). Management activity that qualifies under the active participation test would include approving new tenants, setting rental policies and terms, and approving capital expenditures or repairs (*Madler*, T.C. Memo. 1998-112).

**Example 1:** *F* lives in Texas but owns 100% of a rental property in Arkansas. He receives all rent through the mail and has not been to Arkansas to see the rental property for more than a year. If problems with the property occur or repairs are needed, he hires someone in Arkansas to perform the work. *F* continues to set the policy on rentals and approves tenants when vacancies occur.

Because *F* owns at least 10% of the real estate rental activity, makes all management decisions, and provides for others to perform services for the property in his absence, he actively participates even though he does not visit the property.

**Example 2:** *F* and his cousin, *D*, are equal shareholders in an S corporation that owns an apartment building in Las Vegas. *D* lives in Las Vegas, while *F* lives in Dallas. *D* makes all management decisions about the rental property. She inspects it on a regular basis and collects all rents. *F* has had no contact with the property since he invested in it several years ago.

Both *F* and *D* meet the ownership test under Sec. 469(i)(6). However, since *F* has had no contact with the property and makes no management decisions, he does not actively participate in the rental property. Because *D* makes all management decisions, she actively participates in the rental property.

### Limits on the Allowance

A taxpayer who owns rental real estate through an interest in a limited partnership will not be considered to actively participate in the rental real estate activity for the \$25,000 offset (Sec. 469(i)(6)(C)).

Furthermore, the \$25,000 maximum amount that can be deducted from nonpassive income is reduced by 50% of the amount by which the taxpayer's modified adjusted gross income (AGI) exceeds \$100,000 (Sec. 469(i)(3)(A)). Therefore, the \$25,000 is totally phased out when the taxpayer's modified AGI reaches \$150,000.

This case study has been adapted from *PPC's Guide to Tax Planning for High Income Individuals, 11th Edition*, by Anthony J. DeChellis, Patrick L. Young, James D. Van Grevenhof, and Delia D. Groat, published by Thomson Tax & Accounting, Ft. Worth, TX, 2010 ((800) 323-8724; [ppc.thomson.com](http://ppc.thomson.com)).



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Modified AGI is AGI that is calculated without considering IRA deductions, interest deductions on higher education loans, deductions for domestic production activities, tuition and fees deduction, taxable Social Security benefits, or any passive losses allowed under the exception for real estate professionals, and adding back income excluded for U.S. savings bond interest used for higher education expenses and employer-provided adoption assistance programs (Sec. 469(i)(3)(F)). Special rules apply to married taxpayers filing separately (Sec. 469(i)(5)).

### Maximizing the Available Allowance

To properly plan for the allowance, a taxpayer should analyze his or her active rental real estate activities and projected income and losses, and estimate his or her AGI, before year end.

Because the \$25,000 loss allowance begins being phased out when modified AGI exceeds \$100,000 and is completely phased out when modified AGI exceeds \$150,000, taxpayers with income within or around this range can maximize the allowance with careful tax planning. Because the phaseout is AGI-sensitive, only strategies that either increase above-the-line deductions or shift income from one year to another will affect the deduction.

Strategies that reduce AGI may help increase the allowable deduction when taxpayers are subject to the phaseout. Deductible contributions to Keogh and SEP retirement plans may help self-employed taxpayers reduce their AGI. Investing in tax-exempt securities or investments that defer income to later years (e.g., short-term CDs and Treasury bills) will also reduce AGI. Similarly, self-employed taxpayers using the cash method can shift income from one year to another by timing when they bill and collect revenue.

TTA

#### EditorNotes

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# Passive Loss Concepts

## Classes of Income and Losses

### 1. Active Income

Wages

Business income - if you have material participation

Low Income Housing

### 2. Portfolio Income

Interest, dividends, annuities, royalties

### 3. Passive Income and Losses

Trade or Business - does not materially participate

Any rental activity (But note exception)

### 4. Hobby income and losses, of course

## Passive Limits

Cannot deduct passive losses from active or portfolio income.

Passive losses deductible only from passive income and gains.

## Disallowed passive losses are suspended until

1. You have passive income.
2. You dispose of the property in a taxable transaction [469(f)].

You don't want to have passive losses. If an activity yields a loss, you try to make it fit the definition of "active" --- not "passive."

If the activity generates profits, you would like to classify the activity as passive, because the "passive income" may be offset by passive losses that would otherwise be non-deductible now.

# Passive Loss Illustration

An executive earns a salary of \$300,000 per year in Charlotte. She invested in rental property.

1	<b>Cost of Rental House (Bought on January 1, Year 1)</b>								
2	<b>Down Payment</b>								
3	<b>Balance financed with mortgage (10% interest rate).</b>								
4	<b>Assume she will pay interest only, with a balloon payment to be paid after 5 years.</b>								
5	<b>Results first year.</b>								
6	<b>Rental Income</b>								
									§ 61(a)(5)
7	Interest on mortgage		15,000						§ 163(h)(2)( C)
8	Property taxes		2,500						§ 164(a)(1)
9	Insurance and other expenses		1,500						§ 212(2)
10	Cash expenses				19,000				
11	<b>Net income on cash basis</b>					<b>\$1,000</b>			
12	<b>Depreciation (Assume land has a value of \$35,000)</b>								
13	Cost of Residence		\$200,000						
14	Subtract the cost of land		35,000						
15	Net depreciable base		165,000						§ 167
16	Recovery period for residential real property (27.5 years)		27.5						§ 168( C)
17	<b>Depreciation expense</b>					<b>6,000</b>			§ 168(a)(3)
18	<b>Net Loss after Depreciation Expense</b>					<b>(\$5,000)</b>			§ 165, 62
19	<b>Annual tax returns</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>			
20	Revenue	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000			§ 61(a)(5)
21	Cash Expenses	(19,000)	(19,000)	(19,000)	(19,000)	(19,000)			
22	Net income before depreciation	1,000	1,000	1,000	1,000	1,000			
23	Depreciation	(6,000)	(6,000)	(6,000)	(6,000)	(6,000)			§ 167
24	<b>Loss incurred in current year</b>	<b>(5,000)</b>							§ 165( c)(2)
25	Suspended losses	5,000							
26	Deductible in year incurred	0							§ 469(a)(1)
27	Year 5 loss deductible in Year 5								§ 469(b)
28	Suspended losses from first four years deducted in Yr. 5								§ 469(g)(1)(A)
29	<b>Total losses deducted in Year 5 from operation of rental property</b>								
30	<b>Sale of Property at end of Year 5</b>								
31	Selling price of house			\$290,000					
32	Cost of House		\$200,000						
33	Accumulated Depreciation		30,000						
34	Book value (basis)			170,000					
35	<b>Profit (or gain) on sale of house</b>								§ 1001
36	<b>Loss from above</b>								§ 469
37	<b>Overall gain or (loss) on project over 5 years</b>								
38	<b>In the first four years, this shelter provided losses for the taxpayer.</b>						<b>Total</b>		
39	<b>How are the losses be treated in each of the first four years under section 469?</b>								§ 469
40	<b>What is the reporting procedure for year 5 (year of sale)?</b>								
41	<b>What tax rates apply to the gain on the sale of the property in year 5?</b>						<b>25%</b>		§1250, 1(h)(1)(D)
42	<b>(It would be a great shelter if you could save taxes at the 35% rate when deducting the</b>								
43	<b>losses (from depreciation) and then pay tax at 15% when reporting profit on sale of building.)</b>								

## Installment Sales

**Installment Sale:** Sale with at least one payment to be received after year of sale.

**Election.** If sale qualifies as an installment sale, you must use the installment method unless you elect out. **453(d)(1).**

**Capital Gain (not loss) is reported on installment basis.**

With this method, income is reported proportionately as collections are made. The installment method is not used for losses.

See Reg. 15A.453-1(c) for contingent payment sales.

### Installment Sale Denied for Certain Sales:

- 1. Dealer Sales.** The 1986 Tax Act eliminated the use of this method for certain sales of real and personal property by **dealers 453(b)(2)(A)** or sales of **inventory 453(b)(2)(B)**
- 2. Depreciation Recapture** (ordinary income under 1245 & 1250) is reported before capital gain. All recapture income is recognized in year of sale **regardless of the amount collected** in that year. See **Sec. 453(i)**. Remaining gain is reported on installment sales method.
- 3. Gains on Sales of stocks or securities** traded on securities markets (**453(l)**)

### Limits:

- 1. Limit for Installment Sales of non-depreciable property to Relatives 453(e).** [Second disposition by the related party results in deemed collection of original installment sale.]
- 2. Limit for Installment Sales of depreciable property to controlled entity 453(g) & 1239.**  
(Note: it is not necessary to have depreciation recapture for this to apply.)  
(Does not apply if there is no tax avoidance motive. **453(g)(2)**)

### Interest Payments to IRS:

- The installment sales method continues to be available for **dealer sales** of property used or produced in the business of **farming, residential lots** which have not been improved by seller, certain **timeshare sales. 453(l)(2)(A) & (B)**. Sellers of residential lots and time-shares may use installment sales method if they pay interest on the deferred income. **453(l)(3)**. (Technically, the tax is increased by the amount of interest, but that payment is treated in interest paid by taxpayer during the year in computing the deduction for interest expense.)
- The installment method can apply to sales by taxpayers who are not dealers. Interest may be required to be paid to IRS on the deferred tax liability on a sale over \$150,000, if the taxpayer has large installment receivables (over \$5,000,000). **453A(a) and (b)**.

### Imputed Interest:

If the amount of the sale is greater than \$3,000, the payment period is over six months, and the contract does not require payment of reasonable interest, interest will be imputed. **IRC 483 & 1274**. [Note the present value computations in IRC 483(b).]

(Impact: Converts Capital Gain to Ordinary Income.)

## Installment Sales of Real Estate

### Selling Price vs. Contract Price

**Profit** is selling price less basis. Selling price is consideration received.  $\text{Gross profit} \div \text{contract price} = \text{profit element of each collection}$ .

**Contract Price** is amount to be received by seller (not including mortgage assumed by buyer), unless mortgage assumed exceeds basis of property sold. If mortgage exceeds basis, the excess is treated as a collection in year of sale and is added to contract price (This will cause profit percentage to be 100%).

**Collections in Year of Sale (called Payments in Year of Sale) [Reg. 15A.453-1(b)(3)(i)]** include:

- (1) all cash & property, except buyer's debt, (2) marketable bonds received, and
- (3) excess of seller's mortgage assumed by buyer over seller's basis in the property.

Commissions and Selling Expenses are offset against selling price, unless seller is a dealer.

Imputed interest reduces selling price & contract price.

### Disposition of Installment Obligations

Gain or loss is difference between: (a) amount realized from sale or exchange of the obligation and (b) basis (unrecovered cost). **Sec. 453B**

**If obligation is given away**, the amount realized is FMV of obligation. (You report gain as if you collected the receivable.)

How do you handle an inheritance of an installment obligation or transfer to former spouse as result of divorce?

## Chapter 7. Investments-Homework

Assume the “current year” is 2017, unless a question indicates another year.

**LO 1. Explain how interest income and dividend income are taxed.**

1. What is the market rate of interest for a bond issue which sells for less than its par value?
  - a. Less than rate stated on the bond.
  - b. Equal to rate stated on the bonds
  - c. Higher than rate stated on the bond.
  - d. Rate is independent of rate stated on the bonds.
  
2. On January 1, Year 1, Local Corp. received a loan from an investor in the amount of \$165,289.26. The loan matures on December 31, Year 2. At that time Local Corp. will pay the maturity value of \$200,000. Assume the interest rate is 10%. Assume interest is compounded annually under the loan contract and under the income tax law. How much income is recognized by the investor for Year 2?
  - a. \$16,528.93
  - b. \$17,355.37
  - c. \$18,181.82
  - d. Other
  
3. On January 1, Year 1, Singapore Corporation purchased Fay Corp. 9% bonds with a face amount of \$400,000 for \$375,422, to yield 10%. The bonds are dated January 1, Year 1, mature on December 31, Year 10, and pay interest annually on December 31. Singapore uses the interest method of amortizing discount. What is Singapore’s interest revenue for Year 2?
  - a. \$40,000
  - b. \$37,542
  - c. \$36,000
  - d. \$37,696
  
4. Which of the following types of interest income is not taxed as it is earned?
  - a. interest from savings accounts
  - b. original issue discounts on corporate bonds
  - c. interest from money market accounts
  - d. accrued market discount on bonds
  
5. The amount of interest income a taxpayer recognizes when he redeems a U.S. savings bond is:
  - a. the excess of the taxpayer's basis in the bonds over the bond proceeds
  - b. the bond proceeds
  - c. the excess of the bond proceeds over the taxpayer's basis in the bonds
  - d. the taxpayer's basis in the bonds
  
6. Which of the following is not a tax advantage of a Series EE Saving Bond?
  - a. taxes are paid as the original issue discount on the bond is amortized
  - b. interest earned is exempt from state taxation
  - c. taxes on the interest income may be deferred until the bond is cashed in at maturity
  - d. interest is exempt from federal taxation when used for qualifying educational expenses
  - e. None of the above
  
7. When a bond is purchased in the secondary bond market at a discount, the amount of discount treated as interest income when the bond is sold prior to maturity is the:
  - a. market premium
  - b. market discount
  - c. accrued market premium
  - d. accrued market discount
  - e. None of the above

8. (§ 301) On January 1, Year1, Ernie started Local Corp. (a C corp.) with an investment of \$100,000 for 100% of the stock. In Year1, Local had after-tax income of \$40,000 and paid no dividend. In Year 2, Local had after-tax income of \$40,000. Earnings and profits equal after-tax income for Local. Local made a distribution of \$90,000 to Ernie on December 31, Year 2. How much dividend income does Ernie report for Year 2?

- a. \$0.00      b. \$40,000      c. \$80,000      d. \$90,000

**LO 2. Compute the tax consequences associated with the disposition of capital assets, including the netting process for calculating gains and losses.**

**Include Capital gains/losses, unrecaptured sec. 1250 gain, collectibles, loss limits, related party sales, wash sales.**

9. (§ 1221) All of the following are capital assets, except

- a. Personal residence.  
 b. Land held for investment.  
 c. Pickup truck used in a business.  
 d. Corporate bonds held for investment purposes.  
 e. A hand-written letter by Ronald Reagan held in a private collection.

10. When selling stocks, which method of calculating basis provides the greatest opportunity for minimizing gains or increasing losses?

- a. LIFO      b. FIFO      c. Weighted average      d. Specific identification

11. Long-term capital gains can be taxed at a maximum rate of:

- a. 15 percent      b. 25 percent      c. 28 percent      d. All of the above

12. (§1221) Which of the following is a capital asset?

- a. Personal residence.      b. Machinery used in manufacturing a product.  
 c. Inventory.      d. Real estate used in business operations.

13. (§1211) An individual had AGI of \$100,000, before considering the following:

Long-term capital gain of	\$3,000
Short-term capital loss of	(8,000)

What is her adjusted gross income?

- a. \$96,000      b. \$97,000      c. \$98,000      d. \$93,000      e. \$94,000

14. Sue is single and earns a salary of \$200,000 per year.

Sue claims the standard deduction and one personal exemption for **the current year**.

She had short-term capital gain of \$10,000 and a short-term capital loss of \$8,000.

What tax rate will apply to her net capital gain?

- a. 5%      b. 10%      c. 15%      d. 25%      e. 33%

15. Kevin bought 200 shares of Intel stock on January 1 for \$50 per share with a brokerage fee of \$100.

Then, Kevin sold all 200 shares for \$75 per share on December 12. The brokerage fee on the sale was \$150. What is the amount of the gain/loss Kevin must report on his federal income tax return?

- a. \$4,500      b. \$4,750      c. \$5,000      d. \$5,250      e. Other

16. George bought the following amounts of Stock A over the years:

	Year bought	Month bought	Day bought	Number of Shares	Adjusted Basis
Stock A	1986	November	21	1,000	\$24,000
Stock A	1992	March	18	500	9,000
Stock A	2001	May	22	750	27,000

This year, he sold 1,200 of his shares of Stock A for \$38 per share.

How much gain/loss will George have to recognize if he uses the FIFO method for the shares sold?

- a. \$7,800    b. \$18,000    c. \$20,000    d. \$22,000    e. Other

17. Continue the preceding question. How much gain/loss will George have to recognize if he told his broker to sell all 750 shares from the 5/22/2001 purchase and 450 shares from the 11/21/1986 purchase?

- a. \$7,800    b. \$18,000    c. \$20,000    d. \$22,000    e. Other

18. If an individual taxpayer's marginal tax rate is 35 percent and he holds the following assets for more than a year, which gains will be taxed at the highest rate at the time of sale?

- a. gains from investment land
- b. gains from personal-use property
- c. gains from a coin collection
- d. gains from the sale of qualified small business stock held for 3 years
- e. gains attributable to tax depreciation taken on real property

19. Ann invests in stock. Each stock is a capital asset.

Ann (single, no dependent). Annual salary		\$ 134,050		
Itemized deduction -Charity		\$10,000		
Itemized deduction- Home Mortgage Interest		\$20,000		
Exemption		\$4,050		
Taxable Income, before items below.		\$100,000		
Asset	Date Acquired	Date Sold	Total Cost	Total Selling Price
ABC Stock	2017	2017	\$10,000	\$16,000
DEF Stock	2017	2017	\$10,000	\$5,000
GHI Stock	2007	2017	\$10,000	\$11,000
KLM Stock	2007	2017	\$10,000	\$16,000
NOP Stock	2007	2017	\$10,000	\$6,000

As shown above, Ann is single and has no dependent. She has a salary of \$134,050.

She claims one exemption for herself, and total itemized deductions of \$30,000.

This results in taxable income of \$100,000, before considering gains and losses from sales of stock.

When you take into account the stock sales shown above, what is her taxable income for the year?

- a. \$106,000    b. \$105,000    c. \$104,000    d. \$107,000    e. Other

20. Continue preceding question.

What is Ann's total federal income tax for the year, before considering any tax credits (nearest dollar)?

- a. \$21,990    b. \$22,890    c. \$22,590    d. \$21,767    e. Other

21. Continue preceding question. Assume the NOP stock was sold for \$1,000 (not \$6,000).

What is her taxable income under this revised assumption?

- a. \$99,000    b. \$96,000    c. \$100,000    d. \$97,000    e. \$95,000

22. (§ 1221, 1231, 1211) An individual had AGI of \$100,000 for the current year, before considering the following:

Long-term capital gain of	\$3,000
Short-term capital loss of	(7,000)
Gain from sale of business land (owned 2 years)	1,000

What is her adjusted gross income for the current year?

- a. \$96,000    b. \$99,000    c. \$98,000    d. \$97,000    e. \$94,000

23. (§1211) The maximum amount of capital losses an individual may deduct against ordinary income per year is:

- a. \$3,000    b. \$5,000    c. Zero    d. There is no maximum    e. Other

24. (§ 1221, 1231, 1211) Taxpayer had AGI of \$100,000, before considering the following:

Long-term capital gain of	\$3,000
Short-term capital loss of	(9,000)
Loss sale of land used in business (owned 2 years)	(4,000)

What is her adjusted gross income?

- a. \$96,000    b. \$97,000    c. \$93,000    d. \$100,000    e. Other amount

25. Taxpayer earns \$400,000 per year as CEO of a corporation. Taxpayer is single. Her exemptions and itemized deductions total \$20,000.

She bought stock for \$30,000 on October 5, Year 1. The stock is now worth \$40,000.

She is considering selling the price on September 30, Year 2, or waiting until October 10, Year 2.

She does not expect the selling price to change in the next few weeks. Ignore selling commissions.

How much federal income tax will she save by waiting and selling the stock on October 10?

- a. \$0    b. \$1,500    c. \$2,000    d. \$2,500    e. Other

26. Mike has the following capital gains and losses for the current year:

Long-term capital loss	\$(15,000)
Long-term capital gain	6,000
Short-term capital loss	(10,000)
Short-term capital gain	12,000

What is Mike's net capital gain or loss for the year?

- a. Net long-term capital loss of \$9,000.    b. Net short-term capital gain of \$2,000.  
 c. Net long-term capital loss of \$7,000.    d. Net short-term capital gain of \$1,000.  
 e. Net long-term capital loss of \$3,000.

27. In the current year, Norris, an individual, has \$50,000 of ordinary income, a Net Short Term Capital Loss (NSTCL) of \$10,000 and a Net Long Term Capital Gain (NLTCG) of \$2,800.

From his capital gains and losses, Norris reports:

- a. an offset against ordinary income of \$10,000  
 b. an offset against ordinary income of \$3,000 and a NSTCL carryforward of \$7,000  
 c. an offset against ordinary income of \$2,800 and a NSTCL carryforward of \$7,200  
 d. an offset against ordinary income of \$3,000 and a NSTCL carryforward of \$7,200  
 e. an offset against ordinary income of \$3,000 and a NSTCL carryforward of \$4,200

28. Barbara operates a proprietorship that had taxable income of \$60,000 per year, before taking into account any Section 1231 gains or losses. She had these Section 1231 gains and losses:

Section 1231 gain (loss)	Year 1	Year 2	Year 3	Year 4
	\$60,000	(45,000)	\$50,000	\$15,000

How will Barbara treat the \$15,000 gain in year 4?

- |    |                        |                     |    |                        |                     |                          |
|----|------------------------|---------------------|----|------------------------|---------------------|--------------------------|
|    | <u>Ordinary Income</u> | <u>Capital Gain</u> |    | <u>Ordinary Income</u> | <u>Capital Gain</u> | <input type="checkbox"/> |
| a. | \$5,000                | \$0                 | c. | \$5,000                | \$10,000            |                          |
| b. | \$0                    | \$15,000            | d. | \$10,000               | \$5,000             |                          |

29. (§ 1245) Big corporation purchased equipment for \$400,000 in 2014.

This year, Big sold that equipment for \$390,000, when accumulated depreciation was \$30,000.

The company should report the sale as:

- |                                 |                                 |                          |
|---------------------------------|---------------------------------|--------------------------|
| a. Ordinary income of \$20,000. | c. Sec. 1231 gain of \$20,000.  | <input type="checkbox"/> |
| b. Capital gain of \$20,000.    | d. Ordinary income of \$30,000. |                          |

30. (§ 1(h)) Bob purchased an apartment building for \$550,000 in several years ago. **This year**, Bob sold the apartment building to an unrelated party for \$540,000. Accumulated Depreciation (straight-line) was \$60,000. Bob had taxable income of \$400,000 before considering the results of this sale.

What is Bob’s federal income tax rate on the gain from this sale?

- a. 5%      b. 10%      c. 15%      d. 25%      e. 33%

31. Mary Jane is single and earns a salary of \$200,000 per year. Sue claims the standard deduction and one personal exemption for **the current year**. She has no other income, except for her capital gains. She had a long-term capital gain of \$10,000 and a short-term capital loss of \$8,000.

What tax rate will apply to her net capital gain?

- a. 5%      b. 10%      c. 15%      d. 25%      e. 33%

32. In the current year, Tim has a short-term capital loss of \$9,000 and a long-term capital gain of \$1,500. Due to these transactions Tim reports

- a. A capital loss deduction of \$3,000 and a loss carryforward of \$4,500.
- b. A capital loss deduction of \$3,000 and a loss carryforward of \$6,000.
- c. A capital loss deduction of \$9,000.
- d. A capital loss deduction of \$3,000 and a loss carryforward of \$7,500.
- e. A capital loss deduction of \$7,500

33. (§ 1244) Mr. Jones is single. He has provided the following information

Date	Transaction	Description	Amount
2000	Bought stock in small business (§1244) corporation	Cost of stock	\$500,000
2017	Sold same stock (above)	Selling price	300,000
2017	Total other income (salary)	Salary	150,000

What is his adjusted gross income for 2017?

- a. \$150,000    b. \$100,000    c. \$97,000    d. \$47,000    e. Other amount

34. (§ 267(a)) In April of the current year, Pam sold stock with a basis of \$15,000 to Lisa (her sister) for \$10,000 (FMV). Later in the year, Lisa sold the stock to her neighbor, Niki, for \$8,000.

How much loss does Pam deduct?

- a. \$0      b. \$2,000      c. \$5,000      d. \$7,000



**35. (§ 267(d)) In April of the current year, Pam sold stock with a basis of \$15,000 to Lisa (her sister) for \$10,000 (FMV). Later in the year, Lisa sold this stock to her neighbor, Niki, for \$16,000.**

How much gain does Lisa report?

- a. \$6,000      b. \$5,000      c. \$1,000      d. \$0

**36. Lisa sells some stock she purchased several years ago for \$10,000 to her brother Bart for \$8,000. One year later Bart sells the stock for \$12,000. The tax consequences to Lisa and Bart are:**

- |    |                 |              |    |                 |                 |
|----|-----------------|--------------|----|-----------------|-----------------|
|    | <b>Lisa</b>     | <b>Bart</b>  |    | <b>Lisa</b>     | <b>Bart</b>     |
| a. | \$2,000 loss    | \$4,000 gain | c. | No gain or loss | \$2,000 gain    |
| b. | No gain or loss | \$4,000 gain | d. | \$2,000 gain    | No gain or loss |

**37. (§ 1091) Ms. Rich had the following transactions in GM Corp. common stock.**

Asset-Stock	Date bought	Year bought	Transaction	Number	Description	Amount
GM Corp.	January 2	2004	Bought:	4,000 shares	Cost	\$20,000
GM Corp.	December 31	2017	Sold:	4,000 shares	Selling Price	\$12,000
GM Corp.	January 2	2018	Bought:	3,000 shares	Cost	\$9,000

How much loss may she deduct for 2017 and what is the basis of the stock bought in 2018?

- |    |             |              |    |             |              |
|----|-------------|--------------|----|-------------|--------------|
|    | <b>Loss</b> | <b>Basis</b> |    | <b>Loss</b> | <b>Basis</b> |
| a. | \$2,000     | \$9,000      | c. | \$0         | \$15,000     |
| b. | \$0         | \$9,000      | d. | \$2,000     | \$15,000     |

**38. (§ 1091) When the wash sale rules apply, the realized loss is:**

- a. recognized at time of sale
- b. not recognized at time of sale
- c. recognized at time of sale and added to basis of the newly acquired stock
- d. not recognized at time of sale and added to basis of the newly acquired stock
- e. not recognized at time of sale and subtracted from the basis of the newly acquired stock

**39. Ms. Fresh bought 1,000 shares of IBM Corporation stock for \$5,000 on January 15, Year 1. On December 31, Year 4 she sold all 1,000 shares of her IBM stock for \$4,500. Based on a hot tip from her friend, she bought 1,000 shares of IBM stock for \$3,000 on January 23, Year 5.**

What is her recognized loss on her Year 4 sale and her basis in her 1000 shares bought in Year 5?

- a. \$-0- LTCL and \$3,500 basis
- b. \$200 LTCL and \$3,300 basis
- c. \$300 LTCL and \$3,200 basis
- d. \$400 LTCL and \$3,100 basis
- e. \$500 LTCL and \$3,000 basis

**40. Sylvia owns 1,000 shares of Sidney Sails, Inc., for which she paid \$18,000 several years ago. On March 15 of current year, she bought 400 additional shares for \$5,000. Sylvia sold the original 1,000 shares for \$13,500 on April 1 of the current year. These are her only stock transactions this year. Sylvia's capital loss deduction for the current year and her basis in the new shares are:**

- |    |                     |              |    |                     |              |
|----|---------------------|--------------|----|---------------------|--------------|
|    | <b>Capital Loss</b> | <b>Basis</b> |    | <b>Capital Loss</b> | <b>Basis</b> |
| a. | \$3,000             | \$5,000      | c. | \$4,500             | \$5,000      |
| b. | \$2,700             | \$6,800      | d. | \$3,000             | \$6,800      |

**LO 3. Describe common sources of tax-exempt investment income and explain the rationale for exempting some investments from taxation.**

**41.** An investor owns municipal bonds with a cost, par value, and a FMV of \$200,000. These bonds pay 6% interest. A friend has suggested that the investor sell these bonds and invest in corporate bonds. The investor is in the 40% marginal tax bracket. (Ignore state income taxes.) What return would this investor have to earn on corporate bonds in order to be just as well off as he is now with municipal bonds?

- a. 6%      b. 7.685%      c. 8.333%      d. 8.571%      e. 10%

**42.** An investor owns municipal bonds having a cost, par value, and FMV of \$200,000. The bonds pay 6% interest. A friend has suggested that the investor sell these bonds and invest in corporate bonds. The investor is in the 25% marginal tax bracket. (You may ignore state income taxes.) What return would this investor have to earn on corporate bonds in order to be just as well off as he is now with the municipal bonds?

- a. 6%      b. 7.685%      c. 8.00%      d. 8.571%      e. 10%

**43.** John, a single taxpayer, received interest income of \$40,000 consisting of the following:

Certificate of deposit	\$6,000
Savings account interest	4,000
City of Charlotte Bond interest	8,000
Mortgage note	12,000
Mecklenburg County bond interest	7,000
Corporate bond interest	3,000

What is the amount of interest will he include in income on his Form 1040?

- a. \$40,000      b. \$25,000      c. \$19,000      d. \$33,000      e. Other

**44.** What explicit tax rate would keep Jason indifferent between purchasing a municipal bond with a 3.0 percent return and a taxable bond with a 4.5 percent before-tax return? (Round your answer to the nearest percent)

- a. 25%      b. 30%      c. 33%      d. 36%      e. Other

**.045 x (1 - tax rate) = .03; tax rate = 33 percent.**

**LO 4. Calculate the deduction for portfolio investment-related expenses, including investment expenses and investment interest expense.**

**45.** Unused investment interest expense:

- a. expires after the current year      b. is carried back two years  
c. is carried forward twenty years      d. is carried forward indefinitely

**46.** When calculating net investment income, gross investment income includes:

- a. interest income      b. net short-term capital gains  
c. net long-term capital losses      d. royalty income  
e. All of the above

**47.** Investment interest expense does not include:

- a. interest expense from loans to purchase municipal bonds  
b. interest expense from loans to purchase corporate bonds  
c. interest expense from loans to purchase stocks.

48. Joe has a marginal tax rate of 35 percent and decides to make the election to include long-term capital gains and qualified dividends as investment income.

What rate must Joe use when calculating the tax on these two items?

- a. 15%      b. 25%      c. 28%      d. 35%      e. Other

49. Doug and Sue Click file a joint tax return and decide to itemize their deductions. The Clicks income for the year consists of \$90,000 in salary, \$2,000 interest income, \$800 long-term capital loss. The Clicks expenses for the year consist of \$1,500 investment interest expense. The Clicks marginal tax rate is 35%. What is the amount of their investment interest expense deduction for the year?

- a. \$1,200      b. \$1,500      c. \$2,000      d. \$2,300      e. Other

50. Bob Brain files a single tax return and decides to itemize his deductions. Bob's income for the year consists of \$75,000 of salary, \$3,000 long-term capital gain, and \$1,500 interest income. Bob's expenses for the year consists of \$800 investment advice fees, \$700 unreimbursed employee business expenses (a miscellaneous itemized deduction), and \$250 tax return preparation fees.

What is Bob's actual deduction for miscellaneous itemized deductions?

- a. Zero      b. \$1,590      c. \$1,500      d. \$1,750      e. \$160

**LO 5. Understand the distinction between portfolio investments and passive investments and apply tax basis, at-risk, and passive activity loss limits to losses from passive investments.**

51. Michelle is an active participant in the rental condominium property she owns. During the year, the property generates a (\$30,000) loss; however, Michelle has sufficient tax basis and at-risk amounts to absorb the loss. If Michelle has \$115,000 of salary, \$10,000 of long-term capital gains, \$3,000 of dividends, and no additional sources of income or deductions, how much loss can Michelle deduct?

- a. Zero      b. \$4,000      c. \$11,000      d. \$15,000      e. Other

52. Sam and Sue file a joint income tax return. Sam received wages of \$125,000. Sue actively participated in a rental real estate activity in which she had a \$30,000 loss. They are not realtors. They had no other income. How much of the rental loss may they deduct on their income tax return for the year?

- a. \$0      b. \$12,500      c. \$15,000      d. \$25,000

53. Neil owns a 50% interest in a limited partnership that operates an apartment complex. During the current year, the partnership generates a taxable rental loss of \$42,000. Neil's other sources of income are salary of \$55,000 and interest of \$18,000. What is Neil's deductible loss from the apartment?

- a. \$ - 0 -      b. \$18,000      c. \$21,000      d. \$25,000      e. Other

54. In the current year, Marci worked two "jobs." She performed financial consulting activities for 1,000 hours and real estate development and rental activities for 1,200 hours. Her real estate activities produced a loss of \$35,000. Her financial consulting generated a net business income of \$40,000. How much of the loss can Marci deduct against her financial consulting income?

- a. \$ - 0 -      b. \$17,500      c. \$25,000      d. \$35,000      e. \$40,000

55. Kit is an engineering professor at Southern College. Her annual salary is \$110,000. She owns two 3-unit apartment buildings near the university. Because of the proximity to campus, Kit actively manages the property. During the current year, the rental property produced a \$29,500 loss. How much of the loss may Kit deduct for the current year?

- a. \$ - 0 -      b. \$14,750      c. \$20,000      d. \$25,000      e. \$29,500

56. Karl has the following income (loss) during the current year:

Net business income	\$45,500
Dividends and interest	12,000
Actively managed rental property	(34,000)

What is Karl's adjusted gross income for this year?

- a. \$23,500      b. \$31,400      c. \$32,500      d. \$45,500      e. \$57,500

57. Mary and Philip purchased an apartment building in January of the current year, which they actively manage. During the current year, the apartment building generated a loss of \$35,000. Their other income is as follows:

Salaries	\$70,000
Dividends and interest	8,000
Loss from limited partnership acquired last year	(4,000)

What is Mary and Philip's adjusted gross income?

- a. \$49,000      b. \$53,000      c. \$74,000      d. \$78,000      e. Other