

Capital Gains and Losses

This self-study course discusses investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use – including the special rules for selling your home. Though this basic tax course does not require any prerequisites, its recommended target audience is for existing Enrolled Agents, however anyone may take this course. This course provides 2 CE credits in the IRS Federal Tax Law category.

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NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice

Chapter 1: Basis Of Property

Chapter Objective

After completing this chapter, you should be able to:

- Identify the factors to consider in calculating the basis of property.

I. Reminders

Special rules for capital gains invested in Qualified Opportunity Funds. Effective December 22, 2017, Code section 1400Z-2 provides a temporary deferral of inclusion in gross income for certain capital gains invested in Qualified Opportunity Funds (QOFs), and a potential permanent exclusion of gains from the sale or exchange of an investment in a QOF if the investment is held for at least 10 years. For more information, see the Instructions for Form 8949.

II. Introduction

This chapter discusses how to figure your basis in property. It is divided into the following sections.

- Cost basis.
- Adjusted basis.
- Basis other than cost.

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure gain or loss on the sale, exchange, or other disposition of property. Also use it to figure deductions for depreciation, amortization, depletion, and casualty losses.

If you use property for both business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, or claim certain credits, reduce your basis.

III. Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items.

- Sales tax.
- Freight.
- Installation and testing.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

In addition, you may also have to capitalize (add to basis) certain other costs related to buying or producing property.

Loans with low or no interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus any amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

REAL PROPERTY

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

Lump sum purchase. If you buy buildings and the land on which they stand for a lump sum, allocate the basis among the land and the buildings so you can figure the allowable depreciation on the buildings. Land is not depreciable. Allocate the cost according to the fair market values of the land and buildings at the time of purchase. Figure the basis of each asset by multiplying the lump sum by a fraction. The numerator is the FMV of that asset and the denominator is the FMV of the whole property at the time of purchase.

Fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both have reasonable knowledge of all the necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

Assumption of mortgage. If you buy property and assume (or buy the property subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs for buying the property. (A fee for buying property is a cost that must be paid even if you buy the property for cash.) You cannot include fees and costs for getting a loan on the property in your basis.

The following are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Survey fees.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

The following are some of the settlement fees and closing costs you cannot include in the basis of property.

1. Casualty insurance premiums.
2. Rent for occupancy of the property before closing.
3. Charges for utilities or other services related to occupancy of the property before closing.
4. Charges connected with getting a loan. The following are examples of these charges.
 - a) Points (discount points, loan origination fees).
 - b) Mortgage insurance premiums.
 - c) Loan assumption fees.
 - d) Cost of a credit report.
 - e) Fees for an appraisal required by a lender.
5. Fees for refinancing a mortgage.

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as an expense.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan.

Points on home mortgage. Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by any seller-paid points.

IV. Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the cost of the property. The result is the adjusted basis.

INCREASES TO BASIS

Increase the basis of any property by all items properly added to a capital account. Examples of items that increase basis are shown in Table 1-1.

TABLE 1-1. EXAMPLES OF ADJUSTMENTS TO BASIS

Increases to Basis	Decreases to Basis
<ul style="list-style-type: none"> • Capital improvements: <ul style="list-style-type: none"> Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home • Assessments for local improvements: <ul style="list-style-type: none"> Water connections Extending utility service lines to the property Sidewalks Roads • Casualty losses: <ul style="list-style-type: none"> Restoring damaged property • Legal fees: <ul style="list-style-type: none"> Cost of defending and perfecting a title • Zoning costs 	<ul style="list-style-type: none"> • Exclusion from income of subsidies for energy conservation measures • Casualty or theft loss deductions and insurance reimbursements • Certain vehicle credits • Section 179 deduction • Depreciation • Nontaxable corporate distributions

Improvements. Add to your basis in property the cost of improvements having a useful life of more than one year, that increase the value of the property, lengthen its life, or adapt it to a different use. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

Assessments for local improvements. Increase the basis of property by assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes charges for maintenance, repairs, or interest charges related to the improvements.

Example

Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis. In this example, the assessment is a depreciable asset.

DECREASES TO BASIS

Decrease the basis of any property by all items that represent a return of capital for the period during which you held the property. Examples of items that decrease basis are shown in Table 1-1.

Casualty and theft losses. If you have a casualty or theft loss, decrease the basis in your property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance. You must increase your basis in the property by the amount you spend on repairs that restore the property to its pre-casualty condition.

Depreciation and section 179 deduction. Decrease the basis of your qualifying business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.

Example

You owned a duplex used as rental property that cost you \$40,000, of which \$35,000 was allocated to the building and \$5,000 to the land. You added an improvement to the duplex that cost \$10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of \$23,000. You sold some salvaged material for \$1,300 and collected \$19,700 from your insurance company. You deducted a casualty loss of \$1,000 on your income tax return for last year. You spent \$19,000 of the insurance proceeds for restoration of the duplex, which was completed this year.

You must use the duplex's adjusted basis after the restoration to determine depreciation for the rest of the property's recovery period. Figure the adjusted basis of the duplex as follows:

Original cost of duplex		\$35,000
Addition to duplex		<u>10,000</u>
Total cost of duplex		\$45,000
Minus: Depreciation		<u>23,000</u>
Adjusted basis before casualty		\$22,000
Minus: Insurance proceeds	\$19,700	
Deducted casualty loss	1,000	
Salvage proceeds	<u>1,300</u>	<u>22,000</u>
Adjusted basis after casualty		-0-
Add: Cost of restoring duplex		<u>\$19,000</u>
Adjusted basis after restoration		<u>\$19,000</u>

Note: Your basis in the land is its original cost of \$5,000.

Easements. The amount you receive for granting an easement is generally considered to be from the sale of an interest in real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain.

Vehicle credits. Unless you elect not to claim the qualified vehicle credit, the alternative motor vehicle credit, or the qualified plug-in electric drive motor vehicle credit, you may have to reduce the basis of each qualified vehicle by certain amounts reported.

Exclusion of subsidies for energy conservation measures. You can exclude from gross income any subsidy you received from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property for which you received the subsidy by the excluded amount.

V. Basis Other Than Cost

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of the property can be used. Fair market value (FMV) and adjusted basis were discussed earlier.

TAXABLE EXCHANGES

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

NONTAXABLE EXCHANGES

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred.

Like-Kind Exchanges

The exchange of property for the same kind of property may qualify as a nontaxable exchange under section 1031. Nontaxable like-kind exchange treatment under section 1031 applies only to exchanges of real property held for use in a trade or business or for investment, other than real property held primarily for sale. Beginning after 2017, nontaxable like-kind exchange treatment under section 1031 applies only to exchanges of real property held for use in a trade or business or for investment other than real property held primarily for sale.

To qualify as a like-kind exchange, you must hold for business or investment purposes both the property you transfer and the property you receive. There also must be an exchange of like-kind property.

The basis of the property you receive generally is the same as the adjusted basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the adjusted basis of the property you gave up increased by the money you paid.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the total adjusted basis of the property you gave up, with the following adjustments.

1. Decrease the basis by the following amounts.
 - a) Any money you receive.
 - b) Any loss you recognize on the exchange.
2. Increase the basis by the following amounts.
 - a) Any additional costs you incur.
 - b) Any gain you recognize on the exchange.

If the other party to the exchange assumes your liabilities, treat the debt assumption as money you received in the exchange.

Allocation of basis. If you receive like-kind and unlike properties in the exchange, allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like-kind property.

PROPERTY RECEIVED AS A GIFT

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus

any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property. See Adjusted Basis, earlier.

Example

You received an acre of land as a gift. At the time of the gift, the land had a FMV of \$8,000. The donor's adjusted basis was \$10,000. After you received the property, no events occurred to increase or decrease your basis. If you later sell the property for \$12,000, you will have a \$2,000 gain because you must use the donor's adjusted basis at the time of the gift (\$10,000) as your basis to figure gain. If you sell the property for \$7,000, you will have a \$1,000 loss because you must use the FMV at the time of the gift (\$8,000) as your basis to figure loss. If the sales price is between \$8,000 and \$10,000, you have neither gain nor loss.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift, explained later.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis by any required adjustments to basis while you held the property. See Adjusted Basis, earlier.

If you received a gift during the tax year, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift.

Example

In 2021, you received a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. The amount of the gift for gift tax purposes was \$35,000 (\$50,000 minus the \$15,000 annual exclusion). She paid a gift tax of \$7,100 on the property. Your basis is \$26,106 figured as follows:

Fair market value	\$50,000
Minus: adjusted basis	<u>-20,000</u>
Net increase in value	<u>\$30,000</u>
Gift tax paid	\$7,100
Multiplied by ($\$30,000 \div \$35,000$)	<u>x.86</u>
Gift tax due to net increase in value	\$6,106
Adjusted basis of property to your mother	<u>+20,000</u>
Your basis in property	<u>\$26,106</u>

INHERITED PROPERTY

Your basis in property you inherit from a decedent is generally one of the following.

- The FMV of the property at the date of the decedent's death.
- The FMV on the alternate valuation date if the personal representative for the estate elects to use alternate valuation.

- The value under the special-use valuation method for real property used in farming or a closely held business if elected for estate tax purposes.
- The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

PROPERTY CHANGED FROM PERSONAL TO BUSINESS OR RENTAL USE

If you hold property for personal use and then change it to business use or use it to produce rent, you can begin to depreciate at the time of the change. To do so, you must figure its basis for depreciation at the time of the change. An example of changing property held for personal use to business use would be renting out your former main home.

Basis for depreciation. The basis for depreciation is the lesser of the following amounts.

- The FMV of the property on the date of the change.
- Your adjusted basis on the date of the change.

Example

Several years ago, you paid \$160,000 to have your house built on a lot that cost \$25,000. You paid \$20,000 for permanent improvements to the house and claimed a \$2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, you include only the cost of the house when figuring the basis for depreciation. Your adjusted basis in the house when you changed its use was \$178,000 (\$160,000 + \$20,000 - \$2,000). On the same date, your property had an FMV of \$180,000, of which \$15,000 was for the land and \$165,000 was for the house. The basis for figuring depreciation on the house is its FMV on the date of the change (\$165,000) because it is less than your adjusted basis (\$178,000).

Sale of property. If you later sell or dispose of property changed to business or rental use, the basis you use will depend on whether you are figuring gain or loss.

Gain. The basis for figuring a gain is your adjusted basis in the property when you sell the property.

Example

Assume the same facts as in the previous example except that you sell the property at a gain after being allowed depreciation deductions of \$37,500. Your adjusted basis for figuring gain is \$165,500 (\$178,000 + \$25,000 (land) - \$37,500).

Loss. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then adjust this amount for the period after the change in the property's use, as discussed earlier under Adjusted Basis.

Example

Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of \$37,500. In this case, you would start with the FMV on the date of the change to rental use (\$180,000), because it is less than the adjusted basis of \$203,000 (\$178,000 + \$25,000) on that date. Reduce that amount (\$180,000) by the depreciation deductions to arrive at a basis for loss of \$142,500 (\$180,000 - \$37,500).

STOCKS AND BONDS

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the FMV or the previous owner's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, divide the adjusted basis of the old stock by the number of shares of old and new stock. This rule applies only when the additional stock received is identical to the stock held. Also reduce your basis when you receive nontaxable distributions. The nontaxable distributions are a return of capital.

Example

In 2019 you bought 100 shares of XYZ stock for \$1,000 or \$10 a share. In 2020 you bought 100 shares of XYZ stock for \$1,600 or \$16 a share. In 2021 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of \$5 a share and 200 shares with a basis of \$8 a share.

Other basis. There are other ways to figure the basis of stocks or bonds depending on how you acquired them.

Identifying stocks or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stocks or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first.

Mutual fund shares. If you sell mutual funds you acquired at various times and prices and left on deposit in an account kept by a custodian or agent, you can elect to use an average basis.

Bond premium. If you buy a taxable bond at a premium and choose to amortize the premium, reduce the basis of the bond by the amortized premium you deduct each year. Although you cannot deduct the premium on a tax-exempt bond, you must amortize the premium each year and reduce your basis in the bond by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the OID you include in income for that instrument.

CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. The cost basis of property you buy is usually the sum of its costs. Which of the following would not be a cost added to the cost basis:

- A. the amount you pay in cash
- B. the amount of debt obligations obtained
- C. other property or services provided
- D. charges connected with getting a loan to purchase the property

2. A like-kind exchange requires which of the following to be true:

- A. there must be an exchange of some money
- B. one of the properties involved must be qualifying property
- C. both properties are like-kind property
- D. the cost basis of the old and new property must be the same

3. Your basis in stocks or bonds cannot change after purchase.

- A. true
- B. false

CHAPTER 1: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.
 - A. Incorrect. The amount of cash paid for a property is part of its cost basis. B. Incorrect. Any debt assumed or newly acquired in purchasing property is also a component of its cost basis.
 - B. Incorrect. All other property or services provided to a seller to induce them into transferring property is also part of the property's cost basis.
 - C. **CORRECT**. Fees and/or charges (for example, points, credit reporting, and loan assumption fees) associated with obtaining a loan used to purchase property are not usually added to the property's cost basis.
2.
 - A. Incorrect. There is no requirement for the exchange of money.
 - B. Incorrect. A like-kind exchange requires that both of the properties involved be "qualifying property" as specified in the tax code, not just one of the properties.
 - C. **CORRECT**. A like-kind exchange requires that the property involved be "like-kind property" as specified in the tax code.
 - D. Incorrect. Having the cost basis the same is not a condition required for a like-kind exchange to occur.
3.
 - A. Incorrect. There are a number of reasons that basis may change after purchase.
 - B. **CORRECT**. The basis of stocks or bonds may change after purchase because of nontaxable stock dividends or stock splits or nontaxable distributions.

Chapter 2: Sale Of Property

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the taxability of the sale of personal use property.

I. Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- Figuring gain or loss,
- Nontaxable trades,
- Related party transactions,
- Capital gains or losses,
- Capital assets and noncapital assets, and
- Holding period.

II. Sales And Trades

If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or an equivalent statement from the broker. You should receive a Form 1099-B for 2021 by February 15, 2022. It will show the gross proceeds from the sale. It may also show your basis. The IRS will also get a copy of Form 1099-B from the broker.

Use Form 1099-B received from your broker to complete Form 8949 and/or Schedule D (Form 1040).

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see Like-kind exchanges under Nontaxable Trades, later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend versus sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1. The redemption is not essentially equivalent to a dividend,
2. There is a substantially disproportionate redemption of stock,
3. There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4. The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade.

In addition, a significant modification of a bond is treated as a trade of the original bond for a new bond.

Surrender of stock. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

HOW TO FIGURE GAIN OR LOSS

You figure gain or loss on a sale or trade of property by subtracting the adjusted basis of the property from the amount you realize on the sale or trade.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See Chapter 1 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property minus your expenses of sale (such as redemption fees, sales commissions, sales charges, or exit fees). Amount realized includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest that you must report as ordinary income will reduce the amount realized from the sale.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

Example

You trade A Company stock with an adjusted basis of \$7,000 for B Company stock with a fair market value of \$10,000, which is your amount realized. Your gain is \$3,000 (\$10,000 minus \$7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example

You sell stock that you had pledged as security for a bank loan of \$8,000. Your basis in the stock is \$6,000. The buyer pays off your bank loan and pays you \$20,000 in cash. The amount realized is \$28,000 (\$20,000 plus \$8,000). Your gain is \$22,000 (\$28,000 minus \$6,000).

Payment of cash. If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See Basis Other Than Cost in Chapter 1.

NONTAXABLE TRADES

Note

Per the Tax Cuts and Jobs Act, like-kind exchanges are allowed only for real property after 2017.

Like-kind exchanges. If you trade business or investment property for other business or investment property of a like kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

1. The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home.
2. The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
3. The property you trade and the property you receive must be real property.
4. There must be a trade of like property. The trade of real estate for real estate is a trade of like property. The trade of an apartment house for a store building is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property.
5. The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
6. The property to be received must be received by the earlier of:
 - a) The 180th day after the date on which you transfer the property given up in the trade, or
 - b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See Related Party Transactions, later in this chapter.

Partly nontaxable exchange. If you receive cash or unlike property in addition to like property, and the above six conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Like property and money transferred. If all of the above conditions (1) - (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

Basis of property received. To figure the basis of the property received, see Nontaxable Exchanges in Chapter 1.

How to report. You must report the trade of like property on Form 8824. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of (Form 1040) or on Form 4797, Sales of Business Property, whichever applies.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Corporate reorganizations. In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the

corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you may have to attach to your return a complete statement of all facts pertinent to the exchange.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues designated by the Secretary of the Treasury, with no gain or loss recognized on the trade.

TRANSFERS BETWEEN SPOUSES

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply if property is transferred in trust and liability exceeds basis. Gains must be recognized to the extent the amount of the liabilities assumed by the trust, plus any liabilities on the property, exceed the adjusted basis of the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

RELATED PARTY TRANSACTIONS

Special rules apply to the sale or trade of property between related parties.

Gain on sale or trade of depreciable property. Your gain from the sale or exchange of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See Like-kind exchanges earlier under Nontaxable Trades.

This rule also applies to trades of property between related parties, defined next under Losses on sales or trades of property. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

Losses on sales or trades of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties.

1. Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
2. A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
3. A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock.

4. A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules.

If you sell or trade at a loss property that you acquired from a related party, you cannot recognize the loss that was not allowed to the related party.

Example 1

Your brother sells you stock for \$7,600. His cost basis is \$10,000. Your brother cannot deduct the loss of \$2,400. Later, you sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900. Your reportable gain is \$500 – the \$2,900 gain minus the \$2,400 loss not allowed to your brother.

Example 2

If, in Example 1, you sold the stock for \$6,900 instead of \$10,500, your recognized loss is only \$700 (your \$7,600 basis minus \$6,900). You cannot deduct the loss that was not allowed to your brother.

III. Capital Gains And Losses

This section discusses the tax treatment of gains and losses from different types of investment transactions.

Character of gain or loss. You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short-term or long-term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify any unrecaptured section 1250 gain.

The correct classification and identification helps you figure the limit on capital losses and the correct tax on capital gains.

CAPITAL OR ORDINARY GAIN OR LOSS

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

CAPITAL ASSETS

For the most part, everything you own and use for personal purposes, pleasure, or investment is a capital asset. Some examples are:

- Stocks or bonds held in your personal account,

- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

Investment Property

Investment property is a capital asset. Any gain or loss from its sale or trade is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer.

Personal Use Property

Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue. Acquisition discount is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue. However, to the extent you previously included the discount in income, you do not have to include it in income again.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Market discount bonds. If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. The rest of the gain is capital gain.

Retirement of debt instrument. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a bank, credit union, or other financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss (for example, as a nonbusiness bad debt (short-term capital loss)).

Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

LOSSES ON SECTION 1244 (SMALL BUSINESS STOCK)

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of section 1244 stock. Report an ordinary loss from the sale, exchange, or worthlessness of section 1244 stock on Form 4797. However, if the total loss is more than the maximum amount that can be treated as an ordinary loss, also report the transaction on Form 8949. See the instructions for Forms 4797 and 8949.

Any gain on section 1244 stock is a capital gain if the stock is a capital asset in your hands. Report the gain on Form 8949.

HOLDING PERIOD

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

Long term or short term. If you hold investment property more than 1 year, any capital gain or loss is a long-term capital gain or loss. If you hold the property 1 year or less, any capital gain or loss is a short-term capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

Example

If you bought investment property on February 5, 2020, and sold it on February 5, 2021, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2021, your holding period is more than 1 year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.

Example

You are a cash method, calendar year taxpayer. You sold stock at a gain on December 30, 2021. According to the rules of the stock exchange, the sale was closed by delivery of the stock and payment of the sale price in January 2022. Report your gain on your 2021 return, even though you received the payment in 2022. The gain is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 30.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. Generally, if you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Stock dividends. The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

NONBUSINESS BAD DEBTS

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Generally, nonbusiness bad debts are bad debts that you did not get in the course of operating your trade or business and are deductible as short-term capital losses. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it – that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (as most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

WASH SALES

You cannot deduct losses from sales or trades of stock or securities in a wash sale.

A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

1. Buy substantially identical stock or securities,
2. Acquire substantially identical stock or securities in a fully taxable trade,
3. Acquire a contract or option to buy substantially identical stock or securities, or
4. Acquire substantially identical stock for your individual retirement account (IRA) or Roth IRA.

If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities (except (4) above). The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. Your holding period for the new stock or securities includes the holding period of the stock or securities sold.

CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Generally, no gain or loss is recognized on the transfer of property from an individual to a spouse. In the case of divorce, such a transfer generally must occur within what time period:

- A. 3 months of the final divorce date
- B. 1 year of the final divorce date
- C. 2 years of the final divorce date
- D. 3 years of the final divorce date

2. To be deductible, a nonbusiness bad debt must meet all of the following conditions except:

- A. it must be totally worthless
- B. the owner must have a cost basis in the debt
- C. the debt did not arise from running your trade or business
- D. the debt must be less than \$10,000

CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

- A. Incorrect. Transfers within three months of the final divorce date is not correct.
- B. **CORRECT**. The transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient
- C. Incorrect. Transfers within two years of the final divorce date is a longer period of time than allowed.
- D. Incorrect. Transfers within three years of the final divorce date is a longer period of time than allowed.

2.

- A. Incorrect. To be deductible, a nonbusiness bad debt must be totally worthless in order to make a claim.
- B. Incorrect. A nonbusiness bad debt must originally have had a cost basis.
- C. Incorrect. To be a nonbusiness deduction, it cannot arise from the operation of a trade or business.

- D. **CORRECT**. A limit to the amount of debt is not a condition required for the deductibility of a nonbusiness bad debt. There is not a fixed amount requirement.

Chapter 3: Selling Your Home

Chapter Objective

After completing this chapter, you should be able to:

- Identify the special tax rules related to selling your home.

I. Important Information

Exclusion of forgiven mortgage debt from income. The exclusion of income for mortgage debt canceled or forgiven has been extended through 2025.

II. Introduction

This chapter explains the tax rules that apply when you sell your main home. In most cases, your main home is the one in which you live most of the time.

If you sold your main home in 2021, you may be able to exclude from income any gain up to a limit of \$250,000 (\$500,000 on a joint return in most cases). See *Excluding the Gain*, later. Generally, if you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Form 8949 and Schedule D (Form 1040). You may also have to complete Form 4797, *Sales of Business Property*. See *Reporting the Sale*, later.

If you have a loss on the sale, you cannot deduct it on your return. However, you may need to report it.

The following are main topics in this chapter.

- Figuring gain or loss.
- Basis.
- Excluding the gain.
- Ownership and use tests.
- Reporting the sale.

III. Main Home

Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land. However, if you sell vacant land used as part of your main home and that is adjacent to it, you may be able to exclude the gain from the sale under certain circumstances.

Example

You buy a piece of land and move your main home to it. Then you sell the land on which your main home was located. This sale is not considered a sale of your main home, and you cannot exclude any gain on the sale of the land.

More than one home. If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income the gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time during the year.

Example 1

You own two homes, one in New York and one in Florida. From 2017 through 2021, you live in the New York home for 7 months and in the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York home is your main home. You would be eligible to exclude the gain from the sale of the New York home but not of the Florida home in 2021.

Example 2

You own a house, but you live in another house that you rent. The rented house is your main home.

Property used partly as your main home. If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see Business Use or Rental of Home, later.

IV. Figuring Gain Or Loss

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get your gain or loss.

SELLING PRICE

The selling price is the total amount you receive for your home. It includes money and the fair market value of any other property or any services you receive and all notes, mortgages, or other debts assumed by the buyer as part of the sale.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do not include the payment as part of the selling price. Your employer will include it in box 1 of your Form W-2 and you will include it in your gross income as wages on Form 1040 or 1040-SR, line 1.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on Schedule 1 (Form 1040), line 8.

Form 1099-S. If you received Form 1099-S, Proceeds From Real Estate Transactions, box 2 (Gross proceeds) should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked to indicate your receipt (or expected receipt) of these items.

AMOUNT REALIZED

The amount realized is the selling price minus selling expenses.

Selling expenses. Selling expenses include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or “points.”

ADJUSTED BASIS

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis must be determined before you can figure gain or loss on the sale of your home. For information on how to figure your home's adjusted basis, see Determining Basis later.

AMOUNT OF GAIN OR LOSS

To figure the amount of gain or loss, compare the amount realized to the adjusted basis.

Gain on sale. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, in most cases is taxable.

Loss on sale. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of your main home cannot be deducted.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

DISPOSITIONS OTHER THAN SALES

Trading (exchanging) homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example

You owned and lived in a home that had an adjusted basis of \$41,000. A real estate dealer accepted your old home as a trade-in and allowed you \$50,000 toward a new home priced at \$80,000. This is treated as a sale of your old home for \$50,000 with a gain of \$9,000 (\$50,000 - \$41,000).

If the dealer had allowed you \$27,000 and assumed your unpaid mortgage of \$23,000 on your old home, your sales price would still be \$50,000 (the \$27,000 trade-in allowed plus the \$23,000 mortgage assumed).

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a disposition.

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if you receive cash or other consideration for the home. As a result, the rules in this chapter do not apply.

DETERMINING BASIS

You need to know your basis in your home to determine any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Generally, your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.), your basis is generally either its fair market value when you received it or the adjusted basis of the previous owner.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's adjusted basis, which is used to figure gain or loss on the sale of your home. See Adjusted Basis, later.

Cost as Basis

The cost of property is the amount you pay for it in cash, debt obligations, other property, or services.

Purchase. If you bought your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. In most cases, your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home. If you build, or contract to build, a new home, your purchase price can include costs of construction.

Settlement fees or closing costs. When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs you paid for buying the home, but not the fees and costs for getting a mortgage loan. A fee paid for buying the home is any fee you would have had to pay even if you paid cash for the home (that is without the need for financing).

Adjusted Basis

Adjusted basis is your cost or other basis increased or decreased by certain amounts.

Increases to basis. These include any:

- Additions and other improvements that have a useful life of more than 1 year.
- Special assessments for local improvements.
- Amounts you spent after a casualty to restore damaged property.

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

Example

Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a garage, is also an improvement.

Repairs. These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Example

Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Decreases to basis. These include the following:

- The amount of qualified principal residence indebtedness that has been excluded from income for discharges before January 1, 2026, or was subject to an arrangement that was entered into and evidenced in writing before January 1, 2026.
- Some or all of the cancellation of debt income that was excluded due to your bankruptcy or insolvency.
- Gain you postponed from the sale of a previous home before May 7, 1997.
- Deductible casualty losses.
- Insurance payments you received or expect to receive for casualty losses.
- Payments you received for granting an easement or right-of-way.
- Depreciation allowed or allowable if you used your home for business or rental purposes.
- Adoption credit you claimed for improvements added to the basis of your home.
- Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home.
- Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.
- General sales taxes (beginning in 2004) claimed as an itemized deduction on Schedule A (Form 1040) that were imposed on the purchase of personal property, such as a houseboat used as your home or a mobile home.

V. Excluding The Gain

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under Maximum Exclusion, next. To qualify, you must meet the ownership and use tests described later. You can choose not to take the exclusion. In that case, you must include in gross income your entire gain in the year of sale.

MAXIMUM EXCLUSION

You can exclude up to \$250,000 of the gain (other than gain allocated to periods of nonqualified use) on the sale of your main home if all of the following are true.

1. You meet the ownership test.
2. You meet the use test.
3. During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home.

You may be able to exclude up to \$500,000 of the gain (other than gain allocated to periods of nonqualified use) on the sale of your main home if you are married and file a joint return and meet the requirements listed in the discussion of the special rules for joint returns, later, under Married Persons.

OWNERSHIP AND USE TESTS

To claim the exclusion, you must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, you must have:

1. Owned the home for at least 2 years (the ownership test), and
2. Lived in the home as your main home for at least 2 years (the use test).

Exception

If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. However, the maximum amount you may be able to exclude will be reduced. See Reduced Maximum Exclusion, later.

Period of Ownership and Use

The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous, nor do they both have to occur at the same time.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365×2) during the 5-year period ending on the date of sale.

Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent the property during the absences, are counted as periods of use.

Example

Professor Paul Beard, who is single, bought and moved into a house on August 19, 2018. He lived in it as his main home continuously until January 5, 2020, when he went abroad for a 1-year sabbatical leave. On February 5, 2021, 1 month after returning from leave, he sold the house at a gain. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, because he did not use the residence for the required 2 years.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example

Beginning in 2010, Helen Jones lived in a rented apartment. The apartment building was later converted to condominiums, and she bought her same apartment on December 2, 2018. In 2019, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 7, 2021, while still living in her daughter's home, she sold her condominium.

Helen can exclude gain on the sale of her condominium because she met the ownership and use tests during the 5-year period from July 8, 2016 to July 7, 2021 (more than 2 years). She owned her condominium from December 2, 2018, to July 7, 2021 (over 2 years). She lived in the property from July 8, 2016 (the beginning of the 5-year period), to April 14, 2019 (over 2 years).

The time Helen lived in her daughter's home during the 5-year period can be counted toward her period of ownership, and the time she lived in her rented apartment during the 5-year period can be counted toward her period of use.

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

1. Owned the stock for at least 2 years, and
2. Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the use test if:

1. You become physically or mentally unable to care for yourself, and
2. You owned and lived in your home as your main home for a total of at least 1 year during the 5-year period before the sale of your home.

Under this exception, you are considered to live in your home during any time within the 5-year period that you own the home and live in a facility (including a nursing home) licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale and one spouse meets the ownership and use test, you can exclude up to \$250,000 of the gain. (But see Special rules for joint returns, next.)

Special rules for joint returns. You can exclude up to \$500,000 of the gain on the sale of your main home if all of the following are true.

- You are married and file a joint return for the year.
- Either you or your spouse meets the ownership test.
- Both you and your spouse meet the use test.
- During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

If either spouse does not satisfy all these requirements, the maximum exclusion that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

Example 1

One spouse sells a home. Emily sells her home in June 2021 for a gain of \$300,000. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to

\$250,000 of gain on a separate or joint return for 2021. The \$500,000 maximum exclusion for certain joint filers does not apply because Jamie does not meet the use test.

Example 2

Each spouse sells a home. The facts are the same as in Example 1 except that Jamie also sells a home in 2021 for a gain of \$200,000 before he marries Emily. He meets the ownership and use tests on his home, but Emily does not. Emily can exclude up to \$250,000 of gain and Jamie can exclude \$200,000 of the gain on the respective sales of their individual homes. However, Emily cannot use Jamie's unused exclusion to exclude more than \$250,000 of gain. Therefore, Emily and Jamie must recognize \$50,000 of gain on the sale of Emily's home. The \$500,000 maximum exclusion for certain joint returns does not apply because Emily and Jamie do not jointly meet the use test for the same home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

1. You owned it, and
2. Your spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

REDUCED MAXIMUM EXCLUSION

If you fail to meet the requirements to qualify for the \$250,000 or \$500,000 exclusion, you may still qualify for a reduced exclusion. This applies to those who:

- Fail to meet the ownership and use tests, or
- Have used the exclusion within 2 years of selling their current home.

In both cases, to qualify for a reduced exclusion, the sale of your main home must be due to one of the following reasons.

- A change in place of employment.
- Health.
- Unforeseen circumstances.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you could not reasonably have anticipated before buying and occupying your main home.

VI. Business Use Or Rental Of Home

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1

On May 24, 2015, Amy, who is single for all years in this example, bought a house. She moved in on that date and lived in it until May 31, 2017, when she moved out of the house and put it up for rent. The house was rented from June 1, 2017 to March 31, 2019. Amy claimed depreciation deductions in 2017 through 2019 totaling \$10,000. Amy moved back into the house on April 1, 2019, and lived there until she sold it on January 28, 2021 for a gain of \$200,000. During the 5-year period ending on the date of the sale (January 29, 2016 - January 28, 2021), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five Year Period	Used as Home	Used as Rental
1/29/16 – 5/31/17	16 months	
6/1/17 – 3/31/19		22 months

4/1/19 – 1/28/21	<u>22 months</u>	
	38 months	<u>22 months</u>

Next, Amy must figure how much of her gain is allocated to qualified use.

During the period Amy owned the house (2,076 days), her period of nonqualified use was 670 days. Amy divides 670 by 2,076 and obtains a decimal (rounded to at least three decimal places) of 0.323. To figure her gain attributable to the period of nonqualified use, she multiplies \$190,000 (the gain not attributable to the \$10,000 depreciation deduction) by 0.323. Because the gain attributable to periods of nonqualified use is \$61,370, Amy can exclude \$128,630 of her gain.

Example 2

William owned and used a house as his main home from 2015 through 2018. On January 1, 2019, he moved to another state. He rented his house from that date until April 29, 2021, when he sold it. During the 5-year period ending on the date of sale (April 30, 2016 - April 29, 2021), William owned and lived in the house for more than 2 years. He must report the sale on Form 4797 because it was rental property at the time of sale. Because the period of nonqualified use does not include any part of the 5-year period after the last day William lived in the house, he has no period of nonqualified use. Because he met the ownership and use tests, he can exclude gain up to \$250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed or could have claimed for renting the house, as explained next.

Depreciation after May 6, 1997. If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed as a deduction for periods after May 6, 1997. If you can show by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, then you may limit the amount of gain recognized to the depreciation allowed.

VII. Reporting The Sale

Do not report the 2021 sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it,
- You have a gain and you choose not to exclude it, or
- You received Form 1099-S.

If any of these conditions apply, report the entire gain. For details on how to report the gain, see the Instructions for Schedule D (Form 1040) and the Instructions for Form 8949.

If you used the home for business or to produce rental income, you may have to use Form 4797 to report the sale of the business or rental part (or the sale of the entire property if used entirely for business or rental).

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called “installment sales.” If you finance the buyer’s purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, Installment Sale Income, to report the sale. Enter your exclusion on line 15 of Form 6252.

CHAPTER 3: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. To figure the gain or loss on the sale of your main home, you must know all of the following except:

- A. selling price
- B. age of the home
- C. amount realized
- D. adjusted basis

2. To qualify for the maximum exclusion on the sale of your main home, the required years to meet the ownership and use tests must be continuous.

- A. true
- B. false

CHAPTER 3: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

- A. Incorrect. The selling price is the amount you received for your home.
- B. **CORRECT**. The age of the home does not have any impact on the gain or loss calculation of the sale of a home.
- C. Incorrect. The amount realized is the selling price less the selling expenses.
- D. Incorrect. The adjusted basis is your original basis (determined when you got the home) increased or decreased by certain amounts.

2.

- A. Incorrect. You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days during the 5-year period ending on the date of sale.
- B. **CORRECT**. Not only do the 2 of 5 years not have to be continuous, they do not have to occur at the same time.

Chapter 4: Reporting Gains And Losses

Chapter Objective

After completing this chapter, you should be able to:

- Recall the capital gain rates for the current year.

I. Important Information

Reporting of deferred gain from sale or exchange of QOF investment. If you sold or exchanged your investment in a QOF and you need to report the gain previously deferred, you will need to report the gain on Form 8949. See the instructions for Form 8949 for more information.

II. Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Form 8949 and Schedule D (Form 1040). The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers, and
- How to figure your tax on a net capital gain.

III. Reporting Capital Gains And Losses

Generally, report capital gains and losses on Form 8949. Complete Form 8949 before you complete line 1b, 2, 3, 8b, 9, or 10 of Schedule D (Form 1040).

Use Form 8949 to report:

- The sale or exchange of a capital asset not reported on another form or schedule,
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit,
- Nonbusiness bad debts,
- Securities that become worthless,
- The election to defer capital gains invested in a QOF, and
- The dispositions of interests in QOFs.

Use Schedule D (Form 1040) to report:

- Overall gain or loss from transactions reported on Form 8949;
- Certain transactions you do not have to report on Form 8949;
- Gain from Form 2439 or 6252 or Part I of Form 4797;
- Gain or loss from Form 4684, 6781, or 8824;
- Gain or loss from a partnership, S corporation, estate, or trust;
- Capital gain distributions not reported directly on your Form 1040 or 1040-SR; and
- Capital loss carryover from the previous year to the current year.

On Form 8949, enter all sales and exchanges of capital assets, including stocks, bonds, etc., and real estate (if not reported on Form 4684, 4797, 6252, 6781, 8824 or line 1a or 8a of Schedule D (Form 1040)). Include these transactions even if you did not receive a Form 1099-B or 1099-S for the transaction. Report short-term gains or losses in Part I. Report long-term gains or losses in Part II. Use as many Forms 8949 as you need.

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on Form 8582. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its instructions for more information about reporting capital gains and losses from a passive activity.

Sale expenses. On Form 8949, include in column (g) any expense of sale, such as broker's fees, commissions, state and local transfer taxes, and option premiums, unless you reported the net sales price in column (d). If you include an expense of sale in column (g), enter "E" in column (f).

For more information about adjustments to basis, see Chapter 1.

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Form 8949.

You combine your share of short-term capital gains or losses from partnerships, S corporations, estates, and trusts, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on Schedule D (Form 1040), line 7.

Long-term gains and losses. A capital gain or loss on the sale or trade of property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Form 8949.

Beginning in 2018, the long-term holding period for certain gains with respect to "applicable partnership interests" is more than 3 years.

You also report the following in Part II of Schedule D (Form 1040):

1. Undistributed long-term capital gains from a mutual fund (or other regulated investment company) or real estate investment trust (REIT),
2. Your share of long-term capital gains or losses from partnerships, S corporations, estates, and trusts,
3. All capital gain distributions from mutual funds and REITs not reported directly on Form 1040 or 1040-SR, line 7, and
4. Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss on Schedule D (Form 1040), line 15.

CAPITAL LOSSES

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on Form 1040 or 1040-SR, line 7, in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D (Form 1040), is the lesser of:

1. \$3,000 (\$1,500 if you are married and file a separate return), or
2. Your total net loss as shown on Schedule D (Form 1040).

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit.

Capital loss carryover. If you have a total net loss on Schedule D (Form 1040), line 16 that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it, and whether or not you filed a return for the current year.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1. Your allowable capital loss deduction for the year, or
2. Your taxable income increased by your allowable capital loss deduction for the year.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the Capital Loss Carryover Worksheet in the Schedule D (Form 1040) instructions to determine the part of your capital losses that you can carry over.

Example

Bob and Gloria sold securities in 2021. The sales resulted in a capital loss of \$7,000. They had no other capital transactions. Their taxable income was \$26,000. On their joint 2021 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 - \$3,000), can be carried over to 2022.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

Decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

CAPITAL GAIN TAX RATES

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

For 2021, the maximum capital gain rates are 0%, 15%, 20%, 25%, or 28%.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the Schedule D Tax Worksheet or the Qualified Dividends and Capital Gain Tax Worksheet.

Tax computation using maximum capital gains rates. Use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet (whichever applies) to figure your tax if you have qualified dividends or net capital gain. You have net capital gain if Schedule D (Form 1040), lines 15 and 16, are both gains.

CHAPTER 4: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. What is the maximum amount of a capital loss, in excess of that year's capital gain, that a married couple (filing jointly) can deduct:

- A. \$1,500
- B. \$3,000
- C. \$6,000
- D. unlimited

CHAPTER 4: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.

- A. Incorrect. The maximum capital loss deduction is greater than \$1,500.
- B. **CORRECT**. The maximum capital loss deduction is \$3,000 (\$1,500 if married and file separate returns).
- C. Incorrect. Any amounts greater than \$3,000 can be carried over to future tax years.
- D. Incorrect. The capital loss deduction is not unlimited in any one year.

PART FOUR: ADJUSTMENTS TO INCOME

The four chapters in this part discuss some of the adjustments to income that you can deduct in figuring your adjusted gross income. These chapters cover:

- Contributions you make to traditional and Roth individual retirement arrangements (IRAs),
- Alimony you pay,
- Student loan interest you pay, and
- Business expenses you pay as an Armed Forces reservist, a performing artist, or a fee-basis government official.

GLOSSARY

401(k) plan. A deferred compensation plan, authorized by Section 401(k) of the Internal Revenue Code, under which a percentage of an employee's salary is withheld and placed in a savings account or the company's profit-sharing plan. Income accumulates on the deferred amount until withdrawn by the employee at age 59½ or when the employee retires or leaves the company.

Accelerated cost recovery system (ACRS). A statutory method of depreciation allowing accelerated rates for most types of property used in business and income-producing activities during the years 1981 through 1986. It has been superseded by the modified accelerated cost recovery system (MACRS) for assets placed in service after 1986.

Accelerated death benefit. Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death.

Accelerated depreciation. A method of depreciation that allows a person to deduct the cost of property more rapidly than straight-line depreciation. Accelerated depreciation rates are included in ACRS rates and most Modified Accelerated Cost Recovery System (MACRS) rates if a person wants to use them.

Accountable plan. An employer's plan for reimbursing employees for business – related expenses, under which the employees are required to substantiate each business expense to the employer and return any reimbursement in excess of the substantiated expenses. Reimbursements received under an accountable plan are generally excluded from wages and are not subject to employment taxes.

Accrual method. A business method of accounting requiring income to be reported when earned and expenses to be deducted when incurred. However, deductions generally may not be claimed until economic performance has occurred.

Acquisition debt. Debt used to buy, build, or construct a principal residence or second home and that generally qualifies for a full interest expense deduction.

Active participation. The level of activity necessary to claim rental losses up to \$25,000 from real estate rental activities.

Adjusted basis. A statutory term describing the cost used to determine your profit or loss from a sale or exchange of property. It is generally your original cost, increased by capital improvements, and decreased by depreciation, depletion, and other capital write-offs.

Adjusted gross income (AGI). Important tax term representing gross income less allowable adjustments, such as IRA, alimony, and Keogh deductions. AGI determines whether various tax benefits are phased out, such as, itemized deductions and the rental loss allowance. Also see modified adjusted gross income (MAGI).

Administrator. Person who is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. The administrator will have to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.

Alimony. Payments made to a separated or divorced spouse as required by a decree or agreement. Alternate payee. The recipient of qualified retirement benefits under a court order, judgment, decree, or approved property settlement constituting a qualified domestic relations order.

Alternative Depreciation System (ADS). A way of depreciating assets using the straight-line depreciation method and longer recovery period than are available under MACRS. Mandatory for such items as foreign assets, luxury automobiles, and tax-exempt use property.

Alternative Minimum Tax (AMT). A tax that may apply in lieu of income tax when a taxpayer has tax preference items or certain deductions allowed in determining regular taxable income.

Amended return. Filed on Form 1040X within a three-year period to correct a mistake made on an original or previously amended return.

American Opportunity credit. The maximum credit is generally \$2,500 per student, and it is allowed for the first four years of post-secondary education. The phaseout of the credit applies if modified

adjusted gross income is between \$80,000 and \$90,000, or between \$160,000 and \$180,000 on a joint return.

Amortization. A deductible expense allowed as a means of recovering the investment in an intangible asset. Compare with depreciation.

Amount realized. The fair market value of property, including money (at face value), received in a sale or an exchange.

Amount recognized. The amount of gain reportable and subject to tax. On certain tax-free exchanges of property, gain is not recognized in the year it is realized.

Annual gift tax exclusion. An exclusion that applies to gifts of present interests on a per donee basis.

Annualized rate. A rate for a period of less than a year computed as though for a full year.

Annuity. A sum of money paid periodically that includes the return of the invested capital plus income generated by it. An annuity is frequently purchased by an individual for investment purposes and is used by retirement plans to pay pensions.

Applicable federal rate. Interest rate fixed by the Treasury for determining imputed interest on transactions providing for below-market interest.

Archer Medical Savings Account (MSA). A type of medical plan combining high deductible medical insurance protection with an IRA-type savings account fund to pay unreimbursed medical expenses.

Assessment. The IRS action of fixing tax liability that sets in motion collection procedures, such as charging interest, imposing penalties, and, if necessary, seizing property.

At-risk limitations. Generally, partnership losses are deductible up to the amount you have a risk in the activity. The amount at risk is your basis in the activity and any amounts borrowed for use in the activity for which you are personally liable.

At-risk rules. Rules limiting loss deductions to cash investments and personal liability notes. An exception for real estate treats certain nonrecourse commercial loans as amounts “at risk.”

Audit. An IRS examination of your tax return, generally limited to a three-year period after you file.

Average cost method. A method of figuring the basis of shares in mutual funds for purposes of determining gain or loss on the sale of less than one’s entire holdings in a fund.

Bad debt. An amount owed you representing a cash outlay or an item already included in income that you are unable to collect.

Basis. Generally, the amount paid for property or the cost of an asset. Needed to figure gain or loss on a sale.

Below market loans. Demand loans on which interest is payable at a rate below the applicable federal rate or term loans where the amount loaned exceeds the present value of all payments due under the loan (using a discount rate equal to the applicable federal rate).

Cafeteria plan. A plan that allows employees to choose between cash and certain qualified benefits.

Calendar year. A year that begins on January 1st and ends on December 31st . Most individual taxpayers are required to file their returns on the basis of such a year. Compare to fiscal year.

Cancellation of debt. Release of a debt without consideration by a creditor. Cancellations of debts are generally taxable.

Capital asset. In general, property held for personal purposes or investment, rather than for business purposes. Property subject to capital gain or loss treatment. Almost all assets you own are considered capital assets except for certain business assets or works you created.

Capital expenses. Costs that are not currently deductible and that are added to the basis of property. A capital expense generally increases the value of property. When added to depreciable property, the cost is deductible over the life of the asset.

Capital gain dividend (capital gain distribution). A distribution to shareholders in a mutual fund of a capital gain realized by the fund on the sale of a part of its investment portfolio.

Capital gain or loss. A gain or loss arising from the sale or exchange of capital assets. Computed by comparing the amount realized on the sale or exchange of an asset with the adjusted basis of the asset.

Capital loss carryover. The excess of capital losses over capital gains that cannot be deducted in a particular year and must be carried over to the succeeding year.

Capitalization. Adding a cost or expense to the basis of the property.

Carryback. A tax technique for receiving a refund of back taxes by applying a deduction or credit from a current tax year to a prior tax year.

Carryforward. A tax technique of applying a loss or credit from a current year to a later year. For example, a business net operating loss may be carried forward indefinitely.

Cash method. Reporting income when actually or constructively received and deducting expenses when paid. Certain businesses may not use the cash method.

Casualty loss. Loss from an unforeseen and sudden event that is deductible, subject to a 10% income floor and \$100 reduction for losses attributable to a federally declared disaster.

Charitable contributions. An itemized deduction is allowed for donations to qualifying charities. For property donations, the deductible amount depends on the type of property and donee organization, the holding period, and in some cases how the property is used.

Child and dependent care credit. A credit of up to 30% based on certain care expenses incurred that allow the taxpayer to work.

Child support. Payments to support a minor child generally to a custodial parent under a divorce or separation decree or agreement. The payments cannot be deducted from gross income and are not taxable to the recipient parent. Starting in 1985, the parent with custody of the child is generally entitled to claim the dependent unless such a right is expressly waived.

Child tax credit. For tax years beginning after 1997, a tax credit is allowed against income with respect to each qualifying child for taxpayers with modified adjusted gross income below certain thresholds.

Community income. Income earned by persons domiciled in community property states and treated as belonging equally to husband and wife.

Community property. Property that belongs equally to husband and wife. This concept of property ownership is currently used in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Condemnation. The seizure of property by a public authority for a public purpose. Tax on gain realized on many conversions may be deferred.

Constructive receipt. Income you are taxed on because it was made available to you to draw on, even if it has not yet been physically transferred to you.

Coverdell Education Savings Account. A special account set up to fund education expenses of a student.

Credit. A tax credit directly reduces tax liability, as opposed to a deduction that reduces income subject to tax.

Declining balance depreciation. A method of accelerated depreciation by which each year's depreciation is a percentage of the reduced basis of the asset.

Deductions. Items directly reducing income. Personal deductions such as for mortgage interest, state and local taxes, and charitable contributions are allowed only if deductions are itemized on Schedule A, but deductions such as for certain alimony, capital losses, business losses, student loan interest, and IRA and Keogh deductions are deducted from gross income even if itemized deductions are not claimed.

Deferred compensation. A portion of earnings withheld by an employer or put into a retirement plan for distribution to the employee at a later date. If certain legal requirements are met, the deferred amount is not taxable until actually paid, for example, after retirement.

Deferred gain. A gain realized but not recognized as taxable income until a later time.

Deficiency. The excess of the tax assessed by the IRS over the amount reported on your return.

Defined benefit plan. A retirement plan that pays fixed benefits based on actuarial projections.

Defined contribution plan. A retirement plan that pays benefits based on contributions to individual accounts, plus accumulated earnings. Contributions are generally based on a percentage of salary or earned income.

Dependent. A person supported by another person.

Depletion. A deductible expense that reflects the decrease of a depletable natural resource, such as oil and gas, as it is extracted.

Depreciable property. A business or income-production asset with a useful life exceeding one year.

Depreciation. Writing off the cost of depreciable property over a period of years, usually its class life or recovery period specified in the tax law.

Depreciation recapture. An amount of gain on the sale of certain depreciable property that is treated as ordinary income in the case of personal property. Recapture is computed on Form 4797.

Designated beneficiary. A person, trust, tax-exempt organization or estate named to receive qualified plan benefits or IRAs after a taxpayer's death. In some cases, the designated beneficiary enables a taxpayer to figure required minimum distributions over joint lives (or joint life expectancy).

Direct rollover. An eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee.

Disaster losses. Casualty losses, such as from a storm, in areas declared by the President to warrant federal assistance. An election may be made to deduct the loss in the year before the loss or the year of the loss.

Dividend. A distribution made by a corporation to its shareholders generally of company earnings or surplus. Most dividends are taxable but exceptions do exist.

Domicile. The place that an individual intends to be his or her permanent residence.

Dual-status alien. An individual who is a nonresident alien for part of the year and a resident alien or U.S. citizen for the rest of the year.

Earned income. Compensation for performing personal services. You must have earned income for a deductible IRA, or to claim the earned income credit. Earned income does not include amounts received from an annuity or a pension.

Earned income credit. A credit allowed to taxpayers with earned income or adjusted gross income (AGI) below certain thresholds.

Education credits. There are two education credits: the American opportunity credit and the lifetime learning credit.

Education savings account. A trust or custodial account created for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account.

Electronic Federal Tax Payment System (EFTPS). A tax deposit method using electronic transfers of funds from bank accounts that must be used by certain businesses with substantial employment tax liability.

Eligible retirement plan. A qualified retirement plan, an individual retirement account, or an individual retirement annuity.

Estate tax. A tax imposed on the value of a decedent's taxable estate, after deductions and credits.

Estimated tax. Advance payment of current tax liability based either on wage withholdings or installment payments of your estimated tax liability. To avoid penalties, you generally must pay to the IRS either 90% of your final tax liability, or either 100% or 110% of the prior year's tax liability, depending on your adjusted gross income.

Exclusion. An amount that is excluded from gross income.

Executor. Person named in the decedent's will to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.

Fair market value (FMV). What a willing buyer would pay to a willing seller when neither is under any compulsion to buy or sell.

Fiduciary. A person or corporation such as a trustee, executor, or guardian who manages property for another person.

Flexible spending arrangements (FSAs). A salary reduction plan that allows employees to pay for enhanced medical coverage or dependent care expenses on a tax-free basis.

Foreign earned income exclusion. Foreign earned income exempt from tax if a foreign residence or physical presence test is met.

Foreign tax credit. A credit allowed for income taxes paid to a foreign tax jurisdiction (e.g., a foreign country) to mitigate double taxation.

Gift tax. Gifts in excess of a \$15,000 per donee annual exclusion are subject to gift tax, but the tax may be offset by a unified gift and estate tax credit.

Gross income. The total amount of income received from all sources before exclusions and deductions.

Gross receipts. Total business receipts reported on Schedule C before deducting adjustments for returns and allowances and costs of goods sold.

Group-term life insurance. Employees are not taxed on up to \$50,000 of group-term coverage.

Head of household. A taxpayer who is unmarried and pays more than 50% of the cost of maintaining a residence for the entire year for a qualifying individual. If you are a head of household, you qualify for special tax rates.

Holding period. The length of time an asset is held. The holding period of a capital asset determines whether a sale or an exchange results in a long-term or a short-term capital gain or loss.

Home equity debt. Debt secured by a principal residence or second home to the extent of the excess of fair market value over acquisition debt.

Home sale exclusion. The tax-free amount of gain on the sale of a principal residence where certain ownership and use tests are satisfied.

Imputed interest. Interest deemed to have been earned or charged on a debt if the stated interest rate is below the rate set by law.

Incentive stock option. A type of stock option that can be received and exercised without recognition of income until the option stock is sold, if certain statutory requirements are met.

Income in respect of a decedent. Income earned by a person before death but taxable to an estate or heir who receives it.

Income shifting. A strategy to direct income to a taxpayer in a lower tax bracket to produce an overall tax savings for both parties involved in the shift.

Independent contractor. One who controls his or her own work and reports as a self-employed person.

Individual retirement account (IRA). A retirement account to which a specific amount may be contributed annually, but deductions for the contribution are restricted if you are covered by a company retirement plan. Earnings accumulate tax free.

Innocent spouse relief. Reduction or forgiveness of joint and several liability for the tax on a joint return for the requesting spouse who meets certain requirements.

Installment sale. A sale of property that allows for tax deferment if at least one payment is received after the end of the tax year in which the sale occurs. The installment method does not apply to year-end sales of publicly traded securities. Dealers may not use the installment method. Investors with very large installment balances could face a special tax.

Intangible assets. Intangible assets that come within Section 197, such as goodwill, are amortizable over a 15-year period.

Internal Revenue Service. The division of the U.S. Treasury Department that is responsible for the enforcement of the tax laws.

Investment interest. Interest on debt used to carry investments, but not including interest expenses from a passive activity. Deductions are limited to net investment income.

Involuntary conversion. Forced disposition of property due to condemnation, theft, or casualty. Upon conversion, you usually receive cash through insurance proceeds or condemnation awards. Tax on gain from involuntary conversion may be deferred if replacement property is purchased.

Itemized deductions. Items, such as interest, state and local taxes, charitable contributions, and medical deductions, claimed on Schedule A for Form 1040. Itemized deductions are subtracted from adjusted gross income to arrive at taxable income.

Joint return. A return filed by a married couple reporting their combined income and deductions. Joint return status provides tax savings to many couples.

Joint tenants. Ownership of property by two persons. When one dies, the decedent's interest passes to the survivor.

Keogh plan. Retirement plan set up by a self-employed person that provides tax-deductible contributions, tax-free income accumulations until withdrawal, and favorable averaging for qualifying lump-sum distributions.

Kiddie tax. The tax on the investment income in excess of \$2,200 (2021) of a dependent child, based on the parent's marginal tax rate and computed on Form 8615.

Legally separated. A husband and wife who are required to live apart from each other by the terms of a decree of separate maintenance. Payments under the decree are deductible by the payor and taxable to the payee as alimony.

Lifetime learning credit. 20% credit for up to \$10,000 of qualified tuition and related expenses for undergraduate or graduate level courses.

Like-kind exchange. An exchange of similar assets used in a business or held for investment on which gain may be deferred.

Long-term capital gain or loss. Gain or loss on the sale or exchange of a capital asset that has been held for a legislatively mandated holding period.

Long-term care. A type of medical care for chronically ill individuals which generally is not covered by Medicare.

Long-term care insurance contract. Insurance contract that only provides coverage for qualified long-term care services.

Lump-sum distribution. Payments within one tax year of the entire amount due to a participant in a qualified retirement plan. Qualifying lump-sums may be directly rolled over tax free, or, in some cases, are eligible for current tax under a favorable averaging method.

Marginal tax rate. The tax rate at which each additional dollar of income over a specified ceiling is taxed.

Marital deduction. An estate tax and gift tax deduction for assets passing to a spouse. It allows estate and gift transfers completely free of tax.

Market discount. The difference between face value of bond and lower market price, attributable to rising interest rates. On a sale, gain on the bond is generally taxed as ordinary income to the extent of the discount.

Material participation. The level of participation required to deduct losses from trade or business activities otherwise subject to the passive activity loss limitations.

Miscellaneous itemized deductions. A class of itemized deductions (e.g., investment expenses, fee for tax advice, union dues) that previously were deductible to the extent that the total exceeded 2% of adjusted gross income.

Modified ACRS (MACRS). Depreciation methods applied to assets placed in service after 1986.

Modified adjusted gross income (MAGI). This is generally adjusted gross income increased by certain items such as tax-free foreign earned income. MAGI usually is used to determine phaseouts of certain deductions and credits.

Mortgage interest. Fully deductible interest on up to two residences if acquisition debt secured by a home up to certain limits of indebtedness.

Mutual fund. A company that is in the business of investing its shareholder's funds, usually in stocks or bonds; sometimes known as a regulated investment company.

Net operating loss. A loss taken in a period where a company's allowable tax deductions are greater than its taxable income. When more expenses than revenues are incurred during the period, the net operating loss for the company can generally be used to recover past tax payments.

Nonperiodic distributions. A 20% withholding rule applies to nonperiodic distributions, such as lump-sum distributions, paid directly to employees from an employer plan.

Nonqualified stock option. A type of stock option that when exercised creates ordinary income for the taxpayer.

Nonrecourse financing. Debt on which a person is not personally liable. In case of non-payment, the creditor must foreclose on property securing the debt. At-risk rules generally bar losses where there is nonrecourse financing, but an exception applies to certain nonrecourse financing for real estate.

Nonresident alien. A person who is not a United States citizen or a permanent resident. Tax is generally limited to income from U.S.

Nontaxable exchange. An exchange of property in which no gain or loss is recognized for tax purposes.

Offers in compromise. Arrangements in which the IRS agrees to accept less than full payment of taxes because it realizes that full payment may never be made.

Ordinary gain or loss. A gain or loss other than a capital gain or loss.

Ordinary income. Income that does not arise from the sale or exchange of a capital asset or a Section 1231 asset and is not subject to any preferential tax treatment.

Ordinary loss. A loss other than a capital loss.

Original issue discount (OID). The difference between the face value of a bond and its original issue price. OID is reported on an annual basis as interest income.

Owner-employee. An employee who is the proprietor of a business. Also, a partner who owns more than 10% of either the capital or the profit interest in a partnership.

Partnership. An unincorporated business or income-producing entity organized by two or more persons. A partnership is not subject to tax but passes through to the partners all income, deductions, and credits, according to the terms of the partnership agreement.

Passive activity loss. A loss from a trade or a business in which the taxpayer is not a material participant. Passive activity losses are subject to deduction limitations. Passive activities include rental activities and investments in limited partnerships.

Pension. Payments to employees from an employer-funded retirement plan for past services.

Percentage depletion. A method of calculating depletion that applies a fixed percentage to the gross income generated by the mineral property.

Personal interest. Tax term for interest on personal loans and consumer purchases. Such interest is not deductible.

Personal-use property. Property that is not held for investment or use in a trade or a business.

Placed in service. The time when a depreciable asset is ready to be used. The date fixes the beginning of the depreciation period.

Points. Certain charges paid by a borrower, calculated as a percentage of the loan proceeds; each point is 1%. They are also called loan origination fees, maximum loan charges, or premium charges. Depending on the type of loan, points may be currently deductible or amortized over the life of the loan.

Premature distributions. Withdrawals before age 59½ from qualified retirement plans are subject to penalties unless specific exceptions are met.

Profit-sharing plan. A defined contribution plan under which the amount contributed to the employee's accounts is based on a percentage of the employer's profits.

Proprietor. An individual who is the sole owner of his or her trade or business.

Qualified business income deduction. For taxable years beginning after December 31, 2017, taxpayers other than corporations may be entitled to a deduction of up to 20 percent of their qualified business income from a qualified trade or business under the Tax Cuts and Jobs Act. This deduction can be taken in addition to the standard or itemized deductions. The deduction is subject to multiple limitations based on the type of trade or business, the taxpayer's taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by the trade or business. Notwithstanding these limitations, however, taxpayers with qualified business income (which does not include income from performing services as an employee) and with taxable income under \$164,900 (2021) or \$329,800 (2021) for joint returns, will generally be eligible for the deduction.

Qualified charitable organization. A nonprofit philanthropic organization specifically approved by the U.S. Treasury as a recipient of charitable contributions that are deductible for tax purposes.

Qualified domestic relations order (QDRO). A court order, judgment, decree or approved property agreement which specifies the amount of qualified plan benefits to be paid to an alternate payee and which are not taxable to the plan participant.

Qualified improvement property. As of the TCJA, a combination of previously identified qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Qualified plan. An employee benefit plan established by an employer that meets certain requirements and therefore qualifies for certain tax benefits.

Qualified tuition programs. State-sponsored plans to allow for higher education savings on a tax-advantaged basis. While there is no federal tax deduction for contributions to these programs, states may provide a deduction from state income tax.

Qualifying widow or widower. A filing status entitling the taxpayer with dependents to use joint tax rates for up to two tax years after the death of a spouse.

Real estate professionals. Taxpayers who are exempt from the passive activity loss limitations because of their level of involvement with real estate activities.

Real property (real estate). Physical property that is permanent and nonmovable in nature. Two examples are land and buildings.

Realized gain or loss. The difference between the amount you are entitled to receive on a sale or exchange of property and the adjusted basis of the property.

Recognized gain or loss. The amount of gain or loss to be reported on a tax return. Gain may not be recognized on certain exchanges of property.

Refundable tax credit. A credit that entitles you to a refund even if you owe no tax for the year. Regulated investment company. An investment company subject to Security and Exchange

Commission regulations. If the investment company distributes its income to its shareholders, it does not pay any taxes.

Remainder interest. An interest in property or a trust that is left after the income beneficiaries have received their income interest.

Required minimum distributions. Distributions from qualified plans and IRAs that generally must commence at age 72 to avoid a 50% penalty.

Resident alien. An individual who is not a citizen of the United States but is a permanent resident of the United States.

Residential rental property. Real property in which 80% or more of the gross income is from dwelling units. Under MACRS, depreciation is claimed over 27.5 years under the straight-line methods.

Return of capital. A distribution of your investment that is not subject to tax unless the distribution exceeds your investment.

Rollover. A distribution from a qualified plan that is reinvested tax-free in another qualified plan or IRA within 60 days of the date of receipt.

Roth IRA. Contributions to a Roth IRA are nondeductible, and, if certain specified conditions are met, distributions are tax free. The contribution may be limited by certain threshold amounts.

Royalty income. Income received for the use of certain kinds of property (e.g., mineral and literary properties, patents).

Salvage value. The estimated value of an asset at the end of its useful life. Salvage value is ignored by ACRS and MACRS rules.

Scholarships. Grants to degree candidates receive tax-free treatment if awarded after August 16, 1986 and used for tuition and course-related expenses, but not room and board.

Section 1231 assets. Generally, depreciable assets used in a trade or a business and held for the required long-term holding period. Net gains from the sale or exchange of Section 1231 assets (after recapture of depreciation), are treated as capital gains; net losses are treated as ordinary losses.

Section 179 expensing. Allows a taxpayer to elect to deduct the cost of certain types of property on their income taxes as an expense, rather than requiring the cost of the property to be capitalized and depreciated.

Section 457 plan. Deferred compensation plan set up by a state or local government, or tax-exempt organization, which allows tax-free deferrals of salary.

Section 529 plans. Qualified tuition plans set up by states or private institutions as either prepaid tuition plans or savings-type plans. While contributions are not deductible for federal income tax purposes, distributions used to pay qualified higher education costs are tax free.

Self-employed person. An individual who operates a business or profession as a proprietor or independent contractor and reports self-employment income on Schedule C.

Self-employment tax. Tax paid by self-employed persons to finance Social Security coverage.

Separate maintenance payments. Payments made from one spouse to another when they are living apart. The payments are made in accordance with a court order or an agreement between the parties.

Separate return. Return filed by a married person who does not file a joint return. Filing separately may save taxes where each spouse has separate deductions, but certain tax benefits require a joint return.

Short-term capital gain or loss. A gain or loss on the sale or exchange of a capital asset that has been held for less than the legislatively mandated holding period.

SIMPLE plans. Qualified retirement plans restricted to small employers that can be either SIMPLE IRAs or SIMPLE 401(k) plans. These plans have easy nondiscrimination rules and no heavy reporting requirements.

Simplified Employee Pension (SEP). IRA-type plan set up by an employer, rather than the employee. Single. The filing status of an individual who is not married on December 31 of the year for which a return is filed.

Standard deduction. A deduction used to reduce income by taxpayers who do not itemize their deductions. The amount of the deduction depends on ones filing status, whether they are 65 or older or blind, and whether they can be claimed as a dependent on another taxpayer's return. Adjusted annually for inflation since 1989.

Standard mileage rate. An IRS-approved optional amount used to claim a deduction for business transportation expenses in lieu of deducting actual expenses (not including parking, tolls, interest, and taxes).

Statute of limitations. The time period within which the IRS can assess and collect taxes and taxpayers can file for refunds.

Statutory employees. Certain employees, such as full-time life insurance salesperson, who may report income and deductions on Schedule C.

Stock dividend. A distribution of additional shares of a corporation's stock to its shareholders.

Stock option. A right to buy stock at a fixed price.

Straight-line depreciation. A method of depreciation in which the cost or other basis of the asset is deducted in equal amounts over the property's useful life.

Sum of the years' digits depreciation. A method of accelerated depreciation that is based on a formula developed from the expected useful life of the property.

Support. Payments made for the care and maintenance of a dependent. Expenditures for support include payments for food, lodging, medical expenses and so on.

Tax attributes. When debts are canceled in bankruptcy cases, the canceled amount is excluded from gross income. Tax attributes are certain losses, credits, and property basis that must be reduced to the extent of the exclusion.

Tax credit carryforward (or carryover). Tax credit that you were unable to use to reduce previous year's tax and that can be applied to offset future tax.

Tax deferral. Shifting income to a later year, such as where you defer taxable interest to the following year by purchasing a T-bill or savings certificate maturing after the end of the current year. Investments in qualified retirement plans provide tax deferral.

Tax preference items. Items that may subject a taxpayer to the alternative minimum tax (AMT). Two examples are accelerated depreciation of real property and percentage depletion.

Tax year. A period (generally 12 months) for reporting income and expenses.

Taxable income. Net income after claiming all deductions from gross income and adjusted gross income, such as IRA deductions, itemized deductions, or the standard deduction.

Taxpayer identification number. For an individual, his or her social security number; for businesses, fiduciaries, and other non-individual taxpayers, the employer identification number.

Tax-exempt income. Income that is not subject to federal income tax. An example is income for state and municipal bonds.

Tax-sheltered annuity. A type of retirement annuity offered to employees of charitable organizations and educational systems, generally funded by employee salary-reduction contributions.

Trade date. The date on which a purchase or sale of securities occurs. The trade date is used in determining the holding period of a security.

Trust. An arrangement under which one person transfers legal ownership of assets to another person or corporation (the trustee) for the benefit of one or more third persons (beneficiaries).

Undistributed capital gains. Capital gains that investors in mutual funds must report but for which they can claim a tax credit for their share of tax paid by the fund.

Useful life. For property not depreciated under ACRS and MACRS, the estimate of time in which a depreciable asset will be used.

Wash sales. Sales on which losses are disallowed because you recover your market position within a 61-day period.

Withholding. An amount taken from income as pre-payment of an individual's tax liability for the year. In the case of wages, the employer withholds part of every wage payment. Backup withholding from dividend or interest income is required if you do not provide the payer with a correct taxpayer identification number. Withholding on pensions and IRAs is automatic unless you elect to waive withholding.

FINAL EXAM

Capital Gains and Losses

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account online and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. To figure the basis of property a taxpayer receives as a gift, the taxpayer must know each of the following except:

- A. the property's adjusted basis to the donor just before it was gifted
- B. the property's fair market value at the time it was given
- C. any gift tax paid on the property
- D. how long the donor owned the property before gifting it

2. When property is converted from personal use to business use, what is the basis for depreciation:

- A. the fair market value of the property on the date of the change
- B. your adjusted basis on the date of the change
- C. the lesser of A or B above
- D. the greater of A or B above

3. In order for a trade to be nontaxable, it must meet six conditions. Which of the following is not one of these conditions:

- A. the property must be business or investment property
- B. the property must be held primarily for sale
- C. the property must be identified within 45 days after the date the property was given up in the trade
- D. there must be a trade of like property

4. No gain or loss is recognized on the transfer of property from an individual to a spouse or former spouse (if incident to divorce), unless which of the following is true:

- A. the spouse is a nonresident alien
- B. the spouse is over age 72
- C. the spouse earns over \$100,000 in the taxable year
- D. the spouse has been married to the transferor less than 3 years

5. To be deductible, which of the following must be true of a nonbusiness bad debt:

- A. it must be totally worthless
- B. it must be greater than \$500
- C. it must have had a basis of \$0
- D. it must have not been in your income

6. A wash sale occurs when a taxpayer sells or trades stock or securities at a loss and within how many days before or after that sale the taxpayer buys substantially identical stocks or securities:

- A. 10 days
- B. 15 days
- C. 30 days
- D. 45 days

7. When calculating the amount realized on the sale of a home, you can subtract all of the following from the selling price except:

- A. the cost of the land
- B. loan charges paid by the seller
- C. advertising fees
- D. commissions

8. Married persons filing a joint return can exclude up to how much if one of them meets the ownership test, they both meet the use test, and during the 2-year period ending on the date of sale, neither spouse excluded gain from the sale of another home:

- A. \$0
- B. \$250,000
- C. \$500,000
- D. \$1,000,000

9. How long must a capital asset be held for a capital gain or loss to be considered long term:

- A. 30 days
- B. 180 days
- C. more than 1 year
- D. more than 2 years

10. What is the lowest possible capital gain tax rate for 2021:

- A. 0%
- B. 10%
- C. 15%
- D. 28%