

## Income vs Capital

income is levied income not capital capital is

income that has already been taxed the tax toll

booth

## Realized vs Recognized

- gains must realized before they can taxed
- a gain is not usually realized unless there
  - is a disposition of property there is a
  - segregation of the gain when a gain is
- taxed, it is recognized

## Calculating the gain

Amount realized - **adjusted basis** = realized gain cost of property + capital

additions - cost recovery = **adjusted basis**

## Determining Basis

Cost basis initial capital used to purchase the investment includes cash cost of

- property given in exchange recourse debt used for financing costs
- necessary to acquire the asset (sales tax, freight, installation)
  - **Adjusted to basis**
  - increases to basis capital infusions
- amortization of discount bonds profit
- of pass through entities liabilities
- assumed decrease to basis return of
- capital distributions from pass thru
  - entities depreciation amortization of
  - bond premium
- liabilities shed
-

## Basis of property acquired through an estate

Basis = fair market value at: the date of death the alternative valuation date sometimes

- called stepped up basis applies to testamentary transfers of property whose value is
- included in the decedent gross estate

### EXAMPLE

Uncle Frank paid \$10,000 for his 40% ownership interest in the business. He has since paid an additional \$10,000 for capital improvements to the business's location.

– Current basis = \$20,000

- Uncle Frank recently passed away and left his part of the family business to Gerald. The rest of the company is owned by Gerald's father William. The company is worth \$625,000 at the time of Uncle Frank's death.

- Gerald receives a step-up to the fair market value at Uncle Frank's death so his basis becomes \$250,000 (a step-up of \$230,000).

- William does not receive a step-up in his basis.

## Section 1014 and Joint tenancy

applies to • joint tenancy with rights of survivorship the property passes outside of

probate • the surviving joint tenant is deemed to receive the property from the decedent

Basis is stepped up to the extent that the value of property is included in the gross estate of the decedent results in a partial step up in basis

## Section 1014 and Community Property

the property passes through probate • the decedent can give

their half of the property away basis is stepped up on the full

value of the property results in a double step up in basis (really

just a full step up)

## Stepped up basis rule exception

contemplation of death rule appreciated property is

- acquired by a decedent as a gift within one
  - year of death
  -

- the property passes from the donee-decent to the original donor or donors

spouse income in respect of a decent property (IRC section 691) annuity payments transferred from the decedent to a beneficiary

## Basis of Gifted Property

General rule: carryover basis changes in

basis result from:

- payment of gift tax gift of property with FMV < adjusted
- basis on date of gift

## Impact of gift tax on basis

Donee's basis is increased by a portion of gift taxes paid by the donor if

- the donee sells the property
- for more than donors original basis

$\frac{\text{Appreciation in the Property}}{\text{FMV of Property at Date of Gift}}$	x	Gift Tax Paid	=	Increase in Basis for Donee
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### EXAMPLE

Cathy received a gift from Darren on June 15 of this year that had a FMV of \$20,000. Darren's adjusted basis in the asset was \$15,000, and he paid a gift tax on the transfer of \$800. (Assume that a previous gift equal to the gift tax annual exclusion amount was made earlier in the year.)

- Cathy's basis in the gifted property is \$15,200
- Calculation:  $\$15,000 + (\$5,000/\$20,000 \times \$800)$

## Gift of Loss Property

if the FMV of gifted property < the donors adjusted basis on the date of the gift, the dual basis rule applies to the donee to determine a loss, the adjusted basis of the donee is the MFV of the property on the date of gift

to determine a gain, the basis of the donee is the adjusted basis of the donor if the donee sells the property for an amount that is between the gain and the loss basis, no gain or loss is recognized

### **Gifted Property - Dual Basis rule: example**

Sully purchased 100 shares of Hyde, Inc. five years ago for \$5,000. He just gave those shares to his son, Randall, when the value of the 100 shares was 1,000

### **Holding Period for Gifted Property**

General Rule:

- holding period in the hands of the donee includes the holding period in the hands of the donor

Exception:

- if dual basis asset is sold for a loss, holding period for donee starts on date of gift

### **Basis and Spousal transfers**

all transfers between spouses and incident to a divorce are treated as gifts • basis carries over spouses are treated as a single economic unit

### **Related Party transactions**

Related Party

- spouse, ancestors & descendants, brothers and sisters (of the whole or half blood)

Sales to a related party if a gain results, normal

- rules apply if loss results, double basis rule
- applies holding period resets
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### **Depreciation**

allows taxpayer to recover capital over useful life of asset

may be claimed for assets used in a

- trade or business held for
- production of income

Capital invested in personal use assets is recovered when the asset is sold

## Depreciation conventions

Personalty half year

- convention
- if more than 40% placed in service in 4th quarter, mid quarter conventions applies

Real Estate • mid month

convention intangible

Property straight line

- 15 year (180 month)
- Referred to as “amortization”
- EXAMPLE

Kasey purchases an 8-unit rental apartment unit for \$900,000. The value of the land is determined to be \$60,000. Since the property is used for residential rental purposes, Kasey will be able to depreciate the building (at a value of \$840,000, which equals the purchase price of \$900,000 less the land value of \$60,000) over a 27.5 year period.

### EXAMPLE 2

Ryan purchases an office building that he plans to rent out. The building cost \$1.4 million, and \$200,000 of the purchase price is attributed to the land.

Since the property is used for commercial rental purposes, Ryan can depreciate the building (at a value of \$1.2 million, which equals the purchase price of \$1.4 million less the land value of \$200,000) on a straight-line basis over a 39 year period.

Therefore, Ryan’s annual depreciation deduction will be \$30,769.23.

## Modified Accelerated Cost Recovery System (MACRS)

applies to most types of property excluded

property intangible property (goodwill,

- copyrights) Public utility property motion
- pictures and sound recordings real estate
- Real estate - straight line
- residential - 27.5 yrs
- commercial - 39 yrs land:
- not depreciable

Personalty - accelerated

- 3 yr - Double Declining Balance
- 5 yr - Double Declining Balance
- 7 yr - Double Declining Balance
- 10 yr - Double Declining Balance
- 15 yr - 150% declining balance
- 20 yr - 150% declining balance

## Listed Property

property that can be used for business or personal purposes cars (<6,000 lbs GVW) property

- generally used for entertainment, recreational, or amusement purposes
- If used >50% for business • normal MACRS rules apply for portion that represent business use

## Bonus Depreciation

Up to 80% bonus depreciation available on new or used equipment put into use in 2023

- for years prior to 2023 when bonus depreciation was 100%, the entire cost could be deducted in the year it was placed in service

Taxpayers can elect 50% bonus depreciation if they prefer

## IRS Section 179

Permits business owners to expense capital acquisitions

Requirements asset must have > 50% business use limit on deduction:

- \$1,160,000 (indexed for inflation) for 2023 cannot be used to
- generate loss excess is carried forward
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## Section 179 phaseout

Expense election is phased out on a dollar for dollar basis for depreciable property

- placed in service in excess of \$2,890,00 for 2023
- Special Rule for vehicles over 6,000 pounds, less than
- 14,000 pounds section 179 deduction limited to
- \$28,900 for 2023

## Asset Categorization

There are 3 types of assets in the income tax system

1. capital assets
2. ordinary income assets
3. section 1231 assets

ALL assets are capital assets except

- Accounts Receivable - **ordinary income assets**
- Creative works in hands of the creator - **ordinary income assets**
- Inventory - **ordinary income assets**
- Depreciable Real or Personal Property held for use in a trade or business or for the production of income - **section 1231 assets**

## Taxation of capital assets

long term gain generate lower tax rates than ordinary income tax rates

- 0%
- 15%
- 20%
- 25% for unrecaptured section 1250 depreciation
- 28% for collectibles

Long term losses are limited

- \$3,000 maximum (against other income ) per year

#### EXAMPLES

George is an art dealer, and has galleries in New Orleans, New York, and San Diego. George recently purchased a painting by Wentworth, and places it in his New Orleans studio for sale to his customers. Because the painting is being held for sale to customers in the ordinary course of business, it is inventory, and, therefore is an ordinary income asset.

## Taxation of Ordinary Income

Gains

1. taxed at ordinary rates

Losses

1. generate tax benefit at ordinary rates
2. no limitation applies

## Taxation of Section 1231 assets

Gains • taxed at capital gains rates

Losses • treated as ordinary

losses *long term holding period*

*is required*



# Asset Categories

	Capital Assets	Ordinary Assets	1231 Assets
Sold for Gain	Capital Gain Treatment	Ordinary Income Treatment	Capital Gain Treatment (part or all gain may require recapture)
Sold for Loss	Capital Loss Treatment (current loss may be limited)	Ordinary Loss Treatment	Ordinary Loss Treatment