

## Chapter 7 Lecture Notes

- 1) Investments Overview
  - a) Taxes are levied on investment income, and thus, it would be unwise to make an investment without considering the tax cost.
  - b) It is possible that two investments with identical before-tax rates of return will generate different after-tax rates of return because the investments are taxed differently.
  - c) It is possible that an investment with a lower before-tax rate of return compared to an alternative investment will have a higher after-tax rate of return because income from the investment is taxed at a later date or at a lower rate than the alternative investment.
  - d) Two key tax characteristics that affect after-tax rates of return from investments are:
    - i) The timing of tax payments or tax benefits, and
    - ii) The rate at which investment income or gains are taxed or deductible expenses or losses generate tax savings.
  - e) Income from portfolio investments, which are investments producing dividends, interest, royalties, annuities, or capital gains, may be taxed at ordinary or preferential rates, or it may be exempt from taxation.
  - f) Depending on the type of investment, tax on income from a portfolio investment may be imposed annually or may be deferred until the taxpayer sells the investment.
  - g) Losses from portfolio investments are deferred until the investment is sold and are typically subject to limitations.
  - h) In contrast to portfolio investments, passive investments generate operating income and operating losses.
  - i) Operating income is always taxed annually at ordinary rates, while operating losses are either deducted annually at ordinary rates or deferred and deducted later at ordinary rates, depending on the investor's circumstances.
  - j) Losses from passive investments are also subject to limitations.
- 2) Portfolio Income: Interest and Dividends
  - a) Taxpayers who desire current cash flows from their investments may choose investments that generate interest or regular dividends.
  - b) Investments generating interest income include certificates of deposit (CDs), savings accounts, corporate bonds, and governmental bonds.
  - c) Investments generating dividend income include direct equity investments in corporate stocks and investments in mutual funds and exchange traded funds (ETFs) that invest in corporate stock.
  - d) Interest
    - i) Taxpayers recognize interest income from investments when they receive the interest payments.
    - ii) Interest is taxed at ordinary rates.
    - iii) Taxpayers investing in savings accounts, money market accounts, CDs, and most bonds receive interest payments based on a stated annual rate of return at yearly or more frequent intervals.
    - iv) Special rules apply for determining the timing and amount of interest from bonds when there is a bond discount—that is, when bonds are issued at an amount below the maturity value—or a bond premium—that is, when bonds are issued at an amount above the maturity value.
  - e) Corporate and U.S. Treasury bonds
    - (1) The tax consequences of corporate and Treasury bonds are very similar.
    - (2) The two primary differences are that (1) interest from Treasury bonds is exempt from state taxation while interest from corporate bonds is not, and (2) Treasury bonds always pay interest periodically while corporate bonds may or may not.

- vi) U.S. savings bonds
  - (1) U.S. savings bonds such as Series EE or Series I bonds are issued at either face value or at a discount.
  - (2) The amount of interest income taxpayers recognize when they redeem the bonds is the excess of the bond proceeds over the taxpayer's basis (purchase price) in the bonds.
- vii) Work through Examples 7-1 and 7-2.
- viii) Refer to Exhibit 7-1 for Timing of Interest Payments and Taxes.
- e) Dividends
  - i) Dividend payments (including reinvested dividends) are taxed annually.
  - ii) Qualified dividends are taxed at preferential rates. Refer to Exhibit 7-2 for Holding Period for Qualified Dividends.
  - iii) Nonqualified dividends are not eligible for the reduced rate and are therefore taxed at ordinary rates.
  - iv) Work through Example 7-3.
- 3) Portfolio Income: Capital Gains and Losses
  - a) When taxpayers buy and hold assets with appreciation potential, they typically are investing in capital assets.
  - b) From a tax perspective, the real advantages of investing in capital assets are that:
    - i) Gains are deferred for tax purposes until the taxpayer sells or otherwise disposes of the assets and
    - ii) Gains generally are taxed at preferential rates relative to ordinary income.
  - c) When a taxpayer sells a capital asset for more than its tax basis, the taxpayer recognizes a capital gain; if a taxpayer sells a capital asset for less than its tax basis, the taxpayer recognizes a capital loss (to the extent the loss is deductible).
  - d) The amount realized or selling price of a capital asset includes the cash and fair market value of other property received, less broker's fees and other selling costs.
  - e) The basis of any asset, including a capital asset, is generally the taxpayer's "cost" of acquiring the asset, including the initial purchase price and other costs incurred to purchase or improve the asset.
  - f) Because taxpayers cannot accurately compute the gain or loss on the sale of a capital asset without knowing its basis, it is important to maintain accurate records to track the basis in capital assets.
  - g) By default, taxpayers are required to use the first-in, first-out (FIFO) method of determining the basis of the shares they sell.
  - h) However, if they (or their broker) track the basis of their stock, taxpayers can sell (or instruct their broker to sell) specific shares using the specific identification method to determine the basis of the shares they sell. Taxpayers using the specific identification method can choose to sell their high-basis stock first, minimizing their gains or increasing their losses on stock dispositions.
  - i) Work through Example 7-4.
  - j) Types of capital gains and losses
    - i) Short-term capital gains are taxed at ordinary rather than preferential rates.
    - ii) Long-term gains are taxed at preferential rates.
    - iii) Refer to Exhibit 7-3 for Taxable Income by Filing Status.
    - iv) 25 percent gains
      - (1) When individuals sell depreciable real property held more than one year at a gain, a portion (or even all) of the gain may be taxed at a maximum rate of 25 percent (the unrecaptured §1250 gain portion), and a portion may be taxed as a 0/15/20 percent gain.
      - (2) Work through Example 7-5.
    - v) 28 percent gains
      - (1) Gains from two types of capital assets are taxable at a maximum 28 percent rate.
        - (a) Collectibles

- (i) Consists of works of art, rugs or antiques, metals or gems, stamps or coins, alcoholic beverages, or other similar items held for more than one year.
  - (b) Qualified small business stock (§1202 stock) acquired before July 4, 2025
    - (i) Must be held for more than five years.
    - (ii) IRC §1202 defines qualified small business stock as stock received at original issue from a C corporation with a gross tax basis in its assets both before and after the issuance of no more than \$50,000,000 and with at least 80 percent of the value of its assets used in the active conduct of certain qualified trades or businesses.
    - (iii) The capital gain not excluded from income is taxed at 28 percent.
    - (iv) Refer to Exhibit 7-4 for Exclusion for §1202 Stock Held More Than Five Years and Acquired before July 4, 2025.
  - (c) Qualified small business stock acquired after July 4, 2025.
    - (i) The OBBBA expanded the benefits of the exclusion for qualified small business stock. In general, taxpayers can exclude a portion or all of the gain from the sale of qualified small business stock depending on the holding period for stock acquired after July 4, 2025.
    - (ii) Refer to Exhibit 7-5 for Holding Period and Applicable Exclusion Percentage for Stock Acquired after July 4, 2025.
    - (iii) The OBBBA also increased the maximum exclusion amount from \$10,000,000 to \$15,000,000 (\$7,500,000 for married taxpayers filing separately).
    - (iv) The qualifying requirements for corporations to be qualified small businesses also increased under the OBBBA from \$50,000,000 to \$75,000,000 aggregate gross assets.
  - (d) Work through Example 7-6.
  - (e) Refer to Exhibit 7-6 for Classification of Capital Gains by Maximum Applicable Tax Rates.
- vi) Netting process for gains and losses<sup>1</sup>
- (1) To determine the appropriate tax treatment for the capital gains and losses recognized during the year, the taxpayer must complete a netting process.
  - (2) This process can be complex when taxpayers recognize capital losses and long-term capital gains subject to different maximum tax rates.
    - (a) Certain gains from the sale of depreciable real property held long term are taxed at a maximum rate of 25 percent (unrecaptured §1250 gain). Gains from collectibles and from qualified small business stock not held for five years are taxed at a maximum rate of 28 percent.
    - (b) When taxpayers have 25 or 28 percent rate capital gains, the netting process requires that losses be applied to higher-rate groups before lower-rate groups.
    - (c) When taxable income without long-term capital gains exceeds the maximum 15 percent rate amount, 25 and 28 percent capital gains are taxed at their maximum rate. Otherwise, applicable capital gains rates must be adjusted to reflect their inclusion in lower ordinary income rate brackets.
  - (3) Work through Examples 7-7 and 7-8.
  - (4) Reporting capital gains and losses
    - (a) Refer to Exhibit 7-7 for a Form 1099-B example and Exhibits 7-8 and 7-9 for Jeb's Form 8949 and Jeb's Schedule D.

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<sup>1</sup> The chapter includes a simplified version of the netting process for situations when taxpayers have multiple types (28 percent, 25 percent, and 0/15/20 percent) of long-term capital gains and losses. A more thorough step-by-step guide is included in the chapter appendix. Instructors may wish to simplify the netting process for students as they are first introduced to capital gains and losses and refer them to the appendix for more complex situations.

- vii) Calculating tax liability on net capital gains
  - (1) Refer to the guidelines in the book to calculate the tax liability on net capital gains.
  - (2) Work through Example 7-9.
- k) Limits for capital loss deductions
  - i) Losses on the sale of personal-use assets
    - (1) Personal-use assets fall within the category of capital assets.
    - (2) The gain from the sale of a personal-use asset is taxable even though it was not purchased for its appreciation potential.
    - (3) Losses on the sale of personal-use assets are not deductible, and therefore never become part of the netting process.
  - ii) Capital losses on sales to related persons
    - (1) When taxpayers sell capital assets at a loss to related persons, they are not able to deduct the loss.
  - iii) Wash sales
    - (1) 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.
    - (2) 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.
    - (3) When the wash sale provisions apply to a sale of stock, realized losses are not recognized; instead, the amount of the unrecognized loss is added to the basis of the newly acquired stock.
    - (4) The 61-day period ensures that taxpayers cannot deduct losses from stock sales without exposing themselves to the risk that the stock they sold will subsequently increase in value.
    - (5) Work through Example 7-10.
- l) Balancing tax planning strategies for capital assets with other goals
  - i) When taxpayers invest in capital assets and hold the assets for more than a year, they receive at least two benefits.
    - (1) First, taxpayers can defer recognizing gains on the assets until they sell them—the longer the deferral period, the lower the present value of the capital gains tax when taxpayers ultimately sell the assets.
    - (2) Second, they pay taxes on the gains at preferential rates.
  - ii) A productive strategy for managing investments in capital assets is to sell investments with built-in losses.
  - iii) Work through Example 7-11.
- 4) Portfolio Income Summary
  - a) Tax planning must not be done in a vacuum or without considering all relevant parties and taxpayers' economic and personal objectives.
- 5) Investment Interest Expense
  - a) Since 2018, the only expense associated with investments that remains deductible is investment interest expense.
  - b) When taxpayers borrow money to acquire investments, the interest expense they pay on the loan is investment interest expense.
  - c) Investment interest expense may be deductible as an itemized deduction.
    - i) Limited to the taxpayer's net investment income for the year.
      - (1) To avoid confusion, we use the term investment income rather than the term net investment income to discuss the investment interest expense limitation.
      - (2) Because the Tax Cuts and Jobs Act (TCJA) eliminated the deduction for investment expenses, net investment income is simply gross investment income.

- (3) Gross investment income includes interest, annuity, and royalty income not derived in the ordinary course of a trade or business. It also includes net short-term capital gains and nonqualified dividends.
  - (4) However, investment income generally does not include capital gains taxed at a preferential rate and qualified dividends because of the preferential rate.
- d) Work through Examples 7-12 and 7-13.
- e) Taxpayers may deduct their investment interest expense up to the amount of their investment income.
  - i) Any investment interest expense in excess of investment income is carried over and treated as though it was incurred in the next year when it is subject to the same limitations.
  - ii) The carryover amount never expires.
- f) Congress allows taxpayers to *elect to include* preferentially taxed income in investment income if they are willing to subject this income to tax at the ordinary (not preferential) tax rates.
  - (1) Work through Example 7-14.
- g) Net investment income tax
  - i) A net investment income tax is imposed on net investment income.
  - ii) The tax imposed is 3.8 percent of the lesser of
    - (1) net investment income or
    - (2) the excess of modified adjusted gross income over \$250,000 for married-joint filers and surviving spouses, \$125,000 for married-separate filers, and \$200,000 for other taxpayers.
- 6) Passive Activity Income and Losses
  - a) Taxpayers may invest in business- and income-producing activities:
    - i) In ways in which the taxpayer is taxed on portfolio income from the investment.
    - ii) In ways in which the taxpayer is taxed directly on the actual income from the business.
  - b) If the activities generate losses, the losses must clear three hurdles to be currently deductible. The three hurdles are the tax-basis, at-risk, and passive loss limits.
  - c) The tax-basis hurdle limits a taxpayer's deductible operating losses to the taxpayer's tax basis in the business or rental activity.
  - d) In order to apply the tax-basis loss limitation, we must first determine the taxpayer's tax basis in the activity.
  - e) When a loss from a business or business-related activity clears the tax-basis hurdle, it next must clear an at-risk hurdle on its journey toward deductibility.
  - f) Losses that do not clear the at-risk hurdle are suspended until the taxpayer generates more at-risk amounts to absorb the loss or until the activity is sold, when they may offset the seller's gain from the disposition of the activity.
  - g) The at-risk rules are meant to limit the ability of investors to deduct "artificial" ordinary losses produced with certain types of debt. These rules limit ordinary losses to a taxpayer's economic risk in an activity.
  - h) Work through Example 7-15.
  - i) Passive activity definition
    - i) Defined as "any activity which involves the conduct of a trade or business, and in which the taxpayer does not materially participate."
    - ii) According to the tax code, participants in rental activities, including rental real estate, and limited partners in partnerships are generally deemed to be passive participants, and participants in all other trade or business activities are passive unless their involvement in an activity is "regular, continuous, and substantial." Clearly, these terms are quite subjective and difficult to apply.
    - iii) Refer to Exhibit 7-10 for Tests for Material Participation.
  - j) Income and loss categories
    - i) The three different categories are as follows:

- (1) Passive activity income or loss—income or loss from an activity in which the taxpayer is not a material participant.
  - (2) Portfolio income—income from investments including capital gains and losses, dividends, interest, annuities, and royalties.
  - (3) Active business income—income from sources in which the taxpayer is a material participant.
- ii) Refer to Exhibit 7-11 for Income and Loss Categories.
  - iii) Work through Example 7-16.
- k) Rental real estate exception to the passive activity loss rules
- i) Applies to active participants in rental property.
  - ii) Deduct up to \$25,000 of rental real estate loss against ordinary income.
  - iii) \$25,000 maximum deduction phased out by 50 cents for every dollar of AGI over \$100,000 (excluding the rental loss deduction).
  - iv) Fully phased out at \$150,000 of AGI.
- l) Net investment income tax on net passive income
- i) Net investment income tax applies to net passive income.
  - ii) Work through Example 7-18.
- 7) Conclusion
  - 8) Summary
  - 9) Key Terms