



Dbriefs U presents:

Capital Gains and Losses — Fundamental to Individual Income Tax Planning

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Agenda

Overview

Basis considerations

Netting process and treatment of net capital losses

Alternative tax on net capital gain

Reporting procedures

Mutual fund income and sales

Planning points

Overview

- Capital gains tax is a tax on the appreciation of the asset
- Capital gain/loss is the difference between sales proceeds and adjusted basis
- Sale or exchange is required unless reporting worthless stock

What is not a capital asset?

- IRC § 1221(a) defines what is not a capital asset (generally business assets)
 - Inventory
 - Accounts and notes receivable
 - Supplies
 - Most fixed assets of a business
 - Copyrights

What is a capital asset?

- Investment use asset
 - Stock, bonds, vacant land, collectibles
- Generally, includes personal use assets
 - Residence, automobiles, other personal assets
 - Gains taxable, losses nondeductible

Capital gain rates

Long term capital gains rates:

Rate	Applies to
15%	Assets held for > 12 months (0% if in two lowest tax brackets)
25%	Unrecaptured Section 1250 property (real estate)
28%	Collectibles and Section 1202 gains (small business stock)

Short term capital gains rates:

Rate	Applies to
Ordinary income tax rates (highest marginal ordinary rate is 35% for 2010–2012)	Assets held for 12 months or less

Holding periods

Capital gain/loss	Holding period
Long term capital gain/loss	Held asset greater than one year
Short term capital gain/loss	Held asset one year or less

Calculation: Start counting on the day after property was acquired and include the day of disposition (trade dates)

Special holding period rules

Type of gain/loss	Rule
Nontaxable exchanges	Tack on holding period of former asset
Disallowed losses	New holding period
Gifted property	Generally tack on holding period of donor
Inherited property	Always long term

Poll question #1

Bill owns the following assets. Which one is not a capital asset?

- Ten shares of Blue Company common stock
- A note Bill received when he loaned a friend \$10,000
- Bill's custom designed yacht in which he plans to reside when he retires
- Accounts receivable of \$25,000 from Bill's accounting practice
- A letter written by Winston Churchill that Bill purchased at an auction

Capital gain basis considerations

- Adjusted basis is cost or original basis of property on date acquired adjusted to date of disposition
- Capital additions increase basis
 - Capital improvements, amortization of bond discounts
- Capital recoveries decrease basis
 - Depreciation, return of capital distributions, amortization of bond premium

Capital gain basis considerations (cont.)

- What is original basis for the following types of transactions?
 - Spin-offs or tax-free mergers
 - Property received by gift
 - Property received by inheritance
 - Wash sales
 - Mutual fund dividend reinvestments
 - Dividend reinvestment plans (DRIPs)

Netting capital gains and losses

- Net short term capital losses and short term capital gains (Schedule D Part I)
- Net long term capital losses and long term capital gains (Schedule D Part II)
- If result is a net short term capital gain and net long term capital gain, netting process is complete
- If short term gains exceed long term losses, the net gain is a net short term gain taxed at ordinary rates
- If long term gains exceed short term losses, the net gain is a net long term capital gain taxed at the preferential tax rates

Netting capital gains and losses (cont.)

- If result is a net short term capital loss and net long term capital loss, netting process is complete
- If short term losses exceed long term gains, the net loss is a net short term capital loss
- If long term losses exceed short term gains, the net loss is a net long term capital loss

Planning point: Holding period can have a significant impact on tax liability. Why?

Treatment of net capital loss (NCL)

- NCL deductible from gross income to extent of \$3,000 per year
- Capital losses in excess of \$3,000 are carried forward indefinitely
- Short term capital losses used first
- Capital loss carryovers retain original character


Alternative tax on net capital gain

- Special tax rates on net long term capital gains (0%/15%, 25%, 28%)
- Tax is calculated using ordinary rates only (tax tables/tax rate schedule) and a separate calculation using alternative tax rates on net capital gain, if applicable (Schedule D Tax Worksheet)
- Taxpayer pays the lower tax

Alternative tax on net capital gain (cont.)

2010 Form 1040—Line 44

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records 

Before you begin: ✓ See the instructions for line 44 on page 35 to see if you can use this worksheet to figure your tax.
 ✓ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43. However, if you are filing Form 2555 or 2555-EZ (relating to foreign earned income), enter the amount from line 3 of the worksheet on page 36	1.	
2. Enter the amount from Form 1040, line 9b*	2.	
3. Are you filing Schedule D?*		
<input type="checkbox"/> Yes. Enter the smaller of line 15 or 16 of Schedule D. If either line 15 or line 16 is blank or a loss, enter -0-	3.	
<input type="checkbox"/> No. Enter the amount from Form 1040, line 13		
4. Add lines 2 and 3	4.	
5. If filing Form 4952 (used to figure investment interest expense deduction), enter any amount from line 4g of that form. Otherwise, enter -0-	5.	
6. Subtract line 5 from line 4. If zero or less, enter -0-	6.	
7. Subtract line 6 from line 1. If zero or less, enter -0-	7.	
8. Enter: \$34,000 if single or married filing separately, \$68,000 if married filing jointly or qualifying widow(er), \$45,550 if head of household.	8.	
9. Enter the smaller of line 1 or line 8	9.	
10. Enter the smaller of line 7 or line 9	10.	
11. Subtract line 10 from line 9. This amount is taxed at 0%	11.	
12. Enter the smaller of line 1 or line 6	12.	
13. Enter the amount from line 11	13.	
14. Subtract line 13 from line 12	14.	
15. Multiply line 14 by 15% (.15)	15.	
16. Figure the tax on the amount on line 7. If the amount on line 7 is less than \$100,000, use the Tax Table to figure this tax. If the amount on line 7 is \$100,000 or more, use the Tax Computation Worksheet	16.	
17. Add lines 15 and 16	17.	
18. Figure the tax on the amount on line 1. If the amount on line 1 is less than \$100,000, use the Tax Table to figure this tax. If the amount on line 1 is \$100,000 or more, use the Tax Computation Worksheet	18.	
19. Tax on all taxable income. Enter the smaller of line 17 or line 18. Also include this amount on Form 1040, line 44. If you are filing Form 2555 or 2555-EZ, do not enter this amount on Form 1040, line 44. Instead, enter it on line 4 of the worksheet on page 36	19.	

*If you are filing Form 2555 or 2555-EZ, see the footnote in the worksheet on page 36 before completing this line.

Poll question #2

During 2010, Christine had the following transactions:

LTCG	\$3,000	STCG	2,000
LTCL	1,000	STCL	10,000

After the netting process, Christine has the following result:

- STCL \$8,000, LTCG \$2,000
- STCL carryover of \$5,000 and LTCG of \$2,000
- STCL carryover of \$2,000 and LTCL carryover of \$1,000
- STCL carryover of \$3,000
- None of the above

Reporting procedures

- Form 1040 Schedule D
 - Part I reports short term capital gains and losses
 - Part II reports long term capital gains and losses
 - Part III summarizes results of Parts I and II and indicates whether taxpayer has net capital gain or net capital loss

New for 2011: Schedule D filers will use Form 8949, *Sales and Other Dispositions of Capital Assets*, as a continuation sheet and record sales and other dispositions of capital assets. Schedule D-1 is obsolete. Changes were made to Form 1099-B. Visit irs.gov for more information.

Reporting procedures — Schedule D

SCHEDULE D (Form 1040)		Capital Gains and Losses				OMB No. 1545-0074
Department of the Treasury Internal Revenue Service (99)		▶ Attach to Form 1040 or Form 1040NR. ▶ See instructions for Schedule D (Form 1040). ▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.				2010 Attachment Sequence No. 12
Name(s) shown on return					Your social security number	
Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less						
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	
1						
2 Enter your short-term totals, if any, from Schedule D-1, line 2					2	
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)					3	
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824					4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 10 of your Capital Loss Carryover Worksheet on page D-7 of the instructions					6	()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)					7	
Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year						
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	
8						
9 Enter your long-term totals, if any, from Schedule D-1, line 9					9	
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)					10	
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					12	
13 Capital gain distributions. See page D-2 of the instructions					13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your Capital Loss Carryover Worksheet on page D-7 of the instructions					14	()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back					15	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2010

Reporting procedures (cont.)

- Form 1099B, Proceeds from Broker and Barter Exchange Transactions
 - Report proceeds from sale and exchange of stocks and bonds
 - Prepared by brokerage company or transfer agent

Reporting mutual fund income and sales

- Mutual fund distributions (income generated inside the fund)
 - Long term capital gains: Capital gain distributions. Reported on Schedule D line 13.
 - Qualified dividend income: Dividend income qualifying for the reduced 15% rate. Reported on Schedule B and Form 1040 page 1 line 9b.
 - Other dividend income: Interest, nonqualified dividends, and short-term capital gains. Reported on Schedule B.

Reporting mutual fund income — 1099-DIV

9191 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no. Mutual Fund A One Somewhere Lane Money, MA		1a Total ordinary dividends	\$ 4,500	2010 Form 1099-DIV	Dividends and Distributions Copy A For Internal Revenue Service Center File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2010 General Instructions for Certain Information Returns
		1b Qualified dividends	\$ 4,125		
		2a Total capital gain distr.	\$ 12,500	2b Unrecap. Sec. 1250 gain	
PAYER'S federal identification number	RECIPIENT'S identification number	2c Section 1202 gain	\$	2d Collectibles (28%) gain	\$
01-2345678	555-40-1524				
RECIPIENT'S name		3 Nondividend distributions	\$	4 Federal income tax withheld	\$
				5 Investment expenses	\$
Street address (including apt. no.)		6 Foreign tax paid	\$	7 Foreign country or U.S. possession	
Civ. state, and ZIP code		8 Cash liquidation distributions	\$	9 Noncash liquidation distributions	\$
Houston, TX					
Account number (see instructions)	2nd TIN not.				
	<input type="checkbox"/>				

Form 1099-DIV Cat. No. 14415N Department of the Treasury - Internal Revenue Service

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Reporting mutual fund sales

- Sale, exchange or redemption of mutual fund shares
 - Gain or loss is difference between adjusted basis in the shares and the selling price
 - Reported on Schedule D

Reporting mutual fund sales — 1099-B

7979 VOID CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no. Mutual Fund A One Somewhere Lane Money, MA		1a Date of sale or exchange 6/30/2010	OMB No. 1545-0715 2010	Proceeds From Broker and Barter Exchange Transactions
		1b CUSIP no.	Form 1099-B	
PAYER'S federal identification number 01-2345678		RECIPIENT'S identification number 555-40-1524		Copy A For Internal Revenue Service Center File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2010 General Instructions for Certain Information Returns.
RECIPIENT'S name Rich Man		3 Bartering \$	4 Federal income tax withheld \$	
Street address (including apt. no.)		7 Description 230 shs Mutual Fund A		
City, state, and ZIP code Houston, TX		8 Profit or (loss) realized in 2010 \$	9 Unrealized profit or (loss) on open contracts—12/31/2009 \$	
CORPORATION'S name		10 Unrealized profit or (loss) on open contracts—12/31/2010 \$	11 Aggregate profit or (loss) \$	
Account number (see instructions)	2nd TIN not. <input type="checkbox"/>	12 Check the box if recipient cannot take a loss on their tax return based on the amount in box 2 <input type="checkbox"/>		
Form 1099-B		Cat. No. 14411V		

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Sale of mutual fund shares — Basis

- General rule for identifying stock shares sold
 - First-in First-out (FIFO)
 - Specific identification method

Sale of stock index mutual fund A — FIFO

Original purchase 2/2/2008 200 shs @ \$150/sh	\$30,000
Reinvestment 12/31/2008 dividends 20 shs @ \$175/sh	3,500
Reinvestment 12/31/2009 dividends 25 shs @ \$168/sh	4,200
Purchase 2/20/2010 100 shs @ \$170	17,000
Sale 6/30/2010 230 shs @ \$160/sh	36,800

Cost Basis of shares sold:

Original purchase	200 shs @ \$150/sh	\$30,000 LT
DRIP 12/31/2008	20 shs @ \$175/sh	3,500 LT
DRIP 12/31/2009	10 shs @ \$168/sh	1,680 ST

Proceeds of shares sold:

Original purchase	200 shs @ \$160/sh	\$32,000 LT
DRIP 12/31/2008	20 shs @ \$160/sh	3,200 LT
DRIP 12/31/2009	10 shs @ \$160/sh	1,600 ST

	<u>Proceeds</u>	<u>Basis</u>	<u>Gain/(Loss)</u>
Long term	35,200	33,500	1,700
Short term	1,600	1,680	<u>(80)</u>
Net long term gain			1,620

Sale of stock index mutual fund A – Specific ID

Original purchase 2/2/2008 200 shs @ \$150/sh		\$30,000
Reinvestment 12/31/2008 dividends 20 shs @ \$175/sh		3,500
Reinvestment 12/31/2009 dividends 25 shs @ \$168/sh		4,200
Purchase 2/20/2010 100 shs @ \$170	17,000	
Sale 6/30/2010 230 shs @ \$160/sh		36,800

Cost Basis of shares sold:

Purchase 2/20/2010	100 shs @ \$170/sh	\$17,000 ST
DRIP 12/31/2009	25 shs @ \$168/sh	4,200 ST
DRIP 12/31/2008	20 shs @ \$175/sh	3,500 LT
Purchase 2/2/2009	85 shs @ \$150/sh	12,750 LT

Proceeds of shares sold:

Purchase 2/20/2010	100 shs @ \$160/sh	\$16,000 ST
DRIP 12/31/2009	25 shs @ \$160/sh	4,000 ST
DRIP 12/31/2008	20 shs @ \$160/sh	3,200 LT
Purchase 2/2/2008	85 shs @ \$160/sh	13,600 LT

	<u>Proceeds</u>	<u>Basis</u>	<u>Gain/(Loss)</u>
Long term	16,800	16,250	550
Short term	20,000	21,200	(1,200)
Net short term loss			(650)

Sale of mutual fund shares — Basis (cont.)

- Average cost basis (exception to general rule)
calculate average cost basis at time of sale apply short term and long term: two different methods
 - Single category method
 - Double category method

Stock index mutual fund A — Schedule D

Part I

SCHEDULE D (Form 1040) <small>Department of the Treasury Internal Revenue Service (99)</small>	Capital Gains and Losses ▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.	<small>OMB No. 1545-0074</small> <div style="font-size: 2em; font-weight: bold; text-align: center;">2010</div> Attachment Sequence No. 12
Name(s) shown on return Rich Man		Your social security number 555-40-1524

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property <small>(Example: 100 sh. XYZ Co.)</small>	(b) Date acquired <small>(Mo., day, yr.)</small>	(c) Date sold <small>(Mo., day, yr.)</small>	(d) Sales price <small>(see page D-7 of the instructions)</small>	(e) Cost or other basis <small>(see page D-7 of the instructions)</small>	(f) Gain or (loss) <small>Subtract (e) from (d)</small>
1 10 shs. Mutual Fund A	12/31/09	06/30/10	1,600	1,680	(80)
2 Enter your short-term totals, if any, from Schedule D-1, line 2					
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)			1,600		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824					
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					
6 Short-term capital loss carryover. Enter the amount, if any, from line 10 of your Capital Loss Carryover Worksheet on page D-7 of the instructions					()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)					(80)

Stock index mutual fund A — Schedule D

Part II

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year					
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 220 Shs Mutual Fund A	VARIOUS	6/30/10	35,200	33,500	1,700
9 Enter your long-term totals, if any, from Schedule D-1, line 9					
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d).			35,200		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824					
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1					
13 Capital gain distributions. See page D-2 of the instructions					12,500
14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your Capital Loss Carryover Worksheet on page D-7 of the instructions					()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back					14,200

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Schedule D (Form 1040) 2010

Poll question #3

Lea received capital gain distributions from the Balanced Mutual Fund XYZ. Which of the following choices reflect the correct reporting for the capital gain distribution?

- Distribution is reported to Lea on the Form 1099-DIV
- Lea reports the distribution on her Schedule D Part II
- Distribution is reported to Lea on the Form 1099B
- Lea reports the distribution on her Schedule B
- Both the first and second answer
- Both the second and third answer

Loss on worthless securities

- Capital loss allowed in year stock becomes wholly worthless
 - Stock has no liquidation value and no reasonable hope or expectation exists that it will become valuable at some future date
 - Facts and circumstances analysis
 - Obtain letter from broker stating stock is worthless
 - Sell stock to realize loss (beware of wash sale rules)

Planning points

- Planning for capital gains and losses
 - Holding periods
 - Mutual fund transactions
 - Avoid wash sales
 - Substantiating deduction for worthless securities

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