Individual Tax Implications of Capital Asset Transactions

Sara Beth Hall
Certified Public Accountant
Brown, P.C.

Taxpayers should familiarize themselves with the classification of various property items within the internal revenue code because the code treats gains from the sale of property differently depending on classification of the property.[1] This differing treatment can have undesired tax consequences to a taxpayer if proper planning is not implemented. While this article is not designed to cover every aspect of capital gains and losses, it is designed to help individual taxpayers better understand the current code as it applies to the most frequently encountered capital gains and losses issues.

I. PRIMARY CONSIDERATIONS

A. Character of Gains

The most obvious impact to taxpayers is the preferential tax treatment received on net capital gains. Net capital gains are taxed at lower rates than gains related to ordinary income.[2] When figuring the total amount of preferential gain treatment in a given year, it is important to remember that deductions from the sale of capital losses are limited to the extent of gains on related sales or disposals.[3] Once taxpayers have offset capital losses against capital gains in a current year, a maximum additional deduction of $3,000 is allowed against ordinary income.[4] Although individual capital losses may be carried forward indefinitely until the losses are exhausted,[5] it is important for taxpayers to plan so that they are able to fully utilize all capital losses in tax years where income is higher because of the time value of money.

B. Time Value of Money

Since it is usually more advantageous to save money now rather than in future years,[6] the utilization of capital losses in the year these losses are incurred is important. This decreases current -year tax liabilities and keeps money in the taxpayer's hands now as opposed to future years when these savings may not be as useful. This is the concept of time value of money, which from one viewpoint is the theory that current cash flow may be presently invested and earn current interest, making it worth more than the promise of a future deduction.[7]

C. Theory of Capital Gains Preferential Treatment

Capital gains and losses treatment not only allows a taxpayer to save money up front with the deduction of capital losses, it also helps to offset taxes in future years when taxes would be higher because of the increased earnings. Under generally accepted accounting principles, the accepted method of accounting is the accrual basis

[1] I.R.C. §64 (2013); I.R.C. §1(h) (2013); *See also* I.R.C. §1245 (2013) and I.R.C. §1250 (2013).
[2] I.R.C. §1(h) (2013).
[3] I.R.C. §1211 (2013).
[4] I.R.C. §1211 (2013).
[5] I.R.C. §1212(b) (2013).
[6] *See* DON DAYANANDA, RICHARD IRONS, STEVE HARRISON, JOHN HERBOHN & PATRICK ROWLAND, CAPITAL BUDGETING: FINANCIAL APPRAISAL OF INVESTMENT PROJECTS 74 (2002).
[7] *Id.*

of accounting.[8] With respect to financial reporting, this means that revenues are recognized when earned, and expenses are recorded when incurred, ensuring that the expenses incurred in generating the recorded revenues establish the actual net income in the annual financial statements.[9] Preferential capital gains treatment serves the same purpose because the effect is that taxes are assessed on the income as it was earned, although for investment purposes the investment income may have been classified as unearned income. The idea is "to treat an appreciation in value, arising over a period of years, but realized in one year…[as being taxed in all of the previous years so] that the tax…will roughly approximate what it would have been had a tax been paid each year [in line with] the appreciation in value for that year."[10] The result is that taxes are to some degree matched up with the income for each year as is standard with respect to revenues and expenses in the financial reporting sense.[11]

II. DEFINING CAPITAL ASSETS

Capital assets generally consist of all property held by the taxpayer, "but do not include [the following]: (1) stock in [a taxpayer's]…[business]…, inventory…, or [other] property held…for sale to customers in the…course of…business, (2)… property used in [the taxpayer's]…business…subject to…depreciation…or real property used in [the taxpayer's] business, (3)…copyright[s] [and other similar property] held by a taxpayer [who]…created [the] property…, (4) accounts [and] notes receivable…from the sale of property [in the ordinary course of business], (5)…United States Government [publications]…, (6) commodities…held by a commodities dealer…, (7)…hedging transaction[s]…, and (8) supplies…used…[in] the taxpayer['s]…trade or business…."[12]

III. SALE OF CAPITAL ASSETS

A. Defining Gains

In order to determine the preferential tax treatment given to capital gains, it is necessary to first understand the different types of gains related to capital asset sales. In the broadest sense, capital gain net income refers to "the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges."[13] Gains are considered either short term or long term depending on the length of time a capital asset has been held prior to its exchange on the open market.[14] The exact types of gains associated with capital gains are discussed in further detail below.

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[8] U.S. GOV'T ACCOUNTABILITY OFFICE, UNDERSTANDING THE PRIMARY COMPONENTS OF THE ANNUAL FINANCIAL REPORT OF THE UNITED STATES GOVERNMENT 6 (2005); *See also* RESEARCH AND DEV. ARRANGEMENTS, Statement of Fin. Accounting Standards No. 168 (Fin. Accounting Standards Bd. 1982).
[9] *Id.*
[10] Kenan v. Commissioner, 114 F.2d 217, 220 (2d Cir. 1940).
[11] *Id.*
[12] I.R.C. §1221(a) (2013); *See also* I.R.C. §1221(b)(3) (2013) (noting that for self-created works "[a]t the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3)").
[13] I.R.C. §1221(a) (2013).
[14] *See* I.R.C. §1222 (2013).

1. Short-Term Capital Gains
   These are "gain[s] [included in gross income] from the sale or exchange of a capital asset held for [less] 1 year…."[15]
2. Long-Term Capital Gains
   These are "gain[s] [included in gross income] from the sale or exchange of a capital asset held for more than 1 year…."[16]
3. Net Short-Term Capital Gains
   Preferential rates are based on the net impact of gains and losses in a given year.[17] Since the net effect is what determines the impact to current year tax liabilities, it is also important to understand the terminology as set out by the Internal Revenue Service referring to these net impacts. Net Short-Term Capital Gains are "the excess of short-term capital gains for the taxable year over the short-term capital losses…."[18]
4. Net Long-Term Capital Gains
   Consequently, Net Long-Term Capital Gains are "the excess of long-term capital gains for the taxable year over the long-term capital losses…."[19]
5. Net Capital Gain
   The net capital gain calculation determines all of the preferential rates for capital gains included in taxable income in a given year. As a result, it is very important that taxpayers understand the basic concept of net capital gain. This gain is defined as "the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year."[20]

B. Defining Losses

In addition to understanding the specific types of gains related to capital asset sales, it is also necessary to understand how the losses on capital asset sales impact the preferential tax treatment. The losses below describe all of the relevant types of losses needed to determine the tax impact on capital asset sales.

1. Short-Term Capital Losses
   Short-Term Capital Losses are "loss[es] [included in gross income] from the sale or exchange of a capital asset held for less than 1 year…."[21]
2. Long-Term Capital Losses
   Long-Term Capital Losses are "loss[es] [included in gross income] from the sale or exchange of a capital asset held for more than 1 year…."[22]
3. Net Short-Term Capital Losses
   Net Short-Term Capital Losses are used in figuring out the preferential capital gain treatment in a taxable year. The Net Short-Term Capital Loss figure is offset against Net-Short Term Capital Gains to arrive at the total Net Capital

[15] I.R.C. §1222 (2013).
[16] *Id.*
[17] *See* I.R.C. §1(h).
[18] I.R.C. §1222 (2013).
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*

Gain or Loss as the case may be. This number is "the excess of short-term capital losses for the taxable year over the short-term capital gains for [the] year."[23]

4. Net Long-Term Capital Losses
   Net Long-Term Capital Losses are defined as "the excess of long-term capital losses for the taxable year over the long-term capital gains…."[24]
5. Net Capital Loss
   The last concept to describe is a net capital loss. Net capital losses are "the losses from sales or exchanges of capital assets over the [lesser of the excess of losses over gains or $3,000]." Additionally, in the case of corporations, short-term capital losses are not allowed.[25]

C. Capital Asset Categories

After deciphering through the different classifications of gains and losses, a taxpayer must also become familiar with the various categories that the internal revenue code classifies capital assets. These differing categories impact the exact preferential treatment that gains on sales of capital assets receive. Without having a basic understanding of the categories of assets under the tax code, it is impossible to determine the exact preferential treatment for capital gains in a tax year.

1. 28% Rate Property
   i. This category is currently broken down into two types of capital assets per the current internal revenue code.[26] The first asset type consists of collectibles.[27] The code currently includes in this category of assets gains or losses, as the case may be, "from the sale…of…collectible[s]…[that are not excluded from gross income for other reasons stipulated by the code and that were] held for more than one year…."[28] To further help taxpayers identify specific assets that fall under the 28% Collectibles category, the internal revenue code defines a collectible in accordance with I.R.C. §408(m) without taking into account the exclusion under this code section for certain types of coins and bullion.[29] The

[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] I.R.C. §1(h)(4) (2013).
[27] I.R.C. §1(h)(4) (2013).
[28] I.R.C. §1(h)(5)(A) (2013).
[29] I.R.C. §1(h)(5)(A) (2013);
See also I.R.C. 408(m) (2013).

Investment in collectibles treated as distributions. (1) In general. The acquisition by an individual retirement account or by an individually-directed account under a plan described in section 401(a) [IRC Sec. 401(a)] of any collectible shall be treated (for purposes of this section and section 402 [IRC Sec. 402]) as a distribution from such account in an amount equal to the cost to such account of such collectible. (2) Collectible defined. For purposes of this subsection, the term "collectible" means – (A) any work of art, (B) any rug or antique, (C) any metal or gem, (D) any stamp or coin, (E) any alcoholic beverage, or (F) any

Collectibles category includes antiques, gems, coins and various other property items.[30]

ii. The second category of assets in the 28% rate group consists of Section 1202 property.[31] Gains from the sale of section 1202 property are included in the 28% rate group per the current internal revenue code.[32] However, since other sections of the code exclude 50% of gains from section 1202 property from gross income, the analysis for capital gains purposes only includes 50% of the total gains from the sale or exchange of section 1202 property.[33] Section 1202 property is better known as qualified small business stock and includes stock of qualified small business C Corporations.[34]

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other tangible personal property specified by the Secretary for purposes of this subsection. (3) Exception for certain coins and bullion. For purposes of this subsection, the term "collectible" shall not include – (A) any coin which is – (i) a gold coin described in paragraph (7), (8), (9), or (10) or section 5112(a) of title 31, United States Code, (ii) a silver coin described in section 5112(e) of tile 31, United States Code, (iii) a platinum coin described in section 5112(k) of title 31, United States Code, or (iv) a coin issued under the laws of any State, or (B) any gold, silver, platinum, or palladium bullion of a fineness equal to or exceeding the minimum fineness that a contract market (as described in section 7 of the Commodity Exchange Act, 7 U.S.C. section 7 of the Commodity Exchange Act, 7 U.S.C. 7) requires for metals which may be delivered in satisfaction of a regulated futures contract, if such bullion is in the physical possession of a trustee described under subsection (a) of this subsection.

[30] I.R.C. §408(m) (2013).

[31] I.R.C. §1(h)(4) (2013).

[32] I.R.C. §1(h)(4)(A)(ii) (2013).

[33] I.R.C. §1202(a)(1) (2013); *See also* 26 C.F.R. §1.1202-1 (2013).

[34] I.R.C. §1202(c) (2013)

Qualified small business stock. For purposes of this section - (1) In general. Except as otherwise provided in this section, the term "qualified small business stock" means any stock in a C corporation which is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993 [enacted Aug. 10, 1993], if - (A) as of the date of issuance, such corporation is a qualified small business, and (B) except as provided in subsections (f) and (h), such stock is acquired by the taxpayer at its original issue (directly or through an underwriter) - (i) in exchange for money or other property (not including stock), or (ii) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock). (2) Active business requirement; etc. (A) In general. Stock in a corporation shall not be treated as qualified small business stock unless, during substantially all of the taxpayer's holding period for such stock, such corporation meets the active business requirements of subsection (e) and such corporation is a C corporation. (B) Special rule for certain small business investment companies. (i) Waiver of active business requirement. Notwithstanding any provision of subsection (e), a corporation shall be treated as meeting the active business requirements of such subsection for any period during which such corporation qualifies as a specialized small business investment company. (ii) Specialized small business investment company. For purposes of clause (i), the term "specialized small business investment company" means any eligible corporation (as defined in subsection (e)(4)) which is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 [15 USCS § 681(d)] (as in effect on May 13, 1993). (3) Certain purchases by corporation of its own stock. (A) Redemptions from taxpayer or related person. Stock acquired by the taxpayer shall not be treated as qualified small business stock if, at any time during the 4-year period beginning on the date 2 years before the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related (within the meaning of section 267(b) or 707(b) [IRC Sec. 267(b) or 707(b)]) to the

2. Unrecaptured Section 1250 Gain
   This section encompasses gains from dispositions of certain depreciable realty held for more than one year.[35] The code currently treats the majority of gains from the sale of unrecaptured section 1250 gain as a capital gain taxed at a maximum rate of 25%.[36] This portion of the code addresses the fact that a gain is incurred because depreciation is taken on property which results in a lower basis to the taxpayer.[37] The difference between the lowered basis resulting from depreciation and the amount realized on sale of the asset is the gain included in taxable income at a rate a maximum rate of 25%.[38] In other words, but for the depreciation of the property, a smaller gain or no gain would be realized or recognized by the taxpayer.[39] In reality, without depreciation, the taxpayer would probably realize a loss on the sale of the property given that the sales price would most likely be less than the basis to the taxpayer.

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taxpayer. (B) Significant redemptions. Stock issued by a corporation shall not be treated as qualified business stock if, during the 2-year period beginning on the date 1 year before the issuance of such stock, such corporation made 1 or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5 percent of the aggregate value of all of its stock as of the beginning of such 2-year period. (C) Treatment of certain transactions. If any transaction is treated under section 304(a) [IRC Sec. 304(a)] as a distribution in redemption of the stock of any corporation, for purposes of subparagraphs (A) and (B), such corporation shall be treated as purchasing an amount of its stock equal to the amount treated as such a distribution under section 304(a) [IRC Sec. 304(a)].

See also I.R.C. §1202(d) (2013).

Qualified small business. For purposes of this section - (1) In general. The term "qualified small business" means any domestic corporation which is a C corporation if - (A) the aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 [enacted Aug. 10, 1993] and before the issuance did not exceed $ 50,000,000, (B) the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $ 50,000,000, and (C) such corporation agrees to submit such reports to the Secretary and to shareholders as the Secretary may require to carry out the purposes of this section. (2) Aggregate gross assets. (A) In general. For purposes of paragraph (1), the term "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation. (B) Treatment of contributed property. For purposes of subparagraph (A), the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution. (3) Aggregation rules. (A) In general. All corporations which are members of the same parent-subsidiary controlled group shall be treated as 1 corporation for purposes of this subsection. (B) Parent-subsidiary controlled group. For purposes of subparagraph (A), the term "parent-subsidiary controlled group" means any controlled group of corporations as defined in section 1563(a)(1) [IRC Sec. 1563(a)(1)], except that - (i) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a)(1) [IRC Sec. 1563(a)(1)], and (ii) section 1563(a)(4) [IRC Sec. 1563(a)(4)] shall not apply.

[35] I.R.C. §1250 (2013).
[36] I.R.C. §1(h)(6) (2013).
[37] *Id.*
[38] *Id.*
[39] *Id.*

3. Adjusted Net Capital Gain
   The adjusted net capital gain category consists of a catch-all category for all other assets that are not encompassed by the 28% rate property or the unrecaptured section 1250 gain categories.[40] This category also consists of qualified dividends.[41] "In general,…qualified dividend income [consists] of dividends received during the taxable year from domestic corporations corporations, and qualified foreign corporations.[42] Certain dividends are excluded from the qualified category, and taxpayers should discuss with financial advisors or other qualified individuals whether the income received is from an unqualified dividend category.[43] This capital asset category includes the most beneficial rates for taxpayers because gains and dividends falling in this category are taxed currently at a maximum rate of 20%.[44]

D. Basic Rules for Offsetting

Even after mastering the terminology over the different types of gains and losses and learning all of the capital asset categories, most taxpayers find the rules for offsetting capital gains and losses one of the most challenging processes when calculating the total capital gains taxes for any taxable year. In addition to the challenges faced when interpreting the code section regarding offsetting various gains and losses, the code is also not clear on the order the various income items must be accounted for to determine the rates at which the income items are taxed. For taxpayers with similar capital assets, the process is not as challenging. However, for taxpayers with more complicated investment strategies, this process can be frustrating and overwhelming without some plain language guidance over the specific interpretations of the internal revenue code.

In order to determine the preferential tax treatment of capital gains, capital assets must first be divided between long-term and short-term categories. This is necessary because the most preferential tax treatment is only granted on the amount of adjusted net capital gain.[45] Taxpayers should remember the various definitions of gains and losses as well as the capital asset categories described in the previous sections in order to determine exactly how adjusted net capital gain is calculated. As stated above, long-term consists of assets held for more than one year.[46] While short-term consists of assets held for less than one year.[47]

After dividing assets between those considered to be long-term versus those considered short-term, the next step for taxpayers is to break down the assets by the three capital asset categories discussed previously. This final breakdown will not impact the short-term capital gains and losses but will ultimately determine the offset and preferential rate treatment of the long-term capital assets sold or exchanged in a taxable year. Since preferential tax

[40] I.R.C. §1(h)(3) (2013).
[41] *Id.*
[42] I.R.C. §1(h)(11)(B) (2013).
[43] *See* I.R.C. §1(h)(11)(B)(ii) (2013) (noting the categories of dividends excluded from preferential tax treatment).
[44] I.R.C. §1(h)(1)(A), (B),(C), and (D) (2013).
[45] *See generally* I.R.C. §1(h) (2013).
[46] *See generally* I.R.C. §1222 (2013).
[47] *Id.*

treatment is only provided to taxpayers with special categorical capital gains[48] or net capital gains adjusted further by qualified dividends,[49] taxpayers must determine the net capital gains as well as any net gains from the 28% rate category or the section 1250 unrecaptured depreciation gain category. Taxpayers will also be required to determine whether they have any qualified dividend income in a taxable year as this will be added to net capital gains to arrive at the total adjusted net capital gains for the taxable year.[50]

Once all assets have been categorized and divided into short-term and long-term, the third step in calculating the capital gains preferential tax treatment is to calculate the net long-term capital gain for the taxable year by category and the net short-term capital loss for the taxable year. As previously stated, net long-term capital gains are "the excess of long-term gains over long-term capital losses," [51] while net short-term capital losses are "the excess of short-term losses over short-term gains."[52] Qualified dividends are excluded from the calculation of net long-term capital gains and net-short term capital losses but are added to the net capital gains catch-all category to arrive at the total adjusted net capital gain catch-all category for the taxable year.[53] Taxpayers should keep in mind the special 50% rule previously discussed with respect to section 1202 property when determining the net long-term capital gains by category and net short-term capital losses.[54]

Finally, once the net long-term capital gains for each asset category and net-short term capital losses have been determined, net capital gain must be ascertained. Net capital gain is "the excess of net long-term capital gain over net short-term capital loss."[55] For purposes of this step, qualified dividend income is initially excluded from the calculation.[56] Net short-term capital losses are offset against net long-term capital gains by asset category in descending order.[57] From highest to lowest, the offset against net long-term capital gains is as follows: 1.) 28% Rate Category, 2.) Section 1250 Unrecaptured Depreciation Category, and 3.) Adjusted Net Capital Gains.[58] Thus, a taxpayer will need to take the net long-term gains by category calculated in the previous step and subtract from these categories in the order previously stated the net short-term capital losses until these losses are exhausted. The net gain remaining once all net short-term capital losses have been exhausted against the categorical net long-term capital gains is net capital gain.[59] Once net capital gain has been calculated, qualified dividends are added to the total net capital gain to arrive at the adjusted net capital gain number.[60] The first example below illustrates the basic rules of offset in calculating net capital gains to determine the associated tax liability:

[48] I.R.C. §1(h)(1)(E) and (F) (2013).
[49] I.R.C. §1(h)(1) and (2) (2013).
[50] I.R.C. §1(h)(3) (2013).
[51] I.R.C. §1222(7) (2013).
[52] I.R.C. §1222(6) (2013).
[53] *See* I.R.C. §1(h)(3) (2013).
[54] I.R.C. §1202 (2013).
[55] I.R.C. §1222(11) (2013).
[56] I.R.C. §1(h)(3) (2013).
[57] *See generally* I.R.C. §1(h)(3) (2013).
[58] *Id.*
[59] I.R.C. §1222(11) (2013).
[60] I.R.C. §1(h)(3) (2013).

During the current year, husband A and wife B file a joint return and have the following property:

1	Vacation home never used as a principle residence. The home was purchased eight years ago for $150,000. The home was sold in the current year for $300,000.
2	A vase purchased as an investment five years ago for $50,000, sold in the current year for $120,000.
3	Stock purchased as an investment five months ago. The stock was purchased for $50,000 and sold for $20,000 in the current year.
4	Qualified small business stock purchased 7 years before for $50,000, sold in the current year for $160,000.
5	Another vacation home never used as a principle residence. The home was purchased 10 years ago for $150,000. The home was sold in the current year for $50,000.
6	A painting purchased 4 months ago for $200,000, sold in the current year for $150,000.

In addition to the capital assets sold, the couple also has salary compensation income of $300,000 for the current year and qualified dividend income of $20,000 for the current year.

Step 1 and 2 Classify property and associated gains or losses as long-term or short-term and categorize assets.

	Gain	**Loss**	**Type**	**Category**
Vacation Home	150,000	-	Long-Term	ANCG
Vase	70,000	-	Long-Term	Collectible
Stock - 3	-	(30,000)	Short-Term	ANCG
Stock - 4	110,000	-	Long-Term	Section 1202
Vacation Home 2	-	(100,000)	Long-Term	ANCG
Painting	-	(50,000)	Short-Term	Collectible

Step 3 and 4 Calculate net long-term capital gain and net short-term capital loss by category and total adjusted net capital gain.

	Long-Term Gain	**Long-Term Loss**	**Net Long-Term Capital Gain**	**Short-Term Gain**	**Short-Term Loss**	**Net Short-Term Capital Loss**	**Net Capital Gain / (Loss)**
Total	275,000	(100,000)	175,000	-	(80,000)	(80,000)	95,000
						ST - Offset	
Section 1202	55,000	-	55,000	-	-	(55,000)	-
Collectible	70,000	-	70,000	-	-	(25,000)	45,000
ANCG	150,000	(100,000)	50,000	-	-	-	50,000
Net Capital Gain / (Loss)							95,000
Check Figure						-	-
Qualified Dividend							20,000
ANCG							70,000
Adjusted Net Capital Gain							115,000

In the example above, all asset categories sustained net long-term capital gains for the taxable year. However, the net short-term capital loss exceeded the net long-term gains for each asset category. Accordingly, the loss was allocated among the asset categories in descending order individually. Since Section 1202 property and collectibles are both taxed at 28%, the decision to offset first against the Section 1202 property rather than the collectibles category has no impact on the overall tax liability. In practice, these two categories would be netted together in calculating the tax liability. However, for illustration purposes, it is easiest to separate out all net long-term capital gains. The important rule to remember is that the loss is first allocated against the 28% rate property prior to allocation against the ANCG catch-all category because the ANCG category is taxed at a lower rate than the 28% rate property group.

The allocation above of the net short-term capital loss partially reduces the net long-term capital gains in the 28% rate property group. Accordingly, the tax liability for the net capital gain in the example above will be based on the reduced 28% rate property net long-term capital gain and the net long-term capital gain for the adjusted net capital gain category. Any other potential losses incurred by the taxpayers not discussed in the illustration above may be taken as a deduction against ordinary income if the code allows for such a deduction.[61] Since the taxpayers in this example have an overall net capital gain, the income will have to be accounted for in the order prescribed by the code to determine the exact tax liability for the year.[62]

If a taxpayer does not have an overall net capital gain, then the taxpayer has sustained a net capital loss for the taxable year. The rules regarding losses, described above, illustrate that taxpayers may not deduct all of the total losses in a given year. Rather net capital losses may be taken against ordinary income limited to the lesser of the excess of losses over respective gains or $3,000.[63] Example 2 illustrates the effect of an overall net capital loss in a taxable year:

Assume the same facts as previously illustrated, except that the couple had no dividend income during the current year, and the only property consisted of the vase and the painting, but the painting was sold in the current year for $2,000 instead of $150,000 .							
Step 1 and 2	Classify property and associated gains or losses as long-term or short-term and categorize assets.						
	Gain	**Loss**	**Type**	**Category**			
Vase	70,000	-	Long-Term	Collectible			
Painting	-	(198,000)	Short-Term	Collectible			
Step 3 and 4	Calculate net long-term capital gain and net short-term capital loss by category and total adjusted net capital gain.						
	Long-Term Gain	**Long-Term Loss**	**Net Long-Term Capital Gain**	**Short-Term Gain**	**Short-Term Loss**	**Net Short-Term Capital Loss**	**Net Capital Gain / (Loss)**
Total	70,000	-	70,000		(198,000)	(198,000)	(128,000)
						ST - Offset	
Collectible	70,000	-	70,000	-	-	(198,000)	(128,000)
Check Figure						-	-
Net Capital Loss							(128,000)
Ordinary Income Offset							3,000
Short-Term Loss Carryover							(125,000)

In this illustration, the taxpayer has an excess of capital losses over capital gains for the year of $128,000. Since this excess is significantly larger than the total maximum amount allowed annually against ordinary income under the code,[64] the taxpayer in this example would only be able to deduct $3,000 of the loss against ordinary income. Assuming this were the only capital loss sustained by the taxpayer, the taxpayer would have a net short-term capital loss for the taxable year of $125,000. This loss is classified as short-term because it is a loss sustained due to the sale of the painting. Taxpayers are required to track

[61] *See* I.R.C. §165 (2013).
[62] *See* Section F below on determining income tax liability.
[63] I.R.C. §1211(b) (2013).
[64] *Id.*

their capital losses as short-term or long-term because the code specifically requires that capital loss carryovers used to offset subsequent year capital gains consist first of the use of short-term capital losses.[65]

E. Complications with Offsetting Rules

Although the above illustrations seem straightforward, there are often times when some capital asset categories have net long-term losses, while other categories have net long-term capital gains. When this occurs, there are additional rules involved as to how the losses are offset because the tax liability is determined from net capital gain,[66] which is the excess of net long-term capital gains over net short-term capital losses.[67]

When the initial long-term capital gains and long-term capital losses for each category are calculated and net long-term capital losses for any given category exist, these categorical net long-term capital losses are first offset against net long-term capital gains in other categories.[68] Specifically, net long-term capital losses are offset in descending order from the highest taxed asset categories to the lowest taxed asset categories.[69] The order of offsetting categorical net long-term capital losses by category is as follows: 1.) 28% Rate Category Assets, 2.) Section 1250 Category, and 3.) Adjusted Net Capital Gains Category.[70]

After offsetting net long-term capital losses with net long-term capital gains according to the categorical hierarchy, any remaining categorical net long-term capital gains are then offset by net short-term capital losses in descending order as described above.[71] If any gain remains, this is the net capital gain.[72] If there is no gain, then taxpayers first offset the net long-term losses against any net short-term capital gain if available.[73] If a loss still exists, this is considered a capital loss that is subjected to the deduction limitations discussed previously.[74] The third example illustrates the offset rules when some capital asset categories have net long-term capital gains and other asset categories have net long-term capital losses:

[65] I.R.C. §1212(b) (2013).
[66] I.R.C. §1(h) (2013).
[67] I.R.C. §1222(11) (2013).
[68] *See* I.R.C. §1222(7) & (11) (2013).
[69] *See generally* I.R.C. §1(h)(3) (2013).
[70] *Id.*
[71] I.R.C. §1222(7) (2013).
[72] I.R.C. §1222(11) (2013).
[73] *See* I.R.C. §1222 (2013).
[74] I.R.C. §1211(b) (2013).

Assume the same facts as previously illustrated, except that the first vacation home was purchased eight years ago for $150,000 and sold in the current year for $140,000 and the painting was purchased 4 months ago for $180,000 and sold in the current year for $200,000.

Step 1 and 2 Classify property and associated gains or losses as long-term or short-term and categorize assets.

	Gain	Loss	Type	Category
Vacation Home	-	(10,000)	Long-Term	ANCG
Vase	70,000	-	Long-Term	Collectible
Stock - 3	-	(30,000)	Short-Term	ANCG
Stock - 4	110,000	-	Long-Term	Section 1202
Vacation Home 2	-	(100,000)	Long-Term	ANCG
Painting	20,000	-	Short-Term	Collectible

Step 3 and 4 Calculate net long-term capital gain and net short-term capital loss by category and total adjusted net capital gain.

	Long-Term Gain	Long-Term Loss	Net Long-Term Capital Gain Preliminary	LT - Offset	Net Long-Term Capital Gain Final	Short-Term Gain	Short-Term Loss	Net Short-Term Capital Loss	Net Capital Gain / (Loss)
Total	125,000	(110,000)	15,000		15,000	20,000	(30,000)	(10,000)	5,000
							ST - Offset		
Section 1202	55,000	-	55,000	(55,000)	-	-	-	-	-
Collectible	70,000	-	70,000	(55,000)	15,000	-	(10,000)	(10,000)	5,000
ANCG	-	(110,000)	(110,000)	110,000	-	-	-	-	-
Net Capital Gain / (Loss)									5,000
Check Figure				-	-			-	-
Qualified Dividend									20,000
ANCG									20,000
Adjusted Net Capital Gain									25,000

In the illustration above, the taxpayers sustained an overall net long-term capital loss in the ANCG catch-all category. This net long-term loss is first offset against other categorical net long-term losses in the descending order described above. In this particular case, Section 1202 had $55,000 of net long-term capital gains to offset. This completely eliminates the net long-term gain in this category. The remaining balance of the net long-term loss from the ANCG category is then taken against the gain in the collectibles category. As previously mentioned, since Section 1202 property and collectibles are both taxed at 28%, it does not matter which asset the loss is taken against first as there will be no impact to the overall tax liability. The result is an overall net long-term capital gain of $15,000 reduced further by the net short-term capital loss to arrive at the net capital gain for the taxable year of $5,000. Once dividend income is added, the adjusted net capital gain is $25,000 for the taxable year.

Additional complications can arise when dealing with short-term capital gains and short-term capital losses because net short-term capital gains may exist. Typically, only net short-term capital losses are included in the net capital gain calculation because unless an overall net long-term capital loss exists, net short-term capital gains are included in ordinary income and receive no preferential tax treatment.[75] Thus, an overall net short-term capital gain without an overall net long-term capital loss is excluded from the net capital gain

[75] *See generally* I.R.C. §§1(h)(3) & 1222(11) (2013).

calculation and is included in ordinary income and taxed at the ordinary income rate.[76] The final example illustrates this concept:

Assume the same facts as previously illustrated, except that the first vacation home was purchased eight years ago for $300,000 and sold in the current year for $150,000 and the painting was purchased 4 months ago for $150,000 and sold in the current year for $200,000.									
Step 1 and 2	Classify property and associated gains or losses as long-term or short-term and categorize assets.								
	Gain	**Loss**	**Type**	**Category**					
Vacation Home	-	(150,000)	Long-Term	ANCG					
Vase	70,000	-	Long-Term	Collectible					
Stock - 3	-	(30,000)	Short-Term	ANCG					
Stock - 4	110,000	-	Long-Term	Section 1202					
Vacation Home 2	-	(100,000)	Long-Term	ANCG					
Painting	50,000	-	Short-Term	Collectible					
Step 3 and 4	Calculate net long-term capital gain and net short-term capital loss by category and total adjusted net capital gain.								
	Long-Term Gain	**Long-Term Loss**	**Net Long-Term Capital Gain Preliminary**	**LT - Offset**	**Net Long-Term Capital Gain Final**	**Short-Term Gain**	**Short-Term Loss**	**Net Short-Term Capital Gain**	**Net Capital Gain / (Loss)**
Total	125,000	(250,000)	(125,000)		(125,000)	50,000	(30,000)	20,000	(105,000)
							ST - Offset		
Section 1202	55,000	-	55,000	(55,000)	-	-	-	-	-
Collectible	70,000	-	70,000	(70,000)	-	-	-	-	-
ANCG	-	(250,000)	(250,000)	125,000	(125,000)	-	20,000	20,000	(105,000)
Net Capital Gain / (Loss)									(105,000)
Check Figure					-				-
Qualified Dividend									20,000
ANCG									(85,000)
Ordinary Income Offset									3,000
Adjusted Net Capital Gain / (Loss)									(82,000)

In this example, the short-term gains and losses are netted together first. The overall impact of short-term capital gains and losses results in a net short-term capital gain. This gain is only netted against long-term assets in the event that there is a net long-term capital loss. Otherwise, the amount is included in ordinary income for the current taxable year. In most cases, net short-term capital gains receive no preferential tax treatment and are taxed at ordinary rates. However, in this case, the overall impact in the illustration above is a net long-term capital loss of $125,000 and a net short-term gain of $20,000.

As previously discussed, net long-term losses by category are first offset against net long-term gains in other categories in descending order. In this case, both net long-term gains are in categories taxed at 28%. Thus, the offset order does not matter, since it will have no impact to the overall tax liability. Additionally, the net long-term loss in the adjusted net capital gain catch-all category exceeds the total net long-term capital gains in the other categories, so the result is that all of the net long-term gains in the other

[76] *Id.*

categories are eliminated, and the remaining adjusted net long-term capital loss will be further offset by any net short-term capital gains or limited by the deductions against ordinary income previously discussed.

The result in this example is that the net short-term gain is offset against the net long-term loss for an overall net capital loss of $105,000.[77] Qualified dividends are added to this for an adjusted net capital loss of $85,000 for the taxable year.[78] As with all other capital losses, a deduction of up to $3,000 is allowed against ordinary income.[79] Thus the overall net capital loss in the illustration above is reduced by the $3,000 deduction against ordinary income allowed in the current year. The result is a long-term capital loss carryover of $82,000.[80]

In summary, capital assets are categorized according to length of time held by the taxpayer and type of asset. Next, short-term losses are netted with short-term gains and long-term gains are offset by long-term losses. If there are any categorical net long-term losses, these are offset by other categorical net long-term gains. Any net short-term gains are included in ordinary income for the tax year, unless there are net long-term losses to offset the net short-term gains. If short-term losses exist, these are offset against net long-term capital gains. The remaining gains from the net short-term losses and the net long-term gains are considered to be the net capital gain from the year and are included in taxable income at preferential tax rates depending on the categorical makeup of the property.

F. Order of Income and Determining Income Tax Liability

In order to appropriately calculate the income tax liability for the various types of capital gains, taxpayers need to be familiar with the order in which the income flows into the current tax brackets. Income from various activities currently flows into the tax brackets in the following order: 1.) Ordinary income, 2.) Net short-term capital gains, 3.) Section 1250 gains, and 4.) Adjusted net capital gains.[81] For taxpayers with ordinary income above the maximum preferential tax rates the tax calculation is simple because the preferential tax rates provide the maximum rate at which these capital gains are taxed.[82] However, for taxpayers below the maximum rates, or with capital gains that push them into another tax bracket, the calculations can be slightly more complex.

After understanding the order that income flows into the tax brackets, taxpayers need to familiarize themselves with the current preferential capital gains tax rates as well as the current ordinary income tax brackets. This understanding of ordinary income tax rates and preferential tax rates combined with the income flow order becomes important because capital asset gains are taxed according to the relation the asset gains have to ordinary income rates.[83] The following illustrations from the examples under the offsetting section

[77] I.R.C. §1222(8) (2013).
[78] I.R.C. §1(h)(3) (2013).
[79] I.R.C. §1211(b) (2013).
[80] I.R.C. §1212(b) (2013).
[81] *See generally* I.R.C. §1(h) (2013).
[82] *Id.*
[83] *See* I.R.C. §1 (2013) for comparison of the ordinary income and capital gain tax rates.

demonstrate the manner in which capital gains are taxed. All examples assume that there are no additional deductions and do not account for the standard deduction or exemptions for illustration purposes:

Example 1

Step 5	Calculate the associated tax liability.					
	Income	**Rate**	**MFJ Rate**	**Added**	**Previous**	**Total Tax**
1. Salary	300,000	Ordinary	33%	49,919.50	223,050.00	75,313
2. 28% Rate	45,000	Preferential	28%	N/A	N/A	12,600
3. ANCG	70,000	Preferential	15%	N/A	N/A	10,500
Total	415,000					98,413

In the first offset example above, total income for the taxable year consisted of $300,000 in salary income plus the $115,000 in various types of capital gains. This calculation outlines how the income flows into the tax bracket and how the various rates are applied. As stated above, the ordinary salary income is added to the bracket first. There are no net short-term capital gains or section 1250 net gains in this example. As a result, the next items added to the tax bracket are the 28% rate gains followed by the adjusted net capital gains.

The calculation above is fairly straightforward because the ordinary income from salary compensation immediately places the taxpayers in this example above the maximum preferential rates for all of the capital asset categories. Thus, the calculation of the capital gains preferential rates is simple because it is simply the maximum rate multiplied by the total amount of the gain included in taxable income for the current year. The tax liability for the salary income is calculated in accordance with the tax rates for ordinary income for a married filing jointly taxpaying couple. The totals are then added together to arrive at the total tax liability for the taxpayers in the current taxable year.[84]

Example 3

Step 5	Calculate the associated tax liability.					
	Income	**Rate**	**MFJ Rate**	**Added**	**Previous**	**Total Tax**
Salary	300,000	Ordinary	33%	49,919.50	223,050.00	75,313
28% Rate	5,000	Preferential	28%	N/A	N/A	1,400
ANCG	20,000	Preferential	15%	N/A	N/A	3,000
Total	325,000					79,713

This example is similar to the first example with respect to the calculation of the tax liability. In this case, the income is flushed through the tax brackets according to the schedule described above. Since the compensation income is the same, the taxpayers are already above the maximum capital gains rates for the taxable year. As a result, all of the capital gains are taxed at the maximum preferential rates. Examples 2 and 4 previously

[84] Note that rates are representative as of 2013 and may change with future legislation.

discussed in the offset section have no associated tax liability for the current year illustrated because the overall result for the year was a net capital loss.[85]

IV. QUASI CAPITAL ASSETS

A. Defining Quasi Capital Assets

Quasi capital assets are assets that are used in a taxpayer's trade or business that were held for at least one year.[86] Although the internal revenue code does not refer to these assets as "quasi assets", these assets are commonly referred to using this terminology as a distinction between regular capital assets and capital assets used in a trade or business.[87] Any gain or loss recognized from the sale of these types of assets is treated slightly different from typical capital assets held by a taxpayer[88] because the treatment of traditional capital asset gains and losses is governed under a different section of the internal revenue code.[89]

V. TREATMENT OF SALES RELATED TO QUASI CAPITAL ASSETS

A. Casualty Losses and Preliminary Hotchpot Analysis

The first step in determining the tax liability associated with quasi capital assets is to consider casualty gains and losses associated with the quasi capital assets.[90] Casualty losses are those related to "fire, storm, shipwreck, or other casualty, or from theft."[91] Taxpayers first need to determine whether there is a net casualty gain or a net casualty loss.[92] If the casualty losses exceed casualty gains for a total net casualty loss, then the quasi capital asset section of the code does not apply, and the gains and losses in this case are taxable or deductible, as the case may be, in ordinary income.[93] The idea associated with this concept is that taxpayers will better benefit from the ability to take the full amount of losses in this type of situation against ordinary income, rather than limiting losses to the extent of gains, as is the case with traditional capital losses. Thus, the net loss may be used to offset other ordinary income.[94] If the total casualty losses do not exceed the total casualty gains, then all of the casualty gains and casualty losses are included in the analysis with the other section 1231 gains and losses.[95] Although not explicitly stated in the code, this analysis is frequently known as "preliminary hotchpot analysis."[96]

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[85] Note that rates are representative as of 2013 and may change with future legislation.
[86] I.R.C. §1231 (2013).
[87] CHERYL D. BLOCK, CORPORATE TAXATION 12 (3rd ed. 2004).
[88] *See* I.R.C. §1231 (2013).
[89] *See* I.R.C. §1221 (2013).
[90] *Id.*
[91] I.R.C. §1231(a)(4)(C) (2013).
[92] *Id.*
[93] *Id.*
[94] *See* I.R.C. §1231(a)(4)(C) (2013).
[95] *Id.*
[96] DAVID L. CAMERON & ELLIOT MANNING, FEDERAL TAXATION OF PROPERTY TRANSACTIONS §6.02 (2012).

B. Principle Hotchpot Analysis

Once the preliminary hotchpot analysis has been performed, the taxpayer should next move on to the "principal hotchpot analysis."[97] As stated with the previous analysis, the code does not expressly refer to this as "principal hotchpot analysis." However, it is often referred to by this name for those familiar with the income tax code section.[98] In this analysis, all section 1231 gains and losses are evaluated together.[99] This includes any casualty gains and losses that were not included in ordinary income based on the results of the preliminary hotchpot analysis.[100]

If gains exceed losses, then "[these] gains and losses [are] treated as long-term capital gains or long-term capital losses, as the case may be."[101] Since all the items are considered long-term due to the required holding period of section 1231, these items are then divided into the three capital gain categories and run through the same capital gains and loss analysis calculation discussed in detail above.[102] Any preferential tax treatment in this case is governed by the rates related to section 1221 analysis.[103]

If quasi capital asset losses exceed capital gains, then "[these] gains and losses [are] not treated as gains and losses from the sales or exchange of capital assets."[104] For the taxpayer, this means that these gains and losses will be included in ordinary income and the gains will not receive preferential tax treatment.

VI. SALE OF SECTION 1245 PROPERTY

A. Defining Section 1245 Property

Section 1245 property is "property [that] is or has been property of a character subject to [an] allowance for depreciation [per]…26 U.S.C. §167 and is…personal property."[105]

B. Treatment of Gain

Typically, the gain from the sale or disposition of section 1245 property is treated as ordinary income.[106] However, this section of the code does provide for capital gain treatment for certain pieces of the gain on the sale or disposition of section 1245 property under certain circumstances.[107]

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97 *Id.*
98 *Id.*
99 I.R.C. §1231(a)(1) & (2) (2013).
100 I.R.C. §1231(a)(4)(C) (2013).
101 I.R.C. §1231(a)(1) (2013).
102 I.R.C. §1221 (2013).
103 I.R.C. §1(h) (2013).
104 I.R.C. §1231 (2013).
105 I.R.C. §1245(a)(3) (2013).
106 I.R.C. §1245(a)(1) (2013).
107 *Id.*

C. Calculating the Gain

In general, the amount of gain included in ordinary income is the" lower of the recomputed basis of the property or…the amount realized [if the transaction is a sale less] the adjusted basis of the property."[108] The recomputed basis is simply the adjusted basis recomputed to include all depreciation adjustments made since the property was placed in use.[109] Thus, taxpayers will take the lowest number and subtract from this amount the adjusted basis of the property. This gain will then be recognized as ordinary income and taxed at ordinary rates.

D. Treatment when the Amount Realized Exceeds the Recomputed Basis

The complications related to section 1245 property arise when the amount realized exceeds the recomputed basis of the property. When the amount realized on a sale or exchange of property exceeds the recomputed basis, the recomputed basis is the lesser of the two. Thus, the adjusted basis is deducted from the recomputed basis to arrive at the total gain included in ordinary income for the year.[110] However, this leaves the additional amount from the amount realized on the sale that has not been accounted for in the transaction. When this occurs, the additional amount realized that is not accounted for because of the excess over the recomputed basis is treated as a capital gain.[111] The amount will then be included in the capital gain analysis discussed in the previous sections based on the category of the asset and whether the asset was used for personal or business purposes.[112]

VII. CONCLUSION

Although the topics discussed are not meant to thoroughly cover every issue related to individual taxpayer capital gains and losses, the analysis is meant to provide taxpayers with a better understanding of the nature of the most common aspects of capital gains and losses. Since tax consequences of capital gains and losses can vary significantly, taxpayers should ensure that they have a thorough understanding of the character of their assets exchanged or sold in taxable years or consult with tax planners that are better able to help plan so that they may best capitalize on sales or dispositions of capital assets.

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[108] I.R.C. §1245 (2013).
[109] I.R.C. §1245(a)(2) (2013).
[110] *Id.*
[111] *See* I.R.C. §1245 (2013).
[112] *See generally* I.R.C. §§ 1221 & 1231 (2013).