**Chapter 7**

**Investments**

**SOLUTIONS MANUAL**

**Discussion Questions**

1. [LO 1] Describe how interest income and dividend income are taxed. What are the similarities and differences in their tax treatment?

*Because they are cash method taxpayers, individual investors typically are taxed on interest and dividends when they receive them. However, interest income is taxed using ordinary rates while qualified dividends are taxed at lower capital gains rates.*

1. [LO 1] What is the underlying policy rationale for the current tax rules applicable to interest income and dividend income?

*Interest and dividends are typically taxed annually when received because taxpayers have the wherewithal to pay the tax at that time. Interest income is taxed at ordinary rates because it is viewed as a less risky type of income compared to forms of income such as the expected appreciation in capital assets. Qualified dividends are taxed at capital gains rates to mitigate the effect of double taxation on corporate earnings.*

1. [LO 1] Compare and contrast the tax treatment of interest from a Treasury bond and qualified dividends from corporate stock.

*For cash method taxpayers, both the interest from Treasury bonds and dividends are taxed in the year they are received. However, interest is taxed using ordinary rates while qualified dividends are taxed at lower capital gains rates. An additional difference between these types of income relates to their state income tax treatment. The interest from Treasury bonds is exempt from state income taxes while dividends are subject to state income taxes.*

1. [LO 1] How are Treasury notes and Treasury bonds treated for federal and state income tax purposes?

*Generally, interest from Treasury bonds and notes is taxed annually as it is received at ordinary rates for federal income tax purposes. However, interest from Treasury bonds and Treasury notes is exempt from state income taxes.*

*Treasury bonds and Treasury notes are issued at maturity value, at a discount, or at a premium, depending on prevailing interest rates. Treasury bonds and Treasury notes pay a stated rate of interest semiannually. When Treasury bonds and Treasury notes are either issued or subsequently purchased at either a premium or discount, special rules apply. Specifically, taxpayers may elect to amortize the premium to reduce the amount of interest currently reported. To the extent taxpayers amortize the premium, they reduce the tax basis in the related bond or note. If a portion of the premium is unamortized (either because the election to amortize the premium was not made or because the bond is sold prior to maturity), the unamortized premium remains part of the tax basis of the bond or note and affects the amount of capital gain or loss taxpayers recognize when the bond or note is sold or when it matures.*

*Original issue discount must be amortized and included in gross income in addition to any interest payments taxpayers actually receive. Also, the tax basis of a bond or note is increased by the amount of original issue discount amortized into income. In contrast, market discount is not amortized into income unless taxpayers elect to do so. Rather, the market discount that would have been amortized into income (on an annual basis using a straight-line method) if the taxpayer had elected to amortize the market discount into income is treated as ordinary income when the bond or note is sold or when it matures.*

1. [LO 1] Why would taxpayers generally prefer the tax treatment of market discount to the treatment of original issue discount on corporate bonds?

*Taxpayers generally would prefer market discount to original issue discount on bonds because the ordinary income related to market discount is deferred until bonds are sold or until they mature. In contrast, taxpayers must report ordinary income from the amortization of original issue discount yearly until the bonds are sold or until they mature.*

1. [LO 1] In what ways are U.S. savings bonds treated more favorably for tax purposes than corporate bonds?

*U.S. Savings Bonds compare favorably with corporate bonds because any interest related to the original issue discount on savings bonds is deferred until the savings bonds are cashed in. In comparison, any original issue discount on corporate bonds must be amortized and included in the investor’s annual tax returns.*

*Also, interest from savings bonds used to pay for qualifying educational expenses may be excluded entirely from income whereas interest from corporate bonds must eventually be reported.*

1. [LO 1] {Research, Planning} When should investors consider making an election to amortize market discount on a bond into income annually? *[Hint: see §1278(b)]*

*A taxpayer may elect under §1278(b) to amortize market discount on a bond into income currently (as ordinary income) rather than wait to recognize the accrued market discount as ordinary income when the bond is sold or matures.*

*Generally, this election makes sense when the taxpayer’s current marginal tax rate is expected to be significantly lower than the future marginal rate when the bond is sold or matures.*

1. [LO 1] Why might investors purchase interest-paying securities rather than dividend- paying stocks?

*Non-tax considerations may play a role. For example, investors may be willing to give up the tax rate benefit from receiving qualified dividend income in exchange for the certainty of receiving predicable interest payments. In addition, risk preferences might cause investors to prefer one investment over another. FDIC insurance guarantees the security of an investment in savings accounts and certificates of deposit up to a threshold amount; whereas, no guarantees exist for stock investments.*

1. [LO 1] Compare and contrast the tax treatment of dividend-paying stocks and growth stocks.

*Qualified dividends from dividend paying stocks and long-term capital gains from growth stocks are both taxed at favorable capital gains rates. However, dividends are taxed when received in contrast to the appreciation in growth stocks, which is taxed only when growth stocks are sold. All else equal, growth stocks will have a higher after-tax rate of return because the tax is deferred into the future while dividend paying stocks are taxed annually.*

1. [LO 2] What is the definition of a capital asset? Give three examples of capital assets.

*In general, a capital asset is any asset other than an asset used in a trade or business (i.e., equipment, buildings, inventory, etc.), or accounts or notes receivable generated from the sale of services or property by a trade or business.*

*Also, any property that is used for personal rather than business purposes is a capital asset. Examples of capital assets include investment assets such as corporate or governmental bonds, corporate stock, stocks in mutual funds, and land held for investment. Personal assets such as automobiles, personal residences, golf clubs, book collections, and televisions are also capital assets.*

1. [LO 2] Why does the tax law allow a taxpayer to defer gains accrued on a capital asset until the taxpayer actually sells the asset?

*Taxpayers are allowed to defer accrued gains on capital assets until the date of sale because the investment doesn’t provide the wherewithal (i.e., cash) to pay the tax on the accrued gains until after it is sold. When the taxpayer sells the asset, the investment should provide the cash necessary to pay the taxes due on the gain.*

1. [LO 2] Why does the tax law provide preferential rates on certain capital gains?

*Preferential tax rates apply to gains on the sale of certain capital assets (e.g., capital assets held for more than one year). Among other things, these preferential rates are meant to encourage taxpayers to invest in those assets and to hold those assets for the long term. The government believes this will help the national economy by stimulating the demand for risky investments.*

1. [LO 2] What is the deciding factor in determining whether a capital gain is a short-term or long-term capital gain?

*The deciding factor is the amount of time an asset has been held by the taxpayer. When a capital asset that has been held for more than one year is sold, it generates a long-term capital gain. When it has been held for one year or less it generates a short-term capital gain when sold.*

1. [LO 2] What methods may taxpayers use to determine the adjusted basis of stock they have sold?

*Taxpayers can use the FIFO method to determine basis in the stock. That is, the first stock purchased (i.e., the stock the taxpayer has held for the longest time) is treated as though it is the first stock sold. Taxpayers can also use the specific identification method of determining the basis of the stock sold.*

1. [LO 2] What tax rate applies to net short-term capital gains?

*Net short-term capital gains are taxed at the taxpayer’s ordinary tax rates.*

1. [LO 2] What limitations are placed on the deductibility of capital losses for individual taxpayers?

*Individual taxpayers with a net capital loss for the year may deduct up to $3,000 of the capital loss against ordinary income. Taxpayers can deduct up to $3,000 ($1,500 if married filing separately) of net capital losses against ordinary income. Net capital losses in excess of $3,000 ($1,500 if married filing separately) retain their short or long-term character and are carried forward.*

1. [LO 2] What happens to capital losses that are not deductible in the current year?

*Individual capital losses that are not deducted in the current year are carried forward indefinitely and treated as though they were incurred in the subsequent year.*

1. [LO 2] Are all long-term capital gains taxable at the same maximum rate? If not, what rates may apply to long-term capital gains?

*Long-term capital gains may be taxed at one of five different rates (0, 15, 20, 25, or 28 percent). Unrecaptured §1250 gains from the sale of depreciable real estate investments are taxed at a 25 percent maximum rate and gains from collectibles held for more than one year are taxed at a 28 percent maximum rate. The remaining long-term capital gains are taxed at 0, 15, or 20 percent depending on the taxpayer’s filing status and taxable income as follows:*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Preferential Tax Rates** | **Taxable Income by Filing Status** | | | |
|  | **Married Filing Joint** | **Married Filing Separate** | **Single** | **Head of Household** |
| 0% | 0 - $77,200 | 0 - $38,600 | 0 - $38,600 | 0 - $51,700 |
| 15% | $77,201 - $479,000 | $38,601 - $239,500 | $38,601 - $425,800 | $51,701 - $452,400 |
| 20% | $479,000+ | $239,500+ | $425,801+ | $452,401+ |

1. [LO 2] {Planning}This year, David, a taxpayer in the highest tax rate bracket, has the option to purchase either stock in a Fortune 500 company or qualified small business stock in his friend’s corporation. All else equal, which of the two will he prefer from a tax perspective if he intends to hold the stock for six years? Which would he prefer if he only plans to hold the stock for two years?

*If David holds the stock in his friend’s corporation for more than five years, 100 percent of his gain will be excluded. In contrast, gains from the sale of stock in the Fortune 500 company would be taxed at the prevailing maximum capital gains rate (maximum of 20 percent currently). Thus, David would prefer to purchase stock in his friend’s corporation if taxes are the only consideration.*

*If the stocks are only held for two years, the stock in his friend’s corporation would not be treated as qualified small business stock and he would be indifferent, from a tax perspective, between purchasing the two stocks.*

1. [LO 2] What is a “wash sale”? What is the purpose of the wash sale tax rules?

*A wash sale is a tax term that applies to transactions in which a taxpayer purchases the same stock or “substantially identical” stock to the stock they sold at a loss within a 61-day period centered on the date of the sale.*

*A wash sale occurs when an investor sells or trades stock or securities at a loss and within 30 days either before or after the day of sale buys substantially identical stocks or securities. Because the day of sale is included, the 30 days before and after period creates a 61-day window during which the wash sale provisions may apply.*

*The purpose of the wash sale tax rules is to prevent taxpayers from accelerating losses on securities that have declined in value without actually changing their investment in the securities. The 61-day period ensures that taxpayers cannot deduct losses from stock sales while essentially continuing their investment in the stock.*

1. [LO 2] Nick does not use his car for business purposes. If he sells his car for less than he paid for it, does he get to deduct the loss for tax purposes? Why or why not?

*Personal-use of assets falls within the category of capital assets. When a taxpayer sells a personal-use asset, the gain from the sale of the personal-use asset is taxable even though it was not purchased for its appreciation potential. If a taxpayer sells a car for less than he paid for it, the loss from the sale of the personal-use asset is not deductible, and therefore never becomes part of the netting process.*

*Hence losses recognized on assets used for personal purposes are not deductible. However, if Nick sold the car for more than he purchased it, he would be taxed on the capital gain.*

1. [LO 2] {Planning} Describe three basic tax planning strategies available to taxpayers investing in capital assets.

*When a taxpayer holds capital assets for more than one year before selling, she is actually utilizing two basic strategies. First, she defers recognizing capital gains thereby reducing the present value of the capital gains tax due when the asset is sold. Second, by converting the capital gain into a long-term capital gain, the gain is taxed at a preferential maximum tax rate of 0/15/20 percent (depending on her income) instead of her ordinary rate.*

*A third strategy is to sell investments with built-in losses. Selling loss assets reduces taxes by providing up to a $3,000 deduction against ordinary income and by reducing the amount of capital gains that would otherwise be subject to tax during the year. This is particularly beneficial for a taxpayer with short-term capital gains that would be taxed at high ordinary rates absent offsetting capital losses.*

1. [LO 2] {Planning} Clark owns stock in BCS Corporation that he purchased in January of the current year. The stock has appreciated significantly during the year. It is now December of the current year, and Clark is deciding whether or not he should sell the stock. What tax and nontax factors should Clark consider before making the decision on whether to sell the stock now?

*Tax factors:*

*Clark should consider the rate at which the gain will be taxed. If he sells the stock in December of the current year, the gain is a short-term gain that will likely be taxed at his marginal ordinary income rate. If he waits until he has held the stock for more than a year, the gain will be taxed at a maximum of 0/15/20 percent (depending on his filing status and income).*

*Clark should also assess his other capital gains and losses incurred during the year. The gain he recognizes on the sale will enter the netting process. Thus, if he has a large short-term capital loss, he may want to sell the stock this year to absorb the loss.*

*Nontax factors:*

*If Clark decides to hold the stock, there is risk that the value will decline. Likewise, the stock may appreciate in value if Clark decides to wait to sell. Clark should assess his risk of loss and appreciation potential of the stock before selling.*

1. [LO 3] Are dividends and capital gains considered to be investment income for purposes of determining the amount of a taxpayer’s deductible investment interest expense for the year?

*Long-term capital gains and dividends that qualify for the preferential 20 percent (or lower) tax rate are not considered to be investment income for purposes of determining the investment interest expense deduction unless the taxpayer makes an election to tax this income at ordinary rates. If the taxpayer makes this election, the dividends and long-term capital gains count as investment income for this purpose. Dividends and capital gains that are not eligible for the preferential rate are included in investment income in determining the deductibility of investment interest expense.*

1. [LO 3] How is the amount of net investment income determined for a taxpayer?

*Net investment income is gross investment income minus deductible investment expenses. Because investment expenses are not deductible (beginning in 2018), net investment income is essentially equivalent to gross investment income.*

1. [LO 3] What limitations are placed on the deductibility of investment interest expense? What happens to investment interest expense that is not deductible because of the limitations?

*Investment interest expense is deductible, as an itemized deduction, to the extent of net investment income. Net investment income is equivalent to gross investment income because investment expenses are not deductible after 2017. Investment interest expense that is not deductible because of the net investment income limitation is carried forward and treated as though it is incurred in the next year. Unused investment interest expense can be carried forward indefinitely.*

1. [LO 3] When taxpayers borrow money to buy municipal bonds, are they allowed to deduct interest expense on the loan? Why or why not?

*Interest expense incurred on loans used to purchase municipal bonds is not deductible. The interest income from the municipal bonds is not included in income; therefore, the interest expense incurred to produce the tax-exempt income is not deductible.*

1. [LO 3] What types of losses may potentially be characterized as passive losses?

*Losses from limited partnerships, and from rental activities, including rental real estate, are generally considered passive losses. In addition, losses from any other activity involving the conduct of a trade or business in which the taxpayer does not materially participate are also treated as passive losses. Material participation is defined as “regular, continuous, and substantial.”*

1. [LO 4] What are the implications of treating losses as passive?  
     
   *Passive losses may not be used to offset portfolio income or active income. Passive losses can only be used to offset passive income. Passive losses that are limited will be suspended until taxpayers have passive income or until the activity producing the passive loss is sold.*
2. [LO 4]Discuss the treatment of suspended passive losses upon the sale of a passive activity?  
     
   *The passive loss rules limit the deductibility of passive losses to passive income until the activity is sold. When the passive activity is disposed of, the taxpayer may use the related suspended passive losses to offset any gain from the sale of the activity, passive income from other activities, and then to reduce nonpassive income. The losses allowed at the time of the disposition of an activity may be further limited by the excess business loss rules as discussed in the Individual Deductions chapter.*
3. [LO 4] What tests are applied to determine if losses should be characterized as passive?

*In general, losses from trade or business activities are passive unless individuals are material participants in the activity. Regulations provide seven separate tests for material participation, and individuals can be classified as material participants by meeting any one of the seven tests. The seven tests are as follows:*

|  |
| --- |
| *1. The individual participates in the activity more than 500 hours during the year.* |
| *2. The individual’s activity constitutes substantially all of the participation in such activity by the individuals including non-owners.* |
| *3. The individual participates more than 100 hours during the year, and the individual’s participation is not less than any other individual’s participation in the activity.* |
| *4. The activity qualifies as a “significant participation activity” (more than 100 hours* *spent during the year) and the aggregate of all “significant participation activities” is greater than 500 hours for the year.* |
| *5. The individual materially participated in the activity for any five of the preceding 10 taxable years.* |
| *6. The individual materially participated for any three preceding years in any personal service activity (personal services in health, law, accounting, architecture, etc.)* |
| *7. Taking into account all the facts and circumstances, the individual participates on a regular, continuous, and substantial basis during the year.* |

1. [LO 4] {Planning} All else being equal, would a taxpayer with passive losses prefer to have wage income or passive income?

*A taxpayer in this situation would prefer passive income because the taxpayer’s passive losses could be applied currently against the passive income to reduce the amount of tax paid currently. If the taxpayer had received wage income, the passive losses would have been suspended, and the tax benefits associated with the passive losses would be deferred.*

**Problems**

1. [LO 1] Matt recently deposited $20,000 in a savings account paying a guaranteed interest rate of 4 percent for the next 10 years. If Matt expects his marginal tax rate to be 22 percent for the next 10 years, how much interest will he earn after-tax for the first year of his investment? How much interest will he earn after-tax for the second year of his investment if he withdraws enough cash every year to pay the tax on the interest he earns? How much will he have in the account after four years? How much will he have in the account after seven years?

*After one year, Matt will have earned $624 or $20,000 x .04(1-.22) after tax. In the second year, Matt will earn $643 after tax or $20,624 x .04(1-.22) after tax. After four years, Matt will have $22,615 or $20,000 x (1 + .04(1-.22))4 in the savings account. After seven years, Matt will have $24,799 or $20,000 x (1 + .04(1-.22))7 in the savings account.*

1. [LO 1] Dana intends to invest $30,000 in either a Treasury bond or a corporate bond. The Treasury bond yields 5 percent before tax and the corporate bond yields 6 percent before tax. Assuming Dana’s federal marginal rate is 24 percent and her marginal state rate is 5 percent which of the two options should she choose? If she were to move to another state where her marginal state rate would be 10 percent, would her choice be any different? Assume that Dana itemizes deductions.

*When the state rate is 5 percent, Dana would achieve the following returns from the Treasury bond or the corporate bond:*

*The Treasury bond yields $1,140 or $30,000 x [.05 × (1-.24)] after tax. The corporate bond yields $1,300 or $30,000 x [.06 × (1 - .24 - .05(1-.24))] after tax. Note that the actual state rate is reduced by 24 percent to allow for the deductibility of state income taxes on the federal income tax return. Thus, she should choose the corporate bond.*

*When the state rate is 10 percent, Dana would achieve the following returns from the Treasury bond or the corporate bond:*

*The Treasury bond would still yield $1,140 or $30,000 x [.05 × (1-.24)] after tax because state rates don’t affect after- tax returns from Treasury bonds. The corporate bond yields $1,231 or $30,000 x [.06 x (1 - .24 - .10(1-.24))] after tax. Again, note that the actual state rate is reduced by 24 percent to allow for the deductibility of state income taxes on the federal income tax return. If Dana’s state tax rate increases to 10 percent, corporate bonds are still superior to Treasury bonds.*

1. [LO 1] At the beginning of his current tax year David invests $12,000 in original issue U.S. Treasury bonds with a $10,000 face value that mature in exactly 10 years. David receives $700 in interest ($350 every six months) from the Treasury bonds during the current year and the yield to maturity on the bonds is 5 percent.

a. How much interest income will he report this year if he elects to amortize the bond premium?

b. How much interest will he report this year if he does not elect to amortize the bond premium?

* 1. *If David elects to amortize the $2,000 bond premium, he will use the constant yield method (similar to the effective interest method used to amortize bond premium under GAAP) to amortize the bond premium semiannually. Ultimately, he will report $599 of interest income from the bond. The amortization table below reflects the required calculations:*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| ***Column 1***  *Semiannual Period* | ***Column 2***  *Adjusted Basis of Bond at Beginning of Semiannual Period* | ***Column 3***  *Interest Received* | ***Column 4***  *Premium Amortization*  *(Column 3 – Column 5)* | ***Column 5***  *Reported Interest*  *(Column 2 x .05 x .5)* |
| *1* | *$12,000* | *$350* | *$50* | *$300* |
| *2* | *$11,950* | *$350* | *$51* | *$299* |
| *Yearly Total* |  | *$700* | *$101* | *$599* |

* 1. *If David does not elect to amortize the bond, he will simply report the entire $700 payment he receives as interest income for the year.*

1. [LO 1] Seth invested $20,000 in Series EE savings bonds on April 1. By December 31, the published redemption value of the bonds had increased to $20,700. How much interest income will Seth report from the savings bonds in the current year absent any special election?

*Seth will not report any interest income from the EE savings bonds currently unless he elects to have the increase in redemption value taxed currently.*

1. [LO 1] At the beginning of her current tax year, Angela purchased a zero-coupon corporate bond at original issue for $30,000 with a yield to maturity of 6 percent. Given that she will not actually receive any interest payments until the bond matures in 10 years, how much interest income will she report this year assuming semiannual compounding of interest?

*Angela would recognize $1,827 of interest income from OID calculated as follows:*

*$30,000 x .06 × ½ = $900*

*$30,900 x .06 × ½ = 927*

*Total $1,827*

1. [LO 1] At the beginning of his current tax year, Eric bought a corporate bond with a maturity value of $50,000 from the secondary market for $45,000. The bond has a stated annual interest rate of 5 percent payable on June 30 and December 31, and it matures in five years on December 31. Absent any special tax elections, how much interest income will Eric report from the bond this year and in the year the bond matures?

*Accrued market discount on bonds is reported as interest income when the bonds are sold or mature. Therefore, Eric will only report the interest he actually receives or $2,500 [($50,000 × .025) x 2]. In the year the bond matures, he will again report $2,500 of interest income related to the semiannual interest payments received and an additional $5,000 of interest income related to the market discount on the bonds.*

1. [LO 1] Hayley recently invested $50,000 in a public utility stock paying a 3 percent annual dividend. If Hayley reinvests the annual dividend she receives net of any taxes owed on the dividend, how much will her investment be worth in four years if the dividends paid are qualified dividends? (Hayley’s marginal income tax rate is 32 percent and preferential tax rate is 15 percent.) What will her investment be worth in four years if the dividends are nonqualified?

*If Hayley receives qualified dividends, her annual after-tax rate of return will be 2.55 percent or 3% × (1-.15). On the other hand, if the dividends are nonqualified her annual after-tax rate of return will be 2.04 percent or 3% × (1-.32). As a result, her investment will be worth $55,298 or 50,000 x (1+.0255)4 if the dividends are qualified. Otherwise, her investment will be worth $54,207 or $50,000 × (1+.0204)4.*

1. [LO1] {Planning} Five years ago, Kate purchased a dividend-paying stock for $10,000. For all five years, the stock paid an annual dividend of 4 percent before tax and Kate’s marginal tax rate was 24 percent. Every year Kate reinvested her after-tax dividends in the same stock. For the first two years of her investment, the dividends qualified for the 15 percent capital gains rate; however, for the last three years the 15 percent dividend rate was repealed and dividends were taxed at ordinary rates.

a. What is the current value (at the beginning of year 6) of Kate’s investment assuming the stock has not appreciated in value?

b. What will Kate’s investment be worth three years from now (at the beginning of year 9) assuming her marginal tax rate increases to 35 percent for the next three years?

* 1. *The following formula takes into account the change in dividend tax rates in the last three years of Kate’s investment:*

*$10,000 × (1+ (.04 × (1-.15))) 2 × (1+ (.04 × (1-.24))) 3 = $11,697*

* 1. *$11,697 × (1+ (.04 × (1-.35))) 3 = $12,633*

1. [LO 2] John bought 1,000 shares of Intel stock on October 18, 2014 for $30 per share plus a $750 commission he paid to his broker. On December 12, 2018, he sells the shares for $42.50 per share. He also incurs a $1,000 fee for this transaction.

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

*a. John’s basis in the 1,000 shares of Intel stock is $30,750. This is the purchase price of $30,000 (i.e., 30 × $1,000) plus the $750 commission paid to the broker.*

*b. On the sale, John realizes $41,500. This is the sales price of $42,500 (i.e., 1,000 × $42.50) minus the transaction fee of $1,000.*

*c. John’s gain on the sale is $10,750 which is the amount realized minus his adjusted basis (i.e., $41,500 – 30,750). The gain is a long-term capital gain because John held the stock for more than a year before selling.*

1. [LO 2] Dahlia is in the 32 percent tax rate bracket and has purchased the following shares of Microsoft common stock over the years:

|  |  |  |
| --- | --- | --- |
| **Microsoft common stock** | | |
| Date Purchased | Shares | Basis |
| 7/10/2008 | 400 | $12,000 |
| 4/20/2009 | 300 | $10,750 |
| 1/29/2010 | 500 | $12,230 |
| 11/02/2012 | 250 | $7,300 |

If Dahlia sells 800 shares of Microsoft for $40,000 on December 20, 2018, what is her capital gain or loss in each of the following assumptions?

1. She uses the FIFO method.
2. She uses the specific identification method and she wants to minimize her current year capital gain.

*a. Under the FIFO method, the first 400 shares sold have a $12,000 basis, the next 300 have a $10,750 basis, and the last 100 shares have a basis of $2,446 (100/500 × $12,230) for a total basis of $25,196. The resulting capital gain would be $40,000 less the $25,196 tax basis of the shares sold or $14,804.*

*b. The shares purchased in 2008 cost $30 per share, the shares purchased in 2009 cost $35.83 per share, the shares purchased in 2010 cost $24.46 per share, and the shares purchased in 2012 cost $29.20 per share. To minimize her capital gain, Dahlia should specifically identify the 300 shares purchased in 2009, then the 400 shares purchased in 2008 and then 100 of the shares purchased in 2012. Under the specific identification method, the 300 shares purchased in 2009 have a $10,750 basis, the 400 shares purchased in 2008 have a $12,000 basis, and the 100 shares purchased in 2012 have a basis of $2,920 (100/250 × $7,300) for a total basis of $25,670. The resulting capital gain would be the $40,000 sales proceeds less the $25,670 tax basis of the shares sold or $14,330.*

1. [LO 2] {Research} Karyn loaned $20,000 to her co-worker to begin a new business several years ago. If her co-worker declares bankruptcy on June 22 of the current year, is Karyn allowed to deduct the bad debt loss this year? If she can deduct the loss, what is the character of the loss?

*According to IRC §166 and Publication 550, taxpayers may deduct non-business bad debts in the year the amount of the loss can be determined. Because Karyn will not be able to measure her actual loss until the bankruptcy process is complete, she must wait to deduct her loss until she knows with certainty the amount of her loss.*

1. [LO 2] Sue has 5,000 shares of Sony stock that has an adjusted basis of $27,500. She sold the 5,000 shares of stock for cash of $10,000, and she also received a piece of land as part of the proceeds. The land was valued at $20,000 and had an adjusted basis to the buyer of $12,000. What is Sue’s gain or loss on the sale of 5,000 shares of Sony stock?

*Sue’s gain on the sale is $2,500, which is the amount realized of $30,000 ($10,000+$20,000) less her adjusted basis of $27,500. Note that the value of the land is included in her amount realized along with the cash she received.*

1. [LO 2] Matt and Meg Comer are married and file a joint tax return. They do not have any children. Matt works as a history professor at a local university and earns a salary of $64,000. Meg works part-time at the same university. She earns $31,000 a year. The couple does not itemize deductions. Other than salary, the Comers’ only other source of income is from the disposition of various capital assets (mostly stocks).

a. What is the Comers’ tax liability for 2018 if they report the following capital gains and losses for the year?

Short-term capital gains $9,000

Short-term capital losses ($2,000)

Long-term capital gains $15,000

Long-term capital losses ($6,000)

b. What is the Comers’ tax liability for 2018 if they report the following capital gains and losses for the year?

Short-term capital gains $1,500

Short-term capital losses $0

Long-term capital gains $13,000

Long-term capital losses ($10,000)

1. *Salary $95,000*

*Net short-term capital gain 7,000*

*Net long-term capital gain 9,000*

*AGI $111,000*

*Standard deduction (24,000)*

*Taxable income $87,000*

*Less preferentially taxed income (9,000)*

*Income taxed at ordinary rates $78,000 🡪 tax $8,907 + $132 = $9,039*

*Income subject to capital gains rates $9,000 🡪 tax ($9,000 × 15%) = $1,350*

***Total tax liability = $9,039+ $1,350 = $10,389***

*The Comer’s taxable income of $78,000 before capital gains is above the maximum zero rate amount of $77,200, so their capital gains are taxed at 15 percent.*

1. *Short-term capital gains $1,500*

*Short-term capital losses $0*

*Net short-term capital gain $1,500*

*Long-term capital gains $13,000*

*Long-term capital losses ($10,000)*

*Net long-term capital gains $3,000*

*Salary $95,000*

*Long-term capital gains 3,000*

*Short-term capital gains 1,500*

*AGI $99,500*

*Standard deduction (24,000)*

*Taxable income $75,500*

*Less preferentially taxed income (3,000)*

*Income taxed at ordinary rates $72,500 🡪 tax $1,905 + $6,414 = $8,319*

*Income subject to capital gains rates $3,000 🡪 tax ($3,000 ×0%) = $0*

***Total tax liability = $8,319 + $0 = $8,319***

*The Comer’s taxable income of $72,500 before capital gains is below the maximum zero rate amount of $77,200 by $4,700. As a result, their $3,000 is taxed at zero percent. If the capital gains had been greater than $4,700, the first $4,700 would be taxed at zero percent and the remainder at 15 percent.*

1. [LO 2] Grayson is in the 24 percent tax rate bracket and has the sold the following stocks in 2018:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Date Purchased | Basis | Date Sold | Amount Realized |
| Stock A | 1/23/1994 | $7,250 | 7/22/2018 | $4,500 |
| Stock B | 4/10/2018 | 14,000 | 9/13/2018 | 17,500 |
| Stock C | 8/23/2016 | 10,750 | 10/12/2018 | 15,300 |
| Stock D | 5/19/2008 | 5,230 | 10/12/2018 | 12,400 |
| Stock E | 8/20/2018 | 7,300 | 11/14/2018 | 3,500 |

* 1. What is Grayson’s net short-term capital gain or loss from these transactions?
  2. What is Grayson’s net long-term gain or loss from these transactions?
  3. What is Grayson’s overall net gain or loss from these transactions?
  4. What amount of the gain, if any, is subject to the preferential rate for certain capital gains?

*a. Grayson’s net short-term capital loss is $300, which is the net of the short-term gains and losses for the year. This $300 loss is the short-term capital gain of $3,500 from Stock B (i.e. $17,500 – 14,000) less the short-term capital loss of $3,800 from Stock E (i.e. $3,500 – 7,300).*

*b. Grayson’s net long-term capital gain is $8,970, which is the net long-term gain less the long-term loss for the year. This is the net of the long-term capital gain of $11,720 (i.e. $4,550 from Stock C ($15,300 – 10,750) and $7,170 from Stock D ($12,400 – 5,230)) less the long-term capital loss of $2,750 from Stock A ($4,500 – 7,250).*

*c. Grayson’s net capital gain is $8,670, which is the net short-term loss offset against the net long-term capital gain for the year because the signs are opposite. This $300 short-term capital loss (from part a) is netted against the $8,970 net long-term capital gain (from part b).*

*d. Grayson’s entire net capital gain of $8,670 will be taxed at a preferential 15 percent tax rate because Grayson’s tax bracket of 24 percent puts him above the maximum zero rate amount and below the maximum 15-percent rate amount.*

1. [LO 2] George bought the following amounts of Stock A over the years:

|  |  |  |  |
| --- | --- | --- | --- |
|  | Date Purchased | Number of Shares | Adjusted Basis |
| Stock A | 11/21/1992 | 1,000 | $24,000 |
| Stock A | 3/18/1998 | 500 | 9,000 |
| Stock A | 5/22/2007 | 750 | 27,000 |

On October 12, 2018, he sold 1,200 of his shares of Stock A for $38 per share.

* + 1. How much gain/loss will George have to recognize if he uses the FIFO method of accounting for the shares sold?
    2. How much gain/loss will George have to recognize if he specifically identifies the shares to be sold by telling his broker to sell all 750 shares from the 5/22/2007 purchase and 450 shares from the 11/21/1992 purchase?

*a. George will recognize $18,000 of long-term capital gain. This is the amount realized of $45,600 (i.e. $38 per shares multiplied by 1,200 shares) less the adjusted basis of $27,600. The adjusted basis is calculated under the FIFO method. This means the 1,200 shares sold were the first 1,200 purchased. Therefore the 1,200 sold were the 1,000 shares purchased on 11/21/1992 (basis of $24,000) and 200 of the shares purchased on 3/18/1998 (basis of $3,600 which is calculated by taking the $9,000 total basis divided by 500 shares purchased multiplied by the 200 shares sold).*

*b. George’s long-term capital gain is $7,800. This is the amount realized of $45,600 (i.e. $38 per shares multiplied by 1,200 shares) less the adjusted basis of $37,800. The adjusted basis is calculated under the specific identification method. George identified that the shares sold were the 750 purchased on 5/22/2007 (basis of $27,000) and 450 of the shares purchased on 11/21/1992 (basis of $10,800 or $24,000 total basis divided by 1,000 shares purchased multiplied by the 450 shares sold).*

1. [LO 2] During the current year, Ron and Anne sold the following assets:

|  |  |  |  |
| --- | --- | --- | --- |
| **Capital Asset** | **Market Value** | **Tax**  **Basis** | **Holding Period** |
| L stock | $50,000 | $41,000 | > 1 year |
| M stock | 28,000 | 39,000 | > 1 year |
| N stock | 30,000 | 22,000 | < 1 year |
| O stock | 26,000 | 33,000 | < 1 year |
| Antiques | 7,000 | 4,000 | > 1 year |
| Rental home | 300,000\* | 90,000 | > 1 year |
| \*$30,000 of the gain is 25 percent gain (from accumulated depreciation on the property). | | | |

a. Given that Ron and Anne have taxable income of only $20,000 (all ordinary) before considering the tax effect of their asset sales, what is their gross tax liability for 2018 assuming they file a joint return?

b. Given that Ron and Anne have taxable income of $400,000 (all ordinary) before considering the tax effect of their asset sales, what is their gross tax liability for 2018 assuming they file a joint return?

*a.* *Ron and Anne’s netting process is reflected in the following table:*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| ***Description*** | ***Short-Term*** | ***Long-Term***  ***28%*** | ***Long-Term***  ***25%*** | ***Long-Term***  ***0/15/20%*** |
| *Stock N* | *$8,000* |  |  |  |
| *Stock O* | *$(7,000)* |  |  |  |
| ***Step 1:*** | *$1,000* |  |  |  |
| *Antiques* |  | *$3,000* |  |  |
| *Unrecaptured §1250 Gain* |  |  | *$30,000* |  |
| *Remaining Gain from Rental Property* |  |  |  | *$180,000* |
| *Stock L* |  |  |  | *$9,000* |
| *Stock M* |  |  |  | *$(11,000)* |
| ***Step 2:*** |  |  |  | *$178,000* |
| ***Steps 3(B):*** *Go to step 6* |  |  |  |  |
| ***Step 4 :*** *Go to step 5* |  |  |  |  |
| ***Step 5 :*** | *$1,000* | *$3,000* | *$30,000* | *$178,000* |

*Ron and Anne’s ordinary income will increase from $20,000 to $21,000 due to their $1,000 net short-term capital gain. Ron and Anne’s gross tax liability of $29,319 is computed as follows:*

|  |  |  |  |
| --- | --- | --- | --- |
| ***Amount and***  ***Type of Income*** | ***Applicable***  ***Rate*** | ***Tax*** | ***Explanation*** |
| *$19,050; ordinary* | *10%* | *$1,905* | *$19,050 × 10%*  *The first $19,050 of Ron and Anne’s $21,000 of ordinary income is taxed at 10% (see MFJ tax rate schedule for this and other computations).* |
| *$1,950; ordinary* | *12%* | *$234* | *$1,950 × 12%.*  *Ron and Anne’s remaining $1,950 of ordinary income (21,000 – 19,050) is taxed at 12%.* |
| *$30,000; 25% rate capital gain* | *12%* | *$3,600* | *$30,000 × 12%*  *The 25% gains are taxed at the lower of Ron and Anne’s marginal tax rate (12%) or 25%. In this case, the $30,000 of gains will be taxed at 12%.* |
| *$3,000 28% rate capital gains* | *12%* | *$360* | *$3,000 × 12%*  *The 28% gains are taxed at the lower of Ron and Anne’s marginal tax rate (12%) or 28%. In this case, the $3,000 of gains will be taxed at 12%.* |
| *$23,200; 0/15/20% rate capital gains* | *0%* | *$0* | *$23,200 × 0%*  *$23,200 ($77,200 - $21,000 ordinary income - $30,000 25% capital gain - $3,000 28% capital gain) of 0/15/20% rate capital gain fits into the remaining space below the maximum zero rate amount ($77,200), so it is taxed at 0%.* |
| *$154,800; 0/15/20% rate capital gains* | *15%* | *$23,220* | *$154,800 × 15%*  *All of the remaining $154,800 ($178,000 - $23,200) of 0/15/20% capital gain is taxed at 15% because Ron and Anne’s taxable income (including the gains) is above the maximum zero rate amount ($77,200) and the maximum 15-percent rate amount ($479,000).* |
| ***Gross tax liability*** |  | ***$29,319*** |  |

*b. The netting process used to determine Ron and Anne’s gross tax liability for the year is unchanged from the process used in part a.*

*Ron and Anne’s ordinary income will increase from $400,000 to $401,000 due to their $1,000 net short-term capital gain. Ron and Anne’s gross tax liability of $131,769 is computed as follows:*

|  |  |  |  |
| --- | --- | --- | --- |
| ***Amount and***  ***Type of Income*** | ***Applicable***  ***Rate*** | ***Tax*** | ***Explanation*** |
| *$19,050; ordinary* | *10%* | *$1,905* | *$19,050 × 10%*  *The first $19,050 of Ron and Anne’s $401,000 of ordinary income is taxed at 10% (see MFJ tax rate schedule for this and other computations).* |
| *$58,350; ordinary* | *12%* | *$7,002* | *$58,350 × 12%.*  *The next $58,350 ($77,400 - $19,050) of Ron and Anne’s $401,000 of ordinary income is taxed at 12%.* |
| *$87,600; ordinary* | *22%* | *$19,272* | *$87,600 × 22%*  *The next $87,600 ($165,000-$77,400) of Ron and Anne’s $401,000 of ordinary income is taxed at 22%.* |
| *$150,000; ordinary* | *24%* | *$36,000* | *The next $150,000 ($315,000-$165,000) of Ron and Anne’s $401,000 of ordinary income is taxed at 24%* |
| *$85,000* | *32%* | *$27,200* | *The next $85,000 ($400,000 - $315,000) of Ron and Anne’s $401,000 ordinary income is taxed at 32%.* |
| *$1,000* | *35%* | *$350* | *The remaining $1,000 ($401,000 - $400,000) of Ron and Anne’s $401,000 ordinary income is taxed at 35%.* |
| *$78,000; 0/15/20% rate capital gains* | *15%* | *$11,700* | *$78,000 × 15%*  *$78,000 ($479,000 - $401,000 ordinary income) of 0/15/20% rate capital gain fits below the maximum 15-percent rate amount ($479,000), so it is taxed at 15%.* |
| *$100,000;*  *0/15/20% rate capital gains* | *20%* | *$20,000* | *$100,000 × 20%*  *All of the remaining $133,000 ($178,000 - $78,000) of 0/15/20% capital gain pushes Ron and Anne’s taxable income above the maximum 15-percent rate amount ($479,000) so it is taxed at 20%.* |
| *$30,000; 25% rate capital gains* | *25%* | *$7,500* | *$30,000 × 25%* |
| *$3,000; 28% rate capital gains* | *28%* | *$840* | *$3,000 × 28%* |
| ***Gross tax liability*** |  | ***$131,769*** |  |

1. [LO 2] In 2018, Tom and Amanda Jackson (married filing jointly) have $200,000 of taxable income before considering the following events:
2. On May 12, 2018, they sold a painting (art) for $110,000 that was inherited from Grandma on July 23, 2016. The fair market value on the date of Grandma's death was $90,000 and Grandma's adjusted basis of the painting was $25,000.
3. They applied a long-term capital loss carryover from 2017 of $10,000.
4. They recognized a $12,000 loss on 11/1/2018 sale of bonds (acquired on 5/12/2008).
5. They recognized a $4,000 gain on 12/12/2018 sale of IBM stock (acquired on 2/5/2018).
6. They recognized a $17,000 gain on the 10/17/2018 sale of rental property (the only §1231 transaction) of which $8,000 is reportable as gain subject to the 25 percent maximum rate and the remaining $9,000 is subject to the 0/15/20 percent maximum rates (the property was acquired on 8/2/2012).
7. They recognized a $12,000 loss on 12/20/2018 sale of bonds (acquired on 1/18/2018).
8. They recognized a $7,000 gain on 6/27/2018 sale of BH stock (acquired on 7/30/2009).
9. They recognized an $11,000 loss on 6/13/2018 sale of QuikCo stock (acquired on 3/20/2011).
10. They received $500 of qualified dividends on 7/15/2018.

Complete the required capital gains netting procedures and calculate the Jacksons’ 2018 tax liability.

|  |  |  |  |
| --- | --- | --- | --- |
| *ST* | *LT* | | |
|  | ***28%*** | ***25%*** | ***0/15/20%*** |
| *(d) 4,000* | *(a) 20,000* | *(e) 8,000* | *(c) (12,000)* |
| *(f) (12,000)* | *(b) (10,000)* |  | *(e) 9,000* |
|  |  |  | *(g) 7,000* |
|  |  |  | *(h) (11,000)* |
|  |  |  |  |
|  |  |  |  |
| *(8,000)* | *$10,000* | *$8,000* | *($7,000)* |
|  | *(7,000)* |  | *7,000* |
| *(8,000)* | *$3,000* | *$8,000* | *$ 0* |
| *8,000* | *(3,000)* | *(5,000)* |  |
| *$ 0* | *$ 0* | *$3,000* | *$ 0* |

*2018 Taxable Income:*

*TI b/4 $200,000*

*Qual. Dividend 500*

*LTCG 25% 3,000*

*Taxable Inc $203,500*

*2018 Tax Liability:*

*Ordinary Income: $28,179 + 24% × ($200,000-165,000) = $36,579*

*Capital Gains:\* + 24% × $3,000 25% gains = 720*

*Dividends:\*\* + 15% × $500 = 75*

*Total tax liability $37,374*

*\*The 25% gains are taxed at the lower of the marginal tax rate (24%) or the 25% maximum rate. Since the Jackson’s have $115,000 ($315,000 - $200,000 ordinary income) remaining in the 24% bracket, the 25% gains are taxed at the lower marginal tax rate.*

*\*\*The qualified dividends are taxed at the 15 percent rate because taxable income fits between the maximum zero rate amount and the maximum 15-percent rate amount.*

1. [LO 2] For 2018, Sherri has a short-term loss of $2,500 and a long-term loss of $4,750.
2. How much loss can Sherri deduct in 2018?
3. How much loss will Sherri carryover to 2019 and what is the character of the loss carryover?

*a. Sherri has a $2,500 short-term capital loss and a $4,750 long-term capital loss. Because both are losses they cannot be netted. Individual taxpayers can offset $3,000 of capital loss against ordinary income, with short-term losses being offset first.*

*b. Individual taxpayers can offset $3,000 of capital loss against ordinary income, with short-term losses being offset first. Therefore, Sherri can deduct the $2,500 short-term capital loss and $500 of the long-term capital loss in 2018. The remaining $4,250 of the long-term capital loss (i.e. $4,750 less the $500 deducted currently) is carried forward indefinitely.*

1. [LO 2] Three years ago, Adrian purchased 100 shares of stock in X Corp. for $10,000. On December 30 of year 4, Adrian sells the 100 shares for $6,000.

1. Assuming Adrian has no other capital gains or losses, how much of the loss is Adrian able to deduct on her year 4 tax return?
2. Assume the same facts as in part (a), except that on January 20 of year 5, Adrian purchases 100 shares of X Corp. stock for $6,000. How much loss from the sale on December 30 of year 4 is deductible on Adrian’s year 4 tax return? What basis does Adrian take in the stock purchased on January 20 of year 5?

*a. Adrian has a $4,000 long-term capital loss. She can offset $3,000 of the capital loss against ordinary income. The remaining $1,000 of the capital loss (i.e. $4,000 less the $3,000 deducted currently) is carried forward indefinitely.*

*b. Adrian has a realized $4,000 long-term capital loss on the sale of the 100 shares. However, she has purchased substantially identical stock within the 61 day period (30 days before the sale until 30 days after the sale); therefore, her loss is limited by the wash sale rules. Since Adrian purchased 100 shares the loss is not currently recognized. The loss is added to the basis of the new shares purchased. Thus, the basis of the 100 new shares of stock is $10,000 (i.e. the $6,000 purchase price plus the unrecognized loss of $4,000).*

1. [LO 2] Christopher sold 100 shares of Cisco stock for $5,500 in the current year. He purchased the shares several years ago for $2,200. Assuming his marginal ordinary income tax rate is 24 percent, and he has no other capital gains or losses, how much tax will he pay on this gain?

*Christopher’s long-term capital gain is $3,300 ($5,500 amount realized less his $2,200 tax basis). Since Christopher’s marginal tax rate places his taxable income below the maximum 15-percent rate amount but above the maximum zero rate amount, his long-term capital gains rate is 15 percent. Therefore, he will pay 15 percent of $3,300 or $495 in capital gains tax.*

1. [LO 2] Christina, who is single, purchased 100 shares of Apple Inc. stock several years ago for $3,500. During her year-end tax planning, she decided to sell 50 shares of Apple for $1,500 on December 30. However, two weeks later, Apple introduced its latest iPhone, and she decided that she should buy the 50 shares (cost of $1,600) of Apple back before prices skyrocket.
2. What is Christina’s deductible loss on the sale of 50 shares? What is her basis in the 50 new shares?
3. Assume the same facts, except that Christina repurchased only 25 shares for $800. What is Christina’s deductible loss on the sale of 50 shares? What is her basis in the 25 new shares?

*a. Christina has engaged in a wash sale because she bought identical stock within 30 days of selling Apple stock. Therefore, her $250 ($1,500 less $1,750) loss is disallowed. The basis of Christina’s 50 shares of new Apple stock is $1,850 ($1,600 purchase price plus $250 of disallowed loss).*

*b. Christina has engaged in a partial wash sale because she bought 25 shares of identical stock within 30 days of selling Apple stock. Therefore, she may deduct $125 or 50 percent of her $250 ($1,750 less $1,500) loss; the remaining $125 is disallowed. The basis of Christina’s 25 shares of new stock is $925 ($800 purchase price plus $125 of disallowed loss).*

1. [LO 2] {Research}Arden purchased 300 shares of AMC common stock several years ago for $1,500. On April 30, Arden sold the shares of AMC common for $500 and then purchased 250 shares of AMC preferred stock two days later for $700. The AMC preferred stock is not convertible into AMC common stock. What is Arden’s deductible loss from the sale of the 300 shares of AMC common stock?

*Section 1.1233-1(d) of the Income Tax Regulations indicates that common and preferred stock of the same company are not considered "substantially identical property" for purposes of applying the wash sale rules as long as the preferred stock is not convertible into common stock. Thus, Arden may deduct $1,000 dollars of loss from the sale of the AMC stock in the current year.*

1. [LO 2] {Planning} Shaun bought 300 shares of Dental Equipment, Inc. several years ago for $10,000. Currently the stock is worth $8,000. Shaun’s marginal tax rate this year is 24 percent, and he has no other capital gains or losses. Shaun expects to have a marginal rate of 32 percent next year, but also expects to have a long-term capital gain of $10,000. To minimize taxes, should Shaun sell the stock on December 31 of this year or January 1 of next year (ignore the time value of money)?

*If Shaun sells the stock in the current year, he may deduct his $2,000 capital loss against his ordinary income. Given that his tax rate in the current year is 24 percent, this will produce a tax benefit of 24 percent of $2,000 or $480. On the other hand, if he waits until the following year to recognize the $2,000 capital loss, he must apply the loss against his $10,000 long-term capital gains taxed at a 15 percent rate. If he waits, his loss would produce a tax benefit of only 15 percent of $2,000 or $300. Therefore, Shaun should sell his stock in the current year.*

1. [LO 3] Mickey and Jenny Porter file a joint tax return, and they itemize deductions. The Porters incur $2,000 in investment expenses. They also incur $3,000 of investment interest expense during the year. The Porters’ income for the year consists of $150,000 in salary, and $2,500 of interest income.

What is the amount of the Porters’ investment interest expense deduction for the year?

What would their investment interest expense deduction be if they also had a ($2,000) long-term capital loss?

*a. The $3,000 of investment interest expense is deductible to the extent of net investment income. In this problem, investment income and net investment income are $2,500 because there are no deductible investment expenses to reduce gross investment income. Consequently, $2,500 of the investment interest expense is deductible and $500 is carried forward to next year.*

*b. If the Porters also have a $2,000 long-term capital loss, their net investment income remains $2,500 for purposes of determining the investment interest expense deduction. Capital losses are not included in the calculation of net investment income. Consequently, $2,500 of the investment interest expense is deductible and $500 is carried over to next year.*

1. [LO 3] {Planning} On January 1 of year 1, Nick and Rachel Sutton purchased a parcel of undeveloped land as an investment. The purchase price of the land was $150,000. They paid for the property by making a down payment of $50,000 and borrowing $100,000 from the bank at an interest rate of 6 percent per year. At the end of the first year, the Suttons paid $6,000 of interest to the bank. During year 1, the Suttons only source of income was salary. On December 31 of year 2, the Suttons paid $6,000 of interest to the bank and sold the land for $210,000. They used $100,000 of the sale proceeds to pay off the $100,000 loan. The Suttons itemize deductions and are subject to a marginal ordinary income tax rate of 32 percent.

a. Should the Suttons treat the capital gain from the land sale as investment income in year 2 in order to minimize their year 2 tax bill? If so, how much could the Suttons save?

b. How much does this cost or save them in year 2?

*a. In year one, the Suttons incurred $6,000 of investment interest expense but did not have any investment income so the investment interest expense is not deducted and is carried over to year 2. In year 2, the Suttons incurred another $6,000 of investment interest expense. Combined with the carryover from year 1, the Suttons had $12,000 of investment interest expense they could potentially deduct in year 2. In year 2, the Suttons have $60,000 of long-term capital gain. None of this long-term capital gain is investment income unless the Suttons elect to have some of it taxed at ordinary rates.*

*If the Suttons don’t elect to tax any of the capital gain as ordinary income, they would not be able to deduct any of the investment interest expense and they would owe taxes of $9,000 (i.e., $60,000 x 15 percent). The gain would be taxed at 15 percent because their taxable income would be below the maximum 15-percent rate amount and above the maximum zero rate amount. The Suttons would have a $12,000 investment expense carry forward to next year.*

*If the Suttons elect to include $12,000 of the long-term capital gain in investment income and have it taxed at ordinary rates, the Suttons would owe tax of $3,840 ($12,000 x 32 percent) on this portion of the capital gain and they would owe $7,200 of taxes on the rest of the capital gain (i.e., $48,000 x 15 percent). The $12,000 investment interest expense deduction would save the Suttons $3,840 in taxes (i.e., $12,000 x 32 percent). The end result is that if the Suttons make the election, they will owe $7,200 in taxes (i.e., $3,840 + $7,200 - $3,840). They will not however have an investment interest expense carry forward. Making the election would make sense for the Suttons if they did not expect to have any investment income for the foreseeable future.*

*b. In terms of the year 2 tax bill only, making the election to tax some of the long-term capital gain at ordinary rates saves the Suttons $1,800 in taxes (i.e., $9,000 - $7,200).*

1. [LO 3] {Research} George recently received a great stock tip from his friend, Mason. George didn’t have any cash on hand to invest, so he decided to take out a $20,000 loan to facilitate the stock acquisition. The loan terms are 8 percent interest with interest-only payments due each year for five years. At the end of the five-year period the entire loan principal is due. When George closed on the loan on April 1, 2018, he decided to invest $16,000 in stock and to use the remaining $4,000 to purchase a four-wheel recreation vehicle. George is unsure how he will treat the interest paid on the $20,000 loan. In 2018, George paid $1,200 interest expense on the loan. For tax purposes, how should he treat the 2018 interest expense? (Hint: Visit [www.irs.gov](http://www.irs.gov) and consider IRS Publication 550)

*IRS Publication 550 indicates that “if you borrow money for personal purposes as well as for investment, you must allocate the debt among those purposes.” This means that only interest expense paid on the portion of debt that was used for the investment in the stocks can be deducted as investment interest. The interest paid on the loan allocated to the personal portion isn’t deductible to the taxpayer.*

*Therefore, in determining the deductibility of the $1,200 interest expense paid by George during 2018, George would allocate 80 percent (i.e., $16,000 / 20,000) of the interest expense to the purchase of the stock and 20 percent (i.e., $4,000 / 20,000) of the interest expense to the purchase of the 4-wheeler. Consequently, George would have $960 of investment interest expense (80 percent x $1,200) and he would have $240 (i.e., 20 percent x $1,200) of nondeductible personal interest.*

1. [LO 4] Larry recently invested $20,000 (tax basis) in purchasing a limited partnership interest. His at-risk amount is also $20,000. In addition, Larry’s share of the limited partnership loss for the year is $2,000, his share of income from a different limited partnership was $1,000, and he had $3,000 of dividend income from the stock he owns. How much of Larry’s $2,000 loss from the limited partnership can he deduct in the current year?

*Before considering his $2,000 loss, Larry’s tax basis is $20,000 and his at-risk amount is $20,000. Therefore, the basis and at-risk hurdles do not apply. However, Larry still may not deduct $1,000 of the $2,000 loss because he only has $1,000 of passive income for the year. Therefore, Larry has a $1,000 passive activity loss carryover.*

1. [LO 4] Rubio recently invested $20,000 (tax basis) in purchasing a limited partnership interest. His at-risk amount is $15,000. In addition, Rubio’s share of the limited partnership loss for the year is $22,000, his share of income from a different limited partnership was $5,000, and he had $40,000 in wage income and $10,000 in long-term capital gains.
   1. How much of Rubio’s $22,000 loss is allowed considering only the tax basis loss limitations?
   2. How much of the loss from part (a) is allowed under the at-risk limitations?
   3. How much of Rubio’s $22,000 loss from the limited partnership can he deduct in the current year considering all limitations?

*a. Rubio’s initial tax basis in the limited partnership is $20,000. Rubio’s $22,000 loss reduces his tax basis to zero leaving him with a $2,000 loss carryover because of the tax basis loss limitation.*

*b. Rubio’s initial at-risk amount in the limited partnership is $15,000. Rubio’s $22,000 loss reduces his at-risk amount to zero leaving him with a $5,000 at-risk carryover ($20,000 loss allowed under the tax basis limitation less the $15,000 amount Rubio has at risk).*

*c. After applying the tax basis and at-risk limitations, Rubio can potentially deduct $15,000 of loss. However, because Rubio is a limited partner this loss is considered a passive loss. Therefore, Rubio may only deduct this loss in the current year to the extent he has passive income. Because Rubio has only passive income of $5,000 (from another limited partnership), he may only deduct $5,000 of the $15,000 loss leaving him with a $10,000 passive activity loss that can be carried forward indefinitely.*

1. [LO 4] Molly Grey (single) acquired a 30 percent limited partnership interest in Beau Geste LLP several years ago for $48,000. At the beginning of year 1, Molly has tax basis and an at-risk amount of $20,000. In year 1, Beau Geste incurs a loss of $180,000 and does not make any distributions to the partners.

* In year 1, Molly‘s AGI (excluding any income or loss from Beau Geste) is $60,000. This includes $10,000 of passive income from other passive activities.
* In year 2, Beau Geste earns income of $30,000. In addition, Molly contributes an additional $30,000 to Beau Geste during year 2. Molly’s AGI in year 2 is $63,000 (excluding any income or loss from Beau Geste). This amount includes $8,000 in income from her other passive investments.

1. Based on the above information, determine the following amounts:
   * At-risk amount at the end of year 1
   * At-risk amount at the end of year 2
   * Losses allowed under the at-risk rules in year 2
   * Total suspended passive losses at the end of year 1
   * Total suspended at-risk losses at the end of year 2
   * Deductible losses in year 1
   * Year 2 AGI after considering Beau Geste events
2. Briefly describe actions Molly Grey could undertake in year 2 to utilize any suspended passive losses from year 1.

*To determine the required amounts, Molly must determine her at-risk basis for each year.*

***At-Risk Amount****:*

*Initial year 1 amount: $ 20,000 Given in problem*

*Allowed loss: (20,000) See below*

*End of year 1 at-risk amount $ -0-*

*Contribution for year 2 $ 30,000 Given in problem*

*BG Income (30% x $30,000) 9,000 Given in problem*

*Allowed loss: (34,000) See below*

*End of year 2 at-risk amount $ 5,000*

***At-risk allowed loss calculation:***

*Year Total Loss At-Risk Allowed At-Risk Disallowed*

*1 $ 54,000 $ 20,000 $ 34,000*

*2 34,000 34,000* ***-0-***

***Passive activity loss allowed calculation:***

*Year At-Risk Allowed PAL Allowed PAL Disallowed*

*1 $20,000 $10,000 $10,000*

*2 34,000 17,000 17,000*

*In year 1, Molly has at-risk amount of $20,000 before losses from Beau Geste and therefore is only allowed $20,000 of losses under the at-risk rules. This loss then must pass the passive activity loss rules. Since Molly has $10,000 of passive activity income from other sources in year 1, she may deduct $10,000 of the $20,000 loss allowed under the at-risk rules under the passive activity loss rules. This leaves $10,000 suspended under the passive activity loss rules for year 1.*

*In year 2, Molly’s at-risk amount increases by the amount of her contribution ($30,000) and by the income generated by Beau Geste to $39,000 before considering any losses from Beau Geste. This additional at-risk amount will allow Molly to use up to $39,000 of losses suspended by the at-risk rules in previous years. As a result, the $34,000 of losses suspended in year 1 now flow to the passive activity loss rules. In addition to the $34,000 loss freed from the at-risk rules, Molly must also consider whether she can use the $10,000 loss that was suspended under the passive activity loss rules in year 1. Since she has $17,000 ($9,000 from Beau Geste and $8,000 from other sources) of passive income she may deduct $17,000 of the total $44,000 losses Cumulative losses. This leaves $27,000 of losses that remain suspended under the passive activity loss rules at the end of year 2.*

*Molly’s AGI for year 2 is determined as follows:*

***Year 2 AGI:*** *AGI before Beau Geste: $63,000  
 + Year 2 passive income from Beau Geste 9,000  
 - Year 2 allowed passive losses 17,000****= Year 2 AGI $55,000***

1. *Based on the above calculations the following amounts:*

* *At-risk amount at the end of year 1: $-0-*
* *At-risk amount at the end of year 2 $5,000*
* *Losses allowed under the at-risk rules in year 2 $34,000*
* *Total suspended passive losses at the end of year 1 $10,000*
* *Total suspended at-risk losses at the end of year 2 $-0-*
* *Deductible losses in year 1 $10,000*
* *Year 2 AGI after considering Beau Geste events $55,000*

1. *Molly could a) sell her entire interest in Beau Geste; or b) acquire an additional passive income generator (e.g., rental property).*
2. [LO 4] Anwer owns a rental home and is involved in maintaining it and approving renters. During the year he has a net loss of $8,000 from renting the home. His other sources of income during the year are a salary of $111,000 and $34,000 of long-term capital gains. How much of Anwer’s $8,000 rental loss can he deduct currently if he has no sources of passive income?

*Because Anwer meets the definition of an “active participant” and has adjusted gross income of less than $150,000, before considering his rental loss, he may deduct $2,500 of the loss against his other income. His $2,500 deduction is computed as follows:*

|  |  |  |
| --- | --- | --- |
| ***Description*** | ***Amount*** | ***Explanation*** |
| *(1) Maximum deduction available before phase-out* | *$25,000* |  |
| *(2) Phase-out of maximum deduction* | *$22,500* | *[($145,000 AGI – 100,000) x .5]* |
| *(3) Maximum deduction in current year* | *$2,500* | *(1) – (2)* |
| *(4) Rental loss in current year* | *$8,000* |  |
| *(5) Rental loss deductible in current year* | *$2,500* | *Lesser of (3) or (4)* |
| *Passive loss carry forward* | *$5,500* | *(3) – (4)* |

**Comprehensive Problems**

63. [Tax Forms] During 2018, your clients, Mr. and Mrs. Howell, owned the following investment assets:

|  |  |  |  |
| --- | --- | --- | --- |
| **Investment Assets** | **Date Acquired** | **Purchase Price** | **Broker’s Commission Paid at Time of Purchase** |
| 300 shares of IBM common | 11/22/2015 | $10,350 | $100 |
| 200 shares of IBM common | 4/3/2016 | $43,250 | $300 |
| 3,000 shares of Apple preferred | 12/12/2016 | $147,000 | $1,300 |
| 2,100 shares of Cisco common | 8/14/2017 | $52,500 | $550 |
| 420 Shares of Vanguard mutual fund | 3/2/2018 | $14,700 | No load fund\* |

\*No commissions are charged when no load mutual funds are bought and sold.

Because of the downturn in the stock market, Mr. and Mrs. Howell decided to sell most of their stocks and mutual fund in 2018 and to reinvest in municipal bonds. The following investment assets were sold in 2018:

|  |  |  |  |
| --- | --- | --- | --- |
| **Investment Assets** | **Date Sold** | **Sale Price** | **Broker’s Commission Paid at Time of Sale** |
| 300 shares of IBM common | 5/6 | $13,700 | $100 |
| 3,000 shares of Apple preferred | 10/5 | $221,400 | $2,000 |
| 2,100 shares of Cisco common | 8/15 | $63,250 | $650 |
| 451 Shares of Vanguard mutual fund | 12/21 | $15,700 | No load fund\* |

\*No commissions are charged when no load mutual funds are bought and sold.

The Howells’ broker issued them a Form 1099-B showing the sales proceeds net of the commissions paid. For example, the IBM sales proceeds were reported as $13,600 on the Form 1099-B they received.

In addition to the sales reflected in the table above, the Howells provided you with the following additional information concerning 2018:

* The Howells received a Form 1099-B from the Vanguard mutual fund reporting a $900 long-term capital gain distribution. This distribution was reinvested in 31 additional Vanguard mutual fund shares on 6/30/2018.
* In 2013, Mrs. Howell loaned $6,000 to a friend who was starting a new multilevel marketing company called LD3. The friend declared bankruptcy in 2018, and Mrs. Howell has been notified that she will not be receiving any repayment of the loan.
* The Howells have a $2,300 short-term capital loss carryover and a $4,800 long-term capital loss carryover from prior years.
* The Howells did not instruct their broker to sell any particular lot of IBM stock.
* The Howells earned $3,000 in municipal bond interest, $3,000 in interest from corporate bonds, and $4,000 in qualified dividends.
* Assume the Howells have $130,000 of wage income during the year.

a. Go to the IRS web site ([www.IRS.gov](http://www.IRS.gov)) and download the most current version of Form 8949 and Schedule D. Use Form 8949 and page 1 of Schedule D to compute net long-term and short-term capital gains. Then, compute the Howells’ tax liability for the year (ignoring the alternative minimum tax and any phase-out provisions) assuming they file a joint return, they have no dependents, they don’t make any special tax elections, and their itemized deductions total $25,000. Assume that asset bases are reported to the IRS.

b. Are there any tax planning recommendations related to the stock sales that you should have shared with the Howells before their decision to sell?

c. Assume the Howells’ short-term capital loss carryover from prior years is $82,300 rather than $2,300 as indicated above. If this is the case, how much short-term and long-term capital loss carryover remains to be carried beyond 2018 to future tax years?

*a. The Howell’s Form 8949 and Schedule D for the year would be completed as follows*:







*The Howell’s net capital gain is then included with their other income for the year in calculating their final tax liability for the year.*

|  |  |  |
| --- | --- | --- |
| *Description* | *Amount* | *Explanation* |
| *Wage Income* | *130,000* | *Given* |
| *Interest Income* | *3,000* | *Given* |
| *Qualified Dividends* | *4,000* | *Given* |
| *Net Capital Gain from Schedule D* | *71,700* | *See Schedule D above: short-term capital loss of ($8,200) + long-term capital gain of $79,900 = Net capital gain of $71,200.* |
| *Adjusted Gross Income* | *208,700* |  |
| *Total Itemized Deductions* | *(25,000)* | *The effect of investment interest expense is already included in this number. The itemized deductions exceed the 2018 standard deduction of $24,000.* |
| *Taxable Income* | *183,700* |  |

*The Howell’s 2018 tax liability would be $26,994. This is calculated by determining ordinary income of $108,000, which is $183,700 of taxable income minus $71,700 net long-term capital gain that will be taxed at 15 percent and minus $4,000 qualified dividends that will be taxed at 15 percent. The long-term capital gains and qualified dividends will be taxed at 15 percent because the Howell’s taxable income falls between the maximum zero rate amount and the maximum 15-percent rate amount. The tax on $108,000 is $15,639 and the 15 percent tax on long-term capital gains and qualified dividends of $75,700 is $11,355. This results in a total 2018 tax liability of $26,994.*

*b. Mr. and Mrs. Howell should have told their broker to sell the 200 shares of IBM acquired on 4/3/16 first, using the specific identification method. Because these shares have a much higher tax basis than the shares acquired on 11/22/15, the Howells could have reported a capital loss on the sale of the IBM stock, which could have been used to offset the gains from the sale of the Apple and Cisco stock. However, at this point in time, it’s too late to implement this strategy. Mr. and Mrs. Howell should have consulted with their tax advisor prior to the sale.*

*c. If we assume the Howell’s short-term capital loss carryover into 2018 was $82,300 rather than $2,300 as originally assumed, a number of things change. First, the net short-term capital loss for the year increases to $88,200. When netted against the net long-term capital gain for the year of $79,900, a net short-term capital loss for the year of $8,300 remains. $3,000 of this loss can be used to reduce ordinary income, and the remaining $5,300 constitutes a short-term capital loss carryover to future tax years.*