EA Tax Training

EA Exam Preparation 2025
Part 1: Individuals

VIDEO 3:

CAPITAL GAINS

PRESENTER: TOM NORTON CPA, EA

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What We'll Cover

- Types of property
- Basis of assets
- Capital gains and losses
- Nontaxable and Other Sales

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Free Resources (irs.gov)

- **Publication 17, *Your Federal Income Tax***
- **Instructions for Forms 1040 and 1040-SR**
- **Schedule D (Form 1040), *Capital Gains and Losses*, and its instructions**
- **Form 8949, *Sales and Other Dispositions of Capital Assets*, and its instructions**
- **Publication 544, *Sales and Other Dispositions of Assets***
- Publication 550, *Investment Income and Expenses*
- IRS Notice 2014-21 (virtual currency)
- Publication 523, *Selling Your Home*

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Flow of the Tax Return

START:	Gross income
LESS:	Adjustments to income
EQUALS:	Adjusted gross income (AGI)
LESS:	Deductions (Standard or Itemized, QBI)
EQUALS:	Taxable income
APPLY:	Tax tables/Schedules
EQUALS:	Income tax
LESS:	Credits
PLUS:	Other taxes
EQUALS:	Total tax
LESS:	Payments
EQUALS:	Amount Due/Overpayment (Refund)

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Types of Property

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Types of Property

- **Investment property**: Property that produces investment income
  - e.g. stocks, bonds, Treasury bills and notes
- **Business property**: Property used in a trade or business
  - Buildings, computers, equipment, trucks, etc.
- **Tangible property**: Physical in nature (can touch it)
- **Intangible property**: Not physical in nature
  - Computer software, patents, trademarks, licenses, customer lists, etc.

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Types of Property

- **Depreciable property**: Property subject to depreciation expense
- Only for business use or rental property
- Depreciation expense is a deduction for the cost of property used in a business or income-producing activity, spread out over the estimated useful life or recovery period of the property
- Examples are buildings, machinery, equipment, computers, vehicles, furniture, etc.
  - Land is not depreciable, as it is not considered to "wear out" over time

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Real Property vs. Personal Property

- Tangible property can be broken down into two categories:

1. **Real property**: Land, buildings, equipment and fixtures attached to land or buildings (e.g. building systems- HVAC, plumbing, etc.)
2. **Personal property**: Everything else (alternatively, property that can be moved)
   - Even if used in a business, still called "personal" property to distinguish it from real property

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Capital vs. Noncapital Assets

- **Noncapital assets**: Specific categories of assets that do not result in a capital gain or loss upon sale or disposal.
  - Gain or loss is considered "ordinary"
- **Capital assets**: Any asset not considered noncapital.
  - Results in a capital gain or loss upon sale or disposal.
- Capital gains (long-term) are taxed at a lower rate than ordinary gains; therefore, we generally prefer capital gains
- Capital losses are limited, while ordinary losses are not, and ordinary losses can offset ordinary income; therefore, we generally prefer ordinary losses

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What Is **Not** A Capital Asset?

- Any asset is a capital asset unless it is one of the following:
  - Property held for sale to customers (inventory)
  - Depreciable property used in a trade or business
  - Real property used in a trade or business
  - Intellectual property (patent, copyright, secret formula, etc.) held by the person who created or received it (e.g. letter), or received by gift from such a person
  - Accounts receivable in a business
  - Certain US government publications
  - Certain commodities derivative instruments held by dealers
  - Hedging transactions
  - Supplies used in a trade or business

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Most Assets Are Capital Assets

- Almost everything you own as an individual is a capital asset. This includes your home, cars, furniture, clothing, investments, etc.
- More about how the asset is used than the type of asset.

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Basis of Assets

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Asset Basis (Cost Basis)

- We need to determine the basis of an asset to:
  - Determine a gain or loss when the asset is sold or otherwise disposed of
  - Determine depreciation for some assets
  - Determine the amount to put on a business's balance sheet
  - Other miscellaneous uses

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Determining Gain or Loss on Sale

- To determine a gain or loss, subtract your basis in the asset from the sales price
- In the simplest cases, basis is equal to cost (how much you paid for the asset)
  - Sometimes referred to as "cost basis"
- **Example**: You bought 20 shares of stock in XYZ Corporation for $500 ($25 per share) on June 1, 2022. On June 1, 2024, you sold 10 of the shares for $300 ($30 per share). You have a long-term capital gain of $50 (10 shares at $5 per share).

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Cost

- Basis is usually equal to cost
- "Cost" includes expenses of sale, such as commissions, fees, closing costs, sales tax, etc.
- **Example 1**: You buy 100 shares of stock in XYZ Corporation at $10 per share. You incur brokerage fees of $20. Your basis in the stock is $1,020, or $10.20 per share.
- **Example 2**: You buy a car for $30,000. You pay sales tax of $2,400, a delivery fee of $400, and a dealer administrative fee of $200. Your basis in the car is $33,000.

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Basis of Real Property

- Usually includes costs other than the purchase price
- Found on the closing statement
- Closing or settlement costs:
  - Recording fees
  - Appraisal fees
  - Abstract fees
  - Survey costs
  - Title insurance
  - Amounts legally owed by the seller, but paid by the buyer (e.g. real estate tax)
  - Etc.
- Does not include loan fees, points, etc.

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Basis of Real Property

- If constructing rather than buying, all expenses of construction are included, including materials, labor, permit fees, inspection fees, etc.
- If demolition is done prior to building, demolition costs are added to the basis of the land, rather than the new building.

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Basis Increase After Purchase

- If you make major improvements or additions to the property, your basis increases by the cost of those improvements or additions.
  - Includes adding rooms, driveways, fences, landscaping, flooring, major systems (e.g. HVAC, wiring, septic system), etc., but not repairs of those items
- Do not increase basis for maintenance items, such as painting, fixing leaks, filling holes or cracks, or replacing broken hardware

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Basis Decrease After Purchase

- Depreciation expense
- Other tax expenses/losses (e.g. casualty or theft loss)
- Rebates
- Money received to reimburse for loss (e.g. insurance proceeds)

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Basis-Stock Dividends and Splits

- Stock dividends and splits are usually not taxable
- To determine basis in each share of stock, take your basis in the original shares and divide by the new number of shares
- **Example 1**: Terrance bought 100 shares of BCD Corp. for $1,000, making his basis $10 per share. BCD Corp. issued a stock dividend of 2/10 of a share, per share. Terrance now owns 120 shares. His basis is $1,000/120=$8.33 per share.
- **Example 2**: Sandra bought 100 shares of XYZ Corp. for $1,000, making her basis $10 per share. Later, XYZ Corp. announced a stock split of 3 to 1. Sandra now owns 300 shares. Her basis is $1,000/300=$3.33 per share.

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Nondividend Distributions

- Will often see on 1099-DIV
- Not currently taxed. Instead, reduces the basis of your stock
- When you sell the stock, your taxable gain will be proportionally greater
- **Example**: Terrance bought 100 shares of BCD Corp. for $1,000, making his basis $10 per share. BCD Corp. made a nondividend distribution to Terrance of $100 cash. Terrance's basis in the stock is now $900/100=$9 per share.

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Inherited or Gifted Property

- Basis of inherited property is the FMV at date of death, or if elected by estate, 6 months after the date of death.
  - "Step-up" in basis
- Basis of gifted property is same for donee as for donor (carryover basis)
  - Unless sold at a loss, then basis is lesser of donor's basis or FMV

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Fair Market Value (FMV)

- FMV is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts.

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Capital Gains and Losses

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Two Categories of Capital Assets

- Capital assets held for investment
- Capital assets held for personal use

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Capital Assets Held for Investment

- Stocks, stock rights, and bonds, unless held by a securities dealer
- Gold, silver, stamps, coins, gems, etc., unless held by a dealer in such items
- Gains on the sale of investment property are taxed as capital gains
- Losses are deducted as capital losses

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Capital Assets Held for Personal Use

- Property held for personal use only, rather than as an investment
  - Family home, car, furniture, clothing, etc.
- Gains on the sale of personal-use property are generally taxed as capital gains
- Losses are **not** deductible

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Holding Period of Capital Assets

- **Long-term**: Held the asset for *more than* 1 year
  - Inherited property automatically long-term
  - Gain or loss on sale is a long-term capital gain or loss
  - Taxed at favorable capital gains rates
- **Short-term**: Held the asset for *one year or less*
  - Gain or loss on sale is a short-term capital gain or loss
  - Taxed at ordinary rates

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Capital Losses

- You can deduct capital losses up to the amount of your capital gains, plus an additional $3,000 per year ($1,500 MFS)
- Note: The amount of loss allowed is the same ($3,000) for Single, HOH, QSS and MFJ
- Excess losses can carryover to be used in future years to offset gains and as a deduction up to the $3,000/$1,500 limit

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Calculating Net Capital Gain/Loss

1. Total all short-term gains and subtract all short-term losses
   - This leaves you with a net short-term capital gain or loss
2. Total all long-term gains and subtract all long-term losses
   - This leaves you with a net long-term capital gain or loss
3. If the positions are opposite (one is a gain and the other a loss), net the two together to get either a net gain or loss.
   - If the positions are the same (both gains or both losses), no further netting is necessary, and you have two different kinds of income or loss (see chart)
4. This leaves you with four possible outcomes (see chart)

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Net Capital Gain (Loss) Position	Tax Treatment
Net short-term gain	Ordinary income rates
Net short-term loss	Deductible loss up to $3,000 ($1,500 MFS); remainder carried forward
Net long-term gain	Capital gains rates
Net long-term loss	Deductible loss up to $3,000 ($1,500 MFS); remainder carried forward

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Capital Loss Carryforwards

- Excess (above the $3,000/$1,500 limit) capital losses can be carried forward indefinitely, but if the taxpayer dies, any unused losses are lost
- If losses are carried forward from a previous year, as part of the netting process, short-term carryover losses are netted against current year short-term gains, and long-term carryover losses are netted against current year long-term gains

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Calculating Net Capital Gain/Loss

- **Example 1**: Jerry had the following capital gains and losses in 2024:
- **Long-term**: Sold XYZ Stock for $2,000 gain; Sold ABC mutual fund for ($3,000) loss; Sold FGH Stock for ($5,000) loss.
- **Short-term**: Sold JKL Stock for $2,000 gain; Sold MNO Stock for ($1,000) loss.
- **Net long-term loss**: ($6,000)
- **Net short-term gain**: $1,000
- **Net long-term loss**: ($5,000)
- Jerry is Single and can use $3,000 of his loss to offset ordinary income in 2024; the remaining $2,000 loss is a carryforward.

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Calculating Net Capital Gain/Loss

- **Example 2**: Julie had the following capital gains and losses in 2024:
- **Long-term**: Sold ZYX Stock for $3,000 gain; Sold CBA stock for $2,000 gain; Sold HGF Stock for ($1,000) loss.
- **Short-term**: Sold LKJ Stock for $3,000 gain; Sold ONM Stock for ($2,000) loss.
- Julie also has a $2,000 long-term capital loss carryforward from 2023.
- **Net Long-term gain**: $2,000 ($3,000+$2,000-1,000-$2,000)
- **Net short-term gain**: $1,000
- Julie is Single and will pay capital gains tax on the $2,000 long-term gain, and ordinary income tax on the $1,000 short-term gain. She has no loss carryforward remaining.

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Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.
Go to *www.irs.gov/Form8949* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. **12A**

Name(s) shown on return	**Social security number or taxpayer identification number**

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g).
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 1b** (if **Box A** above is checked), **line 2** (if **Box B** above is checked), or **line 3** (if **Box C** above is checked) . . .							

Note: If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768Z Form **8949** (2024)

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Form 8949 (2024) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	**Social security number or taxpayer identification number**

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are generally long-term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☐ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g).
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) . . .							

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2024)

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SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

Attach to Form 1040, 1040-SR, or 1040-NR.
Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
Go to *www.irs.gov/ScheduleD* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. 12

Name(s) shown on return | **Your social security number**

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ **Yes** ☐ **No**
If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I **Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

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 8 of your **Capital Loss Carryover Worksheet** in the instructions	**6**	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	**7**	

Part II **Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

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 the instructions	**13**	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	**14**	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). 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) 2024**

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Schedule D (Form 1040) 2024 Page **2**

Part III **Summary**

16 Combine lines 7 and 15 and enter the result	**16**	

- If line 16 is a **gain**, enter the amount from line 16 on Form 1040, 1040-SR, or 1040-NR, line 7. Then, go to line 17 below.
- If line 16 is a **loss**, skip lines 17 through 20 below. Then, go to line 21. Also be sure to complete line 22.
- If line 16 is **zero**, skip lines 17 through 21 below and enter -0- on Form 1040, 1040-SR, or 1040-NR, line 7. Then, go to line 22.

17 Are lines 15 and 16 **both** gains?
☐ **Yes.** Go to line 18.
☐ **No.** Skip lines 18 through 21, and go to line 22.

18 If you are required to complete the **28% Rate Gain Worksheet** (see instructions), enter the amount, if any, from line 7 of that worksheet	**18**	
19 If you are required to complete the **Unrecaptured Section 1250 Gain Worksheet** (see instructions), enter the amount, if any, from line 18 of that worksheet	**19**	

20 Are lines 18 and 19 both zero or blank and you are not filing Form 4952?
☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 16. **Don't** complete lines 21 and 22 below.
☐ **No.** Complete the **Schedule D Tax Worksheet** in the instructions. **Don't** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, 1040-SR, or 1040-NR, line 7, the **smaller** of:

- The loss on line 16; or
- ($3,000), or if married filing separately, ($1,500)

21 ( )

Note: When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, 1040-SR, or 1040-NR, line 3a?
☐ **Yes.** Complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 16.
☐ **No.** Complete the rest of Form 1040, 1040-SR, or 1040-NR.

Schedule D (Form 1040) 2024

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Capital Gains Tax Rates 2024

Taxable Income					
Single	MFJ/QSS	MFS	HOH	Capital Gains Tax Rate*	Marginal Ordinary Rates
$0 to $47,025	$0 to $94,050	$0 to $47,025	$0 to $63,000	0%	10% to 12%
$47,026 to $518,900	$94,051 to $583,750	$47,026 to $291,850	$63,001 to $551,350	15%	22% to 35%
$518,901 or more	$583,751 or more	$291,851 or more	$551,351 or more	20%	35% to 37%

*Exceptions:
1. Net capital gain from selling collectibles taxed at ordinary rates, up to a maximum of 28%
2. Taxable part of a sale of section 1202 qualified small business stock taxed at a maximum 28% rate
3. The portion of any unrecaptured section 1250 gain is taxed at a maximum 25% rate

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Securities Sales

- Many capital gains transactions involve securities (stocks, bonds, etc.)
- Usually reported on 1099-B from brokerage house
  - Often provide both sales price and basis, dates bought and sold, and whether long-term or short-term gain or loss
- Mutual funds can generate capital gains in two ways:
  1. Gains the fund has from buying and selling securities (capital gains distributions)
  2. Gain or loss you have by selling the mutual fund

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Capital Gain Distributions

- Will often see on 1099-DIV from a mutual fund
- Report as long-term capital gains, regardless of how long you held the stock or mutual fund

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Liquidating Distributions

- When a corporation is partially or completely liquidating
- First, a return of capital (basis)
- Any amount in excess of your basis is a capital gain
- If total liquidation and you receive less than your basis, you have a capital loss

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Worthless Securities

- Stocks, stock rights, and bonds that became completely worthless during the tax year are treated as though they were sold, for $0.00, on the last day of the tax year
- Report on Form 8949
- Must be able to support worthlessness (e.g. complete liquidation)

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Wash Sales

- A wash sale occurs when you sell stocks or securities at a loss, and within 30 days before or after the sale you:
  - Buy substantially identical stock or securities
  - Acquire substantially identical stock or securities in a fully taxable trade
  - Enter into a contract or option to acquire substantially identical stock or securities
  - Acquire substantially identical stock or securities for your IRA or Roth IRA
- Wash sale losses are not deductible
- Still report the sale on Form 8949
  - Usually listed on 1099-B as a wash sale

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Options

- Gain or loss from the sale or trade of an option to buy or sell property that is (or would be) a capital asset in your hands, is a capital gain or loss
- If you have a loss from an option because you did not exercise it, considered a sale and a capital loss
- If the option is part of a straddle (one option to buy and one to sell the same security), you generally don't report gain or loss until both positions have settled

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Incentive Stock Options

- Statutory stock options
  - No income until you sell or exchange the stock
  - Taxed at capital gains rates
  - Must meet certain rules to be "statutory"
  - Employer will know and will send Form 3921 to report amounts
- Nonstatutory stock options
  - Generally income when received, if fair market value (FMV) can be determined
  - If FMV can't be determined when received, then taxable when exercised or sold
  - Capital gains rates

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Employee Stock Purchase Plans (ESPP)

- Corporate benefit that allows employees to purchase the company's stock at a discount
- For a qualified ESPP, no income recognized until the stock is sold
- If sold more than 24 months after the offering date and more than 12 months after the purchase date, favorable treatment
- Gain is a mix of ordinary and capital gains
- Form 3922 from employer showing amounts of ordinary and capital gains

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Publicly Traded Partnerships (PTPs)

- A PTP is any partnership with ownership units traded on an established securities market, or with units that are readily tradable on a secondary market
- By default, PTPs are treated as corporations, in which case gain or sale on loss is straightforward
- However, if 90% or more of the PTP's income comes from certain types of passive income, it is treated as a partnership, meaning the owners get a K-1
- Any losses flowing through a PTP K-1 are passive, and therefore subject to the PAL rules

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Publicly Traded Partnerships (PTPs)

- Cash distributions from a PTP treated as a partnership can lower basis, resulting in a higher than expected gain on sale
- Because of complex partnership rules, some of the gain on sale may be ordinary rather than capital

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Small Business Stock (Section 1244)

- Section 1244 stock is stock in a domestic small business corporation that is primarily operating a business, rather than investing, and you're the original owner of the stock
- Loss on sale or worthlessness of small business stock can be treated as ordinary loss
  - Up to $50,000 ($100,000 MFJ) treated as ordinary
  - Remainder treated as capital loss
- Gain on sale is a capital gain
- Best of both worlds!

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Small Business Investment Company

- A SBIC is one that is licensed and operated under the Small Business Investment Act of 1958
- Loss on sale or worthlessness is an ordinary loss
- Gain on sale is a capital gain
- Best of both worlds!

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Section 1202 QSB Stock

- Qualified Small Business (QSB) stock, also call Section 1202 stock
- For C corporations that operate qualifying businesses, and stock has been held for at least 5 years.
- Can exclude all or a portion of the gain on sale, up to $10,000,000 or 10 times initial basis, whichever is greater.
- That means the gain can be **tax free!**
- If acquired on or before Feb. 17, 2009, can exclude up to 50% of the gain
- If acquired after Feb. 17, 2009, and before Sep. 28, 2010, can exclude up to 75% of gain
- If acquired after Sep. 27, 2010, can exclude up to 100% of the gain

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Investors, Dealers, and Traders

- **Investors**: Buy and sell securities and expect income from dividends, interest, or capital appreciation. Typically hold securities for a substantial period of time. Not in the "business" of investing.
  - Most people who own securities are investors
  - Sales of securities result in capital gains and losses
  - Subject to the normal capital loss limitations
- **Dealers**: Dealers purchase securities and resell them to their customers, and may keep inventory. They derive their income from marketing securities to customers or by being compensated for services provided as an intermediary or market-maker. Must use mark-to-market rules.

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Investors, Dealers, and Traders

- **Traders**: Are in the "business" of buying and selling securities for their own account. Considered a business even though no inventory and no customers. Must meet all of the following conditions:
  - Must seek to profit from daily market movements
  - Activity must be substantial
  - Must carry on the activity with continuity and regularity
- Report expenses on Schedule C
- No self-employment tax
- Can elect to use mark-to-market rules

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Mark-to-Market

- Any securities that you hold at the end of the year must be treated as sold at its FMV on the last business day of the year, and you must recognize any gain or loss that results.

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Mark-to-Market Election

- Traders can elect mark-to-market, investors cannot. Dealers must use.
- If Traders make a valid mark-to-market election, all gains and losses are treated as ordinary, and are not subject to capital loss limitations, and the wash sale rules do not apply
- If Traders do not make a valid mark-to-market election, their gains and losses are treated just like any investor's
- The election must be made by the due date of the prior year's tax return, and involves an "accounting change." Revoking the election must also be done by the due date of the tax return for the year before it becomes effective.

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Mark-to-Market- Section 1256

- A section 1256 contract is any:
  - Regulated futures contract
  - Foreign currency contract
  - Nonequity option
  - Dealer equity option
  - Dealer securities futures contract

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Mark-to-Market

- Any "section 1256 contract" that you hold at the end of the year must be treated as sold at its FMV on the last business day of the year, and you must recognize any gain or loss that results.
- Does not apply to hedging transactions
- 60/40 rule: 60% of your capital gain or loss will be considered long-term, and 40% will be considered short-term

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Digital Assets (Cryptocurrency)

- For federal tax purposes, digital assets are treated as property. General tax principles applicable to property transactions apply.
  - Not considered "currency"
- Question on page 1 of 1040: "Digital Assets: At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?" Followed by Yes or No checkboxes.

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Digital Assets (Cryptocurrency)

- Taxable gain or loss may result from transactions including, but not limited to:
  - Sale of a digital asset
  - Exchange of a digital asset for property, goods, or services
  - Exchange or trade of one digital asset for another
  - Receipt of a digital asset as payment for goods or services
  - Receipt of a new digital asset as a result of a hard fork
  - Receipt of a new digital asset as a result of mining or staking
  - Receipt of a digital asset as a result of an airdrop
  - Any other disposition of a financial interest in a digital asset
  - Receipt or transfer of a digital asset for free that does not qualify as a bona fide gift

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Digital Assets (Cryptocurrency)

- Gains and losses are treated same as others
  - If FMV of crypto received exceeds basis, you have a gain. If basis exceeds FMV of crypto received, you have a loss.
    - If capital, taxed at capital gains rates, losses limited to $3,000 ($1,500 MFS)
- If ordinary income, such as crypto received by a self-employed person for performing services, treat as gross receipts in your business at the FMV in US dollars **at the time received**.
- If used to pay business expenses, record the expense at the FMV in US dollars **at the time paid**. Could also result in a gain if basis is lower than FMV.
- Use 1099-MISC, if more than $600 worth paid to an individual or partnership
- See IRS Notice 2014-21

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Collectibles

- Art, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, musical instruments, historical objects, and similar assets
  - Includes precious metals-based ETFs (exchange traded funds)
  - Also includes an equity interest in a passthrough entity that holds collectibles
  - IRS can deem assets to be collectibles
- Taxed at ordinary rates, up to a maximum of 28%
- Losses are not deductible unless held for investment
  - Depends on intent of purchasing, whether for personal enjoyment or expectation of a profit
  - IRS will look at facts and circumstances on a case-by-case basis

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Bad Debts

- Business bad debts deductible by the business (Part 2)
- Nonbusiness bad debts may be deductible as a short-term capital loss. Must meet the following criteria:
  - Must be a genuine debt
    - Not intended as a gift
    - Loan from parent to minor child to pay for their basic needs is not a genuine debt
  - Must have basis in the debt
    - Actually loaned out cash
    - No bad debt because you didn't receive something you should have, such as child support, wages, rent, etc.
- Can deduct in year it becomes worthless (no longer any chance it will be repaid)

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Sales of Noncapital Assets

- What if you sell a noncapital asset?
- Almost always a business transaction
  - Report on appropriate business tax form
    - Frequently Form 4797
  - Ordinary income or loss
    - Some exceptions
- Covered in Part 2

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Nontaxable and Other Sales

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Transactions Between Spouses

- Generally, no gain or loss is recognized on a transfer of property between spouses, or if incident to divorce, former spouses.
- Any such transfer is treated as a gift. The receiving spouse's basis is the same as the gifting spouse, even if the property is sold for a loss.

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Related Parties

- Losses on sales between related parties cannot be deducted
  - Family members
  - Corporation and a >50% owner
  - Fiduciary and beneficiary of the same trust
  - Etc.
- Gains are taxable

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Sale of Primary Residence

- Your home is a capital asset, and the general rule is the gain on the sale of a capital asset is taxable income, even if it is a personal (nonbusiness) asset;
- However, there are special rules for when you sell your primary residence which may allow you to exclude all or part of the gain.
- If you qualify, you can exclude up to $250,000 of gain if you file Single, HOH, or MFS. You and your spouse can exclude up to $500,000 of gain if you both qualify and file MFJ.
- Remember, you cannot deduct a capital loss on the sale of a personal-use asset, including your primary residence.

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Sale of Primary Residence

- To qualify for the gain exclusion, you must meet **both** of the following tests:
- **Test 1**: During the 5-year period ending on the date you sold your home, you owned it for 2 years or more (ownership requirement) and lived in it as your main home for 2 years or more (use requirement).
  - The 2 years of ownership and 2 years of use do not have to be the same 2 years.
  - If MFJ, in order to double the exclusion to $500,000, only one spouse has to meet the ownership requirement. Both must meet the use requirement.
- **Test 2**:You haven't excluded gain on the sale of a primary residence of another main home during the 2-year period ending on the date of the sale of your home.

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Sale of Primary Residence

- **Example 1**: John is single and started renting a house as his primary residence on August 1, 2019. On July 1, 2021, John bought the house and continued to live in it until October 1, 2021, when he got married and moved into a new house with his wife. He allowed his brother to live in his first house, until John sold it on August 1, 2024, realizing a $200,000 gain. John can exclude the gain because:
  - He owned the house for 3 years and 1 month as of the date of sale (July 1, 2021, to August 1, 2024), satisfying the ownership test, and
  - He lived in the house as his primary residence for 2 years and 2 months out of the last 5 years (August 1, 2019, to September 30, 2021), satisfying the use test.
  - Note John can exclude up to $250,000 whether he files MFJ or MFS.

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Sale of Primary Residence

- **Example 2**: Maria is single and bought a house on July 1, 2020, in New York, and lived in it as her primary residence. On January 1, 2022, Maria entered a 2-year Masters degree program in California, where she rented an apartment. While she was in California, her brother lived in her New York house. On February 1, 2024, Maria decided to stay in California to pursue a Doctorate degree, and sold her New York house, realizing a gain of $200,000. Maria must pay capital gains tax on the $200,000, because even though she met the ownership test by owning the house for 3 years and 7 months (July 1, 2020, to January 31, 2024), she did not meet the use test, having lived in the house for only 18 months (July 1, 2020, to December 31, 2021), instead of the required 24 months.

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Partial Exclusion of Gain

- If you don’t meet the eligibility tests, you may still qualify for a partial exclusion of the gain.
- You qualify if the main reason for your home sale was:
  - Change in workplace location
  - Health-related
  - Other unforeseeable events
- Exclusion amount is the percentage achieved of the failed test (lowest percentage if more than one test not met) multiplied by $250,000 ($500,000 if MFJ). So, if you failed the test because you only lived in the house for 12 months instead of 24, you can exclude 12/24 x $250,000 = $125,000

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Partial Exclusion of Gain

- **Example 3**: Maria is single and bought a house on July 1, 2020, in New York, and lived in it as her primary residence. On January 1, 2022, Maria accepted a 2-year out-of-state assignment with her employer in California, where she rented an apartment. While she was in California, her brother lived in her New York house. On February 1, 2024, after Maria's employer offered her a permanent position in California and she accepted, she sold her New York house, realizing a capital gain of $200,000. Maria qualifies for a partial exclusion, since the sale of the house was due to a change in work location. She met the ownership test by owning the house for 3 years and 7 months (July 1, 2020, to January 31, 2024), but she did not meet the use test, having lived in the house for only 18 months (July 1, 2020, to December 31, 2021), instead of the required 24 months. She can exclude 18mos/24mos x $250,000 = $187,500. The remaining $12,500 is a taxable capital gain.

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Depreciation Recapture

- If you rented out your home or took a home office deduction, you may have been entitled to a deduction for depreciation.
- When you sell that home, you usually have to "recapture" (i.e. pay tax on) that depreciation
- So even if the gain can otherwise be excluded, you will be taxed on the amount of depreciation you took (or could have taken, even if you did not), at a rate of up to 25%.
- This is to prevent a "double benefit" of deducting part of the cost of the house, and excluding the gain on the sale of that house.

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Depreciation Recapture

- **Example**: Lawrence is single and in the 35% tax bracket. He bought a home and rented it out for two years, taking $22,000 in depreciation deductions, before moving into it as his primary residence. After living in the house for three years, he sold it for a gain of $200,000, which is excluded since he meets all the tests for exclusion. However, since he previously took depreciation on the house, he must recapture that $22,000, and pay 25% capital gains tax on it.

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Reporting the Sale

- You need to report the sale of your primary residence on form 8949 if either:
  - You cannot exclude all or part of the gain; or
  - You received a Form 1099-S
- Note that if you can exclude all of the gain, and you did not receive a 1099-S, you do not have to report the sale on your tax return
- Depreciation recapture is reported on line 19 of Schedule D
- Publication 523, *Selling Your Home*

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Foreclosure or Abandonment

- Normally, if a debt is forgiven, the amount forgiven is cancellation of indebtedness income; there are exceptions, though, and Qualified Principal Residence Indebtedness is one of them.
- If a home is foreclosed on, the lender accepts the proceeds from a short sale, or the owner "hands over the keys" to the lender and abandons it, and the lender accepts the property or proceeds as full satisfaction of the debt, the amount of debt forgiveness may be eligible for exclusion from income.

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Foreclosure or Abandonment

- Certain criteria have to be met for the exclusion:
  - Debt was to buy, build or improve the home (or refinanced)
  - If it was a "cash out" refinancing, and the cash was used for something else, such as paying off other debt, then the cashed-out amount is not eligible
  - Must be your "main home"
- Lender will issue Form 1099-A to the borrower

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Foreclosure or Abandonment

- **Example**: Peter borrowed $200,000 to buy his house. Later, when the balance of the loan was $175,000, Peter refinanced his mortgage to pay off the $175,000, plus cash out of $25,000, for a total new loan of $200,000. He used the $25,000 to pay off his car loan. His Qualified Principal Residence Indebtedness is $175,000. Shortly thereafter, the lender foreclosed on the property, and accepted the property as full payment of the loan. Peter has $25,000 of taxable debt cancellation income.

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Installment Sales

- If you sold property at a gain and will receive a payment in a tax year after the year of sale, you report it as an installment sale. Part of the gain will be recognized in each year one or more payments are received, rather than all in the year of sale.
  - Does not apply to sales of stocks and securities traded on an exchange
  - Can elect out of installment sale treatment and recognize all of the gain in the year of sale
  - Does not apply to sales that results in a loss
- Report on Form 6252 in each year payments are received.

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Installment Sales

- Part of each payment received will be counted as:
  - Return of basis
  - Interest income
  - Gain on sale
- The gain on sale is determined by multiplying the "gross profit percentage" by the amount of the payment received
- The gross profit percentage is determined when the sale takes place, and is applied to each payment
- **Example**: You sell property at a contract price of $60,000 and your gross profit is $15,000. Your gross profit percentage is 25% ($15,000/$60,000). After subtracting interest, you report 25% of each payment as installment sale income.

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Like-Kind Exchanges (Section 1031)

- If you trade business or investment real property solely for other business or investment real property of a like kind, you do not pay tax on any gain or deduct any loss from the trade.
- Also called a "Section 1031" exchange
- Report on Form 8824, and on Schedule D (or Form 4797 for a business)

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Like-Kind Exchanges (Section 1031)

- Must meet all six of the following conditions:
  1. Must be business or investment property (not personal-use)
  2. Property traded and received must be real property
  3. Property must be like-kind. Real estate for real estate considered like-kind, as long as both in the U.S.
  4. Must not be property held for resale
  5. The property to be received must be identified within 45 days after the date you transfer the property given up.
  6. The property received must be received by the earlier of:
     a) The 180th day after the date you transfer the property given up, or
     b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs

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Like-Kind Exchanges (Section 1031)

- Can have an exchange that is partially taxable and partially nontaxable.
- If you receive money or not like-kind property ("boot") in addition to like-kind property, you pay tax on the gain up to the amount of cash and the FMV of the not like-kind property received.
- If you pay money in addition to giving up like kind property, and all 6 conditions are met, still counts as a nontaxable trade.

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Involuntary Conversions (Section 1033)

- An involuntary conversion occurs when;
  - Your property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and
  - You receive other property or money in payment, such as insurance or a condemnation award.
- Treated as a sale, and gain or loss is generally recognized in the year realized.
  - Net payment received less adjusted basis = gain or loss
  - Net payment is the amount of payment less costs of obtaining it

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Involuntary Conversions (Section 1033)

- Gain may be postponed if you receive or purchase a replacement property within the replacement period
  - 2 years for most property
  - 3 years for real property used in a trade or business or held for investment (unless owned by a corporation of which you own 80%)
  - 4 years for main home in a federal disaster area
  - 4 years for livestock in an area eligible for federal assistance

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Involuntary Conversions (Section 1033)

- Remember, losses on personal-use assets are generally not allowed
- Exception for casualty or theft loss in a federally declared disaster area
  - Reduce loss by $100
  - Only deduct what remains to the extent it exceeds 10% of AGI
- Certain major disasters (declared under section 401 of the Stafford Act of 2016), do not have the 10% of AGI rule. In that case, you:
  - Reduce the loss by $500 (instead of $100), and
  - Deduct the rest, without regard to AGI.
  - Can deduct even if you don't itemize.

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Condemnations

- A condemnation is the legal taking of private property by a government body for public use without the owner's consent.
  - A type of involuntary conversion
  - Property sold under a threat of condemnation also qualifies
- If personal residence, can generally exclude up to $250,000 of gain ($500,000 MFJ), as previously discussed. Condemnation is an unforeseeable event that qualifies for partial exclusion.
- For any condemned property, you can postpone the gain by buying replacement property within the replacement period.

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End of Video 3. See you in Video 4!