Income – Capital Gain or Loss

Introduction

This lesson will help you assist taxpayers who must use Form 8949, Sales and Other Dispositions of Capital Assets, in conjunction with Form 1040, Schedule D, Capital Gains and Losses, to report capital gains and/or losses on the sale of assets. This lesson includes topics on the sale of stock, mutual funds, and the sale of a personal residence. If the taxpayers have sold any other assets, refer them to a professional tax preparer. This lesson will help you identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, the tax liability, and the amount of any capital loss carryover.

The intake and interview sheet asks about income from the sale of property such as stock, bonds, or real estate. Ask taxpayers if they sold any stock, securities, other investment property, or a home during the tax year. It is important to ensure that all income is accurately reported on the return.

For additional information on the topics discussed in this lesson, see Publication 544, Sales and Other Dispositions of Assets, Publication 551, Basis of Assets, Publication 550, Investment Income and Expenses, and Publication 523, Selling Your Home.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine the adjusted basis of capital assets
- Determine if the asset's holding period is long-term or short-term
- Calculate the taxable gain or deductible loss from the sale of capital assets
- Determine whether a home is the taxpayer's main home
- Determine if a taxpayer meets the ownership and use tests
- Determine when the 5-year ownership/use test period is suspended

What do I need?

- ☐ Form 13614-C
- ☐ Publication 4012
- ☐ Publication 17

Optional:

- ☐ Publication 523
- ☐ Publication 544
- ☐ Publication 550
- ☐ Publication 551
- ☐ Form 1040 Instructions
- ☐ Form 1040, Schedule D and Instructions
- ☐ Form 1099-B
- ☐ Form 1099-DIV
- ☐ Form 1099-S
- ☐ Form 8949

What information must I have to report a capital gain or loss?

To report capital gain or loss, you will need to identify:

- Basis and/or Adjusted Basis:
  - Basis is the original cost of the asset
  - Adjusted basis includes original cost plus any increases or decreases to that cost (such as commissions, fees, depreciation, deductible casualty losses, insurance reimbursements or major improvements)
  - Brokers must report cost or other basis on Form 1099-B, unless the securities sold were noncovered securities
  - Taxpayers must use codes to report if Form 1099-B was received and whether or not it showed basis reported to the IRS
- Holding period:
  - Short-term property is held one year or less
  - Long-term property is held more than one year
  - Long-term capital gains are taxed at a lower rate than short-term gains
  - Brokers must report whether the gain or loss is short-term or long-term on Form 1099-B, unless the securities sold were noncovered securities
- Proceeds from the sale:
  - Form 1099-B reflects gross or net proceeds for a stock or mutual fund
  - Form 1099-S usually reflects gross proceeds of real estate transactions
  - Other evidence in the absence of the above

CAUTION Taxpayers who have transactions using Bitcoins or other virtual currencies are out of scope for VITA/TCE programs.

Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, Schedule D, Capital Gain or Loss.

What is the basis of stock?

Basis

In order to compute gain or loss on a sale, taxpayers must provide their basis in the sold property. The basis of property is usually its cost.

- If taxpayers need help determining their basis and do not have the original purchase documents, refer them to Publication 551 and their stockbroker.
- If taxpayers cannot provide their basis in the property, the IRS will deem it to be zero.

Special rules apply to inherited property; these rules are covered in this lesson in the topic, “Basis Other Than Cost.” If the taxpayer acquired the stock by means other than a purchase or inheritance, such as a gift or an employee stock option plan (ESOP), and does not know the basis of the stock, refer them to a professional tax preparer. The determination of basis in these situations is beyond the scope of VITA/TCE.

Adjusted Basis

An adjustment to basis may include additional commissions or fees paid to the broker at the time of purchase or sale.

Stock is bought and sold in various quantities. It is important for the taxpayer to keep track of the basis per share of all stock bought and sold. Events that occur after the purchase of the stock can require adjustments (increases or decreases) to the "per share" basis of stock. The original basis per share can be changed by events such as stock dividends and stock splits.

- Stock dividends are issued in lieu of cash dividends. These additional shares increase the taxpayer's ownership (number of shares). The adjusted basis of the original stock shares is split among the new total of shares, including the new stocks issued as a dividend. This lowers the taxpayer's basis per share.
- A stock split is a method used by corporations to lower the market price of stock. A two for one stock split will decrease the basis per share by half. For example, the original basis of $200 for 100 shares becomes $200 for 200 shares.
- DRIP (dividend reinvestment plan) accounts leave cash dividends with the company for the purchase of additional shares. Even though these shares are from the same company, they retain their own individual basis separate from the original purchase. Each new purchased share could have a different basis.

TIP Although stock splits and stock dividends do not occur often, always ask taxpayers if they received any additional shares from these transactions.

Brokers or mutual fund companies will track the basis of mutual fund shares for covered securities. Still, taxpayers should keep track of their basis in mutual fund shares.

- The original basis of mutual fund shares bought is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.
- The cost basis of mutual fund shares acquired by reinvesting distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution was an exempt-interest dividend that was not reported as income.
- The basis in mutual fund shares may need to be increased or reduced. For more information, refer to Publication 550.

example

Alice paid $1,100 for 100 shares of ABC, Inc. stock (which included the broker's commission of $25). The original basis per share was $11 ($1,100 ÷ 100). She received 10 additional shares as a tax-free stock dividend. Her $1,100 basis must be allocated to the 110 shares (100 original shares plus the 10-share stock dividend). This results in an adjusted basis of $10 per share ($1,100 ÷ 110).

Basis Other than Cost

There are times when cost alone cannot be used as basis. In some cases, the fair market value (FMV) or adjusted basis is used.

- Property Received as a Gift – To determine the basis of property received as a gift, taxpayers must know its adjusted basis to the donor just before it was given to the taxpayer. Taxpayers also need to know the FMV at the time of the donation and the amount of any gift tax paid on the donation. Determination of the adjusted basis of property received as a gift can be very complex and is beyond the scope of VITA/TCE.

- Inherited Property
  - Before 2010 and after 2010: the basis of property inherited during this time is generally the FMV of the property on the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date or other acceptable method. If the taxpayer cannot provide the basis for the property, refer the taxpayer to a professional tax preparer.
  - During 2010 (after December 31, 2009, and before January 1, 2011): special rules may apply to property inherited from a decedent who died in 2010. Determining the basis of such property can be complex. If the taxpayer cannot provide the basis for the property, refer the taxpayer to a professional tax preparer for determination of basis issues. For more information on the special rules, search for the historical Publication 4895, Tax Treatment of a Property Acquired from a Decedent Dying in 2010 (Rev. October 2011) under Prior Year Forms and Instructions on irs.gov.
- Wash Sales
  - The reporting of wash sales is in scope only if reported on Form 1099-B (boxes 1f and 1g) or on a brokerage or mutual fund statement.
  - A wash sale is the sale of securities at a loss and the acquisition of the same (substantially identical) securities within 30 days of the sale date (before or after).
  - Taxpayers cannot deduct losses from sales or trades of stock or securities in a wash sale unless the loss was incurred in the ordinary course of business as a dealer in stock or securities.
  - The disallowed loss is added to the cost of the new stock or securities. The result is an increase to the basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities.
  - The holding period for the new stock or securities includes the holding period of the stock or securities sold.

example

The taxpayer buys 100 shares of X stock for $1,000. The taxpayer sells these shares for $750 and within 30 days from the sale buys 100 shares of the same stock for $800. Because the taxpayer bought substantially identical stock, the taxpayer cannot deduct the loss of $250 on the sale. However, the taxpayer adds the disallowed loss of $250 to the cost of the new stock, $800, to obtain the basis in the new stock, which is $1,050.

For additional information on how to figure the basis, refer to the Basis of Property chapter in Publication 17, Your Federal Income Tax for Individuals.

TIP If the taxpayer knows the basis of property that was inherited or received as a gift, you can provide assistance. If they do not know the basis of the property, refer the taxpayer to a professional tax preparer.

How do I determine the holding period?

Long-Term or Short-Term

For purchases prior to 2011, taxpayers must provide the date the stock was acquired. Beginning in 2011, brokers must report the date of acquisition and whether the gain or loss is short-term or long-term on Form 1099-B, unless the securities sold were noncovered securities. Generally, a noncovered security is:

- Stock purchased before 2011
- Stock acquired in 2011 that was transferred in 2011 to a DRIP

- A security acquired due to a stock dividend, stock split, reorganization, redemptions, stock conversion, recapitalization, corporate division, or similar action

Taxpayers will have to provide the information for noncovered securities not reported on Form 1099-B.

Form 1099-B will also indicate the date the stock was sold. The purchase and sell dates will determine the holding period. Capital gains and losses are either long-term or short-term, depending on how long the taxpayer owned the stock. Stock held for:

- One year or less has a short-term holding period
- More than one year has a long-term holding period

CAUTION If a taxpayer acquired property from a decedent who died in 2010, special rules may apply in determining tax items including basis, gain, loss, and character for the property. Determining these tax items is complex and outside the scope of the VITA/TCE programs.

The holding period begins the day after the shares were purchased and includes the day the shares were sold. If investment property is inherited, the capital gain or loss is treated as long-term. This is true regardless of how long the property is held.

You may provide assistance to taxpayers who sold property inherited from someone who died in 2010 as long as the taxpayer knows the basis. Refer taxpayers who do not know this information to a professional tax preparer. Determining basis for property inherited in 2010 is complex and outside the scope of VITA/TCE. For more information, search for the historical Publication 4895, Tax Treatment of a Property Acquired from a Decedent Dying in 2010 (Rev. October 2011) under Prior Year Forms and Instructions on irs.gov.

Determining the correct holding period is important because short-term gains are taxed at regular income tax rates and long-term gains are taxed at a lower rate than the other income reported on the return.

Stock acquired as a nontaxable stock dividend or stock split has the same holding period as the original stock owned. They are considered to have been acquired on the same day as the original stock. Stock acquired in a DRIP has its own purchase date. The holding period for stock received as a taxable stock dividend begins on the date of distribution.

example

Lenny bought 500 shares of XYZ Corporation stock for $1,500, including his broker's commission. Five years later, XYZ distributed a 2% nontaxable stock dividend (10 shares). Three days after the stock dividend was distributed, Lenny sold all his XYZ stock for $2,030.

Although Lenny owned the 10 shares for only three days, all the stock has a long-term holding period. Stock acquired as a nontaxable stock dividend has the same holding period as the original stock owned. Because he bought the stock for $1,500 and then sold it for $2,030 more than a year later, Lenny has a long-term capital gain of $530 on the sale of his 510 shares.

If taxpayers do not have the purchase documents or other records showing the date of purchase and cost, refer them to their stockbroker or financial planner.

For additional information on the holding period and other tax consequences of selling or trading investment property, refer to the Sale of Property Chapter in Publication 17.

TIP Although brokers and mutual fund companies are not required to report basis information for noncovered securities, most brokers and mutual fund companies provide supplemental basis information that can be used if the taxpayer concurs with the information.

Mutual Funds

A mutual fund is a regulated investment company generally created by "pooling" funds of investors providing the advantage of a diversity of investments and professional management.

Owners of mutual funds may receive both Form 1099-DIV and Form 1099-B. Form 1099-DIV reports capital gain distributions from sales of stock held by the mutual fund. Profits of these sales are reported to the shareholders of the fund as capital gain distributions. If taxpayers (owners) decide to sell any of their shares in the mutual fund itself, Form 1099-B will be issued. The taxable gain or loss from the sale or exchange of the taxpayer's shares in a mutual fund is reported on Schedule D as a capital gain or loss.

If mutual fund dividends and capital gain distributions are reinvested in new shares, the holding period of each new share begins the day after that share was purchased. Therefore, if both the new shares and the original shares are sold, there may be both short-term and long-term gains and losses.

To figure the gain or loss on the disposition of mutual fund shares, determine which shares were sold and the basis of those shares. If the shares in a mutual fund were acquired all on the same day and for the same price, figuring their basis is not difficult. However, shares are generally acquired at various times, in various quantities, and at various prices, making it more difficult to figure the basis. Taxpayers can choose to use either a cost basis or an average basis to figure the gain or loss. For more information on how to report the sale or exchange of mutual fund shares, refer to Publication 550.

Stock

Some taxpayers may own shares of stock they bought on different dates or for different prices. This means they own more than one "block" of stock. Each block may differ from the others in its basis (the amount paid for the stock), its holding period (long-term or short-term), or both.

In directing a broker to sell stock, the taxpayer may specify which block, or part of a block, to sell. This is called "specific identification." To be valid, the specification must be made before or at the time of sale, **not** after the sale. If the taxpayer does not do this, the shares are sold from the earliest block purchased (FIFO method – or First In, First Out).

example

Marie bought 100 shares of Antrim Corporation stock for $2,000. A year later, she bought another 100 shares of Antrim for $2,300. Five years later, she sold 100 shares of Antrim for $3,000 but she did not identify the specific block at the time of sale.

Because Marie purchased the earliest block of 100 shares at $2,000, the adjusted basis of the shares she sold was $2,000. The sales price of the 100 shares sold was $3,000. Marie had a long-term capital gain of $1,000.

However, if she had told her broker to sell the 100 shares from the second block of stock she bought, the adjusted basis would have been $2,300, giving Marie a long-term capital gain of $700.

What information do I need from Form 1099-B?

Sale of stock is reported to the taxpayer on Form 1099-B, Proceeds From Broker and Barter Exchange Transactions. Form 1099-B is prepared by the broker who handled the sale of the stock. Refer the taxpayer to a professional tax preparer if any of the following boxes has an entry:

- Accrued market discount
- Profit or (loss) realized on closed contracts
- Unrealized profit (loss) on open contracts – prior year
- Unrealized profit (loss) on open contracts – current year

- Aggregate profit (loss) on contracts
- Proceeds are from collectibles
- Bartering
- If there is a FATCA filing requirement

These boxes provide information about transactions that are out of scope for the VITA/TCE programs.

TIP Most brokers report using a substitute Form 1099-B, not the IRS form. All the same information is included, but the order of the information may vary. Carefully review the broker statement during the interview to confirm that all transactions are in scope.

CAUTION On a brokerage statement, margin interest is investment interest. If the taxpayer is itemizing deductions, the return is out of scope.

Form 1099-B includes these boxes for reporting sales of securities:

- Description of property
- Date acquired
- Date sold or disposed
- Proceeds
- Cost or other basis
- Wash sale loss disallowed
- Type of gain (short-term or long-term)
- Federal or state income tax withheld
- Whether the basis was reported to the IRS or if it is a noncovered security
- Whether the amount reported is gross proceeds or net proceeds

CAUTION When the FATCA box is checked, the taxpayer may have additional reporting responsibilities with respect to their foreign accounts or assets. These topics are beyond the scope for VITA/TCE and affected taxpayers should be referred to a professional tax preparer.

Brokers must complete boxes on the Date of sale or exchange; Date of acquisition; Type of gain or loss; Cost or other basis; and Wash sales when reporting sales of securities unless the box for Noncovered security is checked.

Date of Sale or Exchange

The stockbroker reports the date the stock was sold on Form 1099-B. If the securities sold were noncovered securities, use this date, along with the purchase date provided by the taxpayer to determine the holding period. If the securities sold were covered securities, the stockbroker reports the date the stock was acquired and whether the gain was short-term or long-term.

Sales Price

The stockbroker must reduce the gross proceeds for any commissions or transfer taxes related to the sale:

- If sales price (gross proceeds) is checked, ask the taxpayer for the amount of commissions/fees paid and enter an adjustment on the capital gains worksheet
- If sales price less commissions and option premiums (net proceeds) is checked, the broker subtracted the commissions and fees from the proceeds

example

Richard sold stock for $2,300. He paid his broker a commission of $35 on the sale and received net proceeds of $2,265. Richard's broker has reported:

- Proceeds on Form 1099-B of $2,265
- The box next to net proceeds is checked

EXERCISES

Answers are after the lesson summary.

Question 1: Kevin paid his broker a $75 fee on the sale of his stock. His Form 1099-B shows $925, and the box next to net proceeds is checked. What is the amount Kevin reports as his sales price?

A. $925

B. $1,000

C. $850

D. $75

Other Information

If the securities sold were noncovered securities, Form 1099-B would not report the date the stock was originally purchased, the original purchase price, or any adjustments to the basis. Some brokers report this information on a tax reporting supplement. If not, the taxpayer must provide this information.

How do I enter data on Form 8949 and Schedule D?

Generally, transactions are not reported directly on Schedule D. Instead, they are detailed on various Forms 8949. A separate Form 8949, page 1, is required for each of the three types of short-term transactions. The three types of long-term transactions are recorded on a separate Form 8949, page 2. The subtotals from Forms 8949 are carried over to Schedule D, where aggregate gain or loss is calculated.

A check box on Form 8949 identifies the type of transaction reported; a taxpayer with more than one type of transaction must file a separate form for each type.

Some taxpayers may be able to enter capital gains transactions directly on Schedule D. See the Volunteer Resource Guide, Tab D, Income, for the current information on Schedule D and Form 8949.

Tax Software Hint: All entries are made on the Capital Gains Transactions screen. The software determines the holding period and enters the information on Form 8949, pages 1 and/or 2, provided correct transaction codes are properly entered in both the Capital Gains Transactions screen and Form(s) 8949. Use the Volunteer Resource Guide, Tab D, Income, to review software information.

How do I report capital gain distributions?

Capital gain distributions are reported to the taxpayer on Form 1099-DIV. If there is no sale or disposition of capital assets to report, the Form 1099-DIV amount is reported directly on Form 1040 with a checkmark in the box to indicate a Schedule D is not required.

If a taxpayer has both Form 1099-DIV *and* Form 1099-B, then capital gain distributions are added to Schedule D, Part II, line 13.

EXERCISES (continued)

Question 2: Which of the following taxpayers is required to file Form 1040 and Schedule D?

A. Marriah, who received one Form 1099-B and no Forms 1099-DIV

B. Lorraine, who received Forms 1099-DIV for capital gain distributions from three different mutual funds

C. Both of the above

Tax Software Hint: If the source documents (Forms 1099-DIV and 1099-B) are recorded properly in the tax preparation program, then the numbers will be reported in the proper places. The amount from Form 1099-DIV, box 2a, will be entered on the Dividend entry screen (along with the other information) and will automatically carry over to the capital gain distributions line (line 13) in Schedule D, Part II.

example

Eldridge received a Form 1099-DIV. Box 2a shows he received a total capital gain distribution of $170.

Eldridge also received a Form 1099-B that shows net proceeds of $1,200 on the sale of 600 shares of ABC Group, Inc. He held the stock for over 6 years. His basis in ABC, including commission, is $1,455.

Eldridge must use Schedule D to report his capital gain distribution because he sold stock that must be reported on Schedule D.

How do I complete reporting of capital gain or loss?

Form 8949 contains most capital gain and loss transactions. The subtotals from Form 8949 are carried over to Schedule D, where gain or loss is calculated in the aggregate.

Combining all the amounts in the gain or (loss) column on Schedule D, Part I, results in a net short-term capital gain or loss. Combining all the amounts in the gain or (loss) column on Schedule D, Part II, results in a net long-term capital gain or loss.

The combination of the net short-term and net long-term capital gains or losses impacts the tax liability. If there is a combined net capital loss in excess of $3,000 (or if Married Filing Separately, in excess of $1,500), then the excess is carried to the next tax year and carried forward until exhausted. Carryover losses retain their original holding period.

example

Bill bought 1,000 shares of stock for $15,000 (including commission). One year later he sold 600 shares of the stock for $7,800 in net proceeds. Bill had a net loss of $1,200 as shown below:

Basis = ($15,000 ÷ 1,000) x 600 = $9,000

Sales Price = $7,800

Gain or Loss = Sales Price – Basis = $7,800 – $9,000 = –$1,200

Bill had a short-term loss of $1,200.

example

Margo bought stock for $1,500 plus a $25 commission; 18 months later she sold all the stock for $2,000 and paid a $25 commission. Her Form 1099-B shows the net proceeds of $1,975 as the sales price.

Basis = ($1,500 + $25) = $1,525

Sales Price = $1,975

Gain or Loss = Sales Price – Basis = $1,975 – $1,525 = $450

Margo had a long-term gain of $450.

The Volunteer Reference Guide contains a list of adjustment codes that can be used when completing Forms 8949. When reporting transactions on a grouped basis, use code M. If another code is needed for the grouped transactions, enter both codes in the software.

TIP In the rare event that the net proceeds on Form 1099-B are not correct, do not change the sales price amount. Instead, use the adjustment column on Form 8949 with the proper code.

How do I calculate and report a carryover of a capital loss?

The net allowable capital loss per year is referred to as the "deduction limit." A taxpayer's deduction limit cannot be more than $3,000 ($1,500 for married taxpayers filing separately) in figuring taxable income for any single tax year. Any prior year carryover losses are combined with the capital gains and losses in future years. Unused capital losses can be carried over to later years until they are completely used up.

Capital Loss Carryover Worksheet

To figure any capital loss carryover from the year prior to the current tax year, use the Capital Loss Carryover Worksheet from the Schedule D instructions. To complete the worksheet, you will need information from the prior year return.

If the taxpayer's current year capital loss exceeds the deduction limit and the remainder must be carried forward to the next tax year, remind the taxpayer to bring a copy of the current year's return to assist in preparing next year's return. Make a note on the outside of the taxpayer's tax return record envelope to alert next year's preparer. Next year, whoever assists the taxpayer will use this information to figure how much capital loss the taxpayer can carry over from the prior tax year to the current tax year.

Ask taxpayers for their Schedule D Worksheet (Capital Loss Carryovers from This Year to Next Year) from the previous year to determine the carryover amounts from the prior year to the current year and enter them in the software as detailed in the Volunteer Resource Guide.

For additional information on Schedule D, capital gains and losses, and carryovers, refer to the Reporting Gains and Losses chapter in Publication 17. Also see Publication 17 for carryovers related to decedents and other special situations.

Tax Software Hint: Tax software automatically calculates the taxpayer's capital loss. If the loss is over the limit, the tax software reports the maximum allowable deduction. The tax software also completes the capital loss carryover worksheet showing the amount of loss that can be carried over to future tax years.

Taxpayer Interview and Tax Law Application

Taxpayers Jeremy and Janice Smith checked the "Yes" box for income from the sale of stock on the intake and interview sheet. The volunteer asks for details.

SAMPLE INTERVIEW

VOLUNTEER SAYS...	JEREMY RESPONDS...
Previously we discussed your dividends from the Pembroke Fund, reported on Form 1099-DIV. Did you have any other income from the sale of stock, securities, or other investments?	Yes, I sold some stock this year.
Do you have a Form 1099 for that?	Yes, I have this Form 1099-B and this stockbroker's statement.
We already discussed the capital gain distribution from the mutual fund when we entered the dividends. We'll examine the stock sale information now. I see the broker's statement has the sale details I need, but do you know when you purchased the Purdue stock?	I bought the Purdue stock back on July 13, 2000.
I see the sale date was March 10 of the current tax year. That means the holding period for the stock was more than one year. They call that long-term, and it determines both where the information is reported and the tax rate for any gain. Now, do you know the basis for the stock?	What is that?
That's what it cost you, including any broker fees or commissions.	Yes, it cost $10,053, plus I had to pay $35 in fees.
Have you had any other costs, stock dividends, or stock splits related to the stock since then, such as additional fees?	No, that's it. Wait, when I sold it, I had to pay $35 more.
That means that the basis for the stock is $10,088. The Form 1099-B shows that you received net proceeds of $8,859 when you sold the stock so the $35 you paid on the sale is already taken into account. We'll put all these numbers into the tax software. *After I enter these other transactions from the broker's statement, we'll get a final net gain or loss on Schedule D. This will determine the amount that will be reported on Form 1040.* [Indicate Jeremy's responses to these questions on the intake and interview sheet.]	

Who must file Form 8949 and Schedule D for the sale of a home?

To determine if the sale of the taxpayer's residence must be reported on Form 8949 and Schedule D, identify whether the home was the taxpayer's main home, if the taxpayer meets the ownership and use tests, and if the gain, if any, is more than the allowed exclusion amount. For additional guidance in making this determination, refer to the Selling Your Home Chapter in Publication 17 or Publication 523, Selling Your Home.

The intake and interview sheet lists income from the sale of real estate. Ask taxpayers if they sold any real estate, such as their principal residence or "main home" during the tax year. The taxpayer may be eligible to exclude all or part of the gain from their taxable income.

Who must report the sale of a home?

Taxpayers must report the sale of a home if ANY of the following is true:

- The taxpayer does not meet the ownership test
- The taxpayer does not meet the use test

- During the two-year period ending on the date of the sale, the taxpayer has excluded the gain from the sale of another home
- The taxpayer has a gain and does not qualify to exclude all of it
- The taxpayer has a gain and chooses not to exclude it
- The taxpayer received Form 1099-S

Exclusion Amount

Taxpayers who sold their main home may be able to exclude gain up to a maximum of $250,000 ($500,000 for married taxpayers who file a joint return).

Generally, if the taxpayer can exclude all of the gain, it is not necessary to report the sale. If the taxpayer has gain that cannot be excluded, it is taxable and reported on the return.

A loss on the sale cannot be deducted, however, the taxpayer may be required to report it.

What is considered a "main" home?

Only gain from the sale of a taxpayer's main home may be excluded from the taxpayer's income; gain from the sale of a home that is *not* the taxpayer's main home will generally have to be reported as income.

A taxpayer's "main" home is where they live most of the time. It does not have to be a traditional house; for example, it may be a houseboat, mobile home, cooperative apartment, or condominium, but it must have cooking, sleeping, and bathroom facilities. The taxpayer's main home may also be a rented house or apartment. Taxpayers with more than one home cannot choose which home to designate as their main home.

example

Lucille owns a home in a Colorado ski area (the ski home). She stays at the ski home most weekends and spends the entire months of December, January, and February there. When she is not at the ski home, she lives in a four-room apartment that she rents in Denver. Even though she does not own it, Lucille's main home is her rental apartment in Denver, because she lives there most of the time.

What are the ownership and use tests?

To claim the exclusion on the gain from the sale of a home, the taxpayer must meet the ownership and use tests. This means that during the five-year period ending on the date of the sale, taxpayers must have:

- Owned the home for at least two years (the ownership test), and
- Lived in the home as their main home for at least two years (the use test)

There are special rules for members of the Armed Forces, intelligence personnel and Peace Corps volunteers in the application of the five-year period. See "Five-year Test Period Suspension" later in this lesson.

The required two years of ownership/use do not have to be continuous. Taxpayers meet the tests if they can show that they owned and lived in the property as their main home for either a total of 24 full months or 730 days (365 x 2) during the five-year period ending on the date of sale. Short, temporary absences are counted as periods of use even if the property is rented during those absences.

Ownership and use tests can be met during different two-year periods. However, a taxpayer must meet both tests during the five-year period ending on the date of the sale.

example

Helen lived in a rented apartment in 2008. The apartment building was later changed to a condominium, and she bought her apartment on December 1, 2014. In 2016, Helen became ill and on April 14 of that year she moved into her daughter's home. On July 10, 2018, while still living in her daughter's home, she sold her apartment.

For the 2018 tax year, Helen can exclude all the gain on the sale of her apartment because she met the ownership and use tests. Her five-year period is from July 11, 2013, to July 10, 2018, the date she sold the apartment. She owned her apartment from December 1, 2014, to July 10, 2018 (over two years). She lived in the apartment from July 11, 2013 (the beginning of the five-year period) to April 14, 2016 (over two years).

EXERCISES (continued)

Question 3: Emily, who is single, bought a home in 2000. She lived in the home until January 1, 2009, when she accepted a temporary job assignment in Venezuela and left the house vacant. Emily returned to her home on December 31, 2010 and lived there until she sold the house on January 10, 2014. Does Emily meet the ownership and use test? ☐ Yes ☐ No

Reduced Exclusion

Taxpayers who owned and used a home for less than two years (do not meet the ownership and use test) may be able to claim a reduced exclusion under certain conditions. These include selling the home due to a change in place of employment (beyond a certain distance), health, or unforeseen circumstances. If any apply, refer the taxpayer to a professional tax preparer. Reduced exclusion computations/determinations are beyond the scope of VITA/TCE.

Prior Exclusions

In addition, during the two-year period ending on the date of the sale, the taxpayer must not have claimed an exclusion on a gain from the sale of another home.

Married Homeowners

The ownership and use tests are applied somewhat differently to married homeowners. Married homeowners can exclude up to $500,000 if they meet *all* of these conditions:

- They file a joint return
- Either spouse meets the ownership test
- Both individuals meet the use test
- Neither one excluded gain in the two years before the sale of the current home

If either spouse does not satisfy all these requirements, they cannot claim the maximum exclusion ($500,000). The most they can claim is the total of the maximum exclusions each would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property. This calculation is outside the scope of VITA/TCE.

Sale of Main Home by Surviving Spouse

Beginning with main home sales after 2007, the maximum exclusion ($500,000) by an unmarried surviving spouse is allowed if the sale occurs no later than two years after the date of the spouse's death, and all other requirements are met.

TIP Upon the death of the first spouse, some or all of the property may have a new basis based on the fair market value on the date of death. This may substantially reduce the amount of gain.

How do I figure the gain (or loss) from the sale of a home?

After determining that a taxpayer is eligible for the exclusion, figure the gain (or loss) on the sale based on the selling price, amount realized, basis, and adjusted basis. If the selling price of the taxpayer's home is less than the allowable exclusion of up to $250,000 ($500,000 if Married Filing Jointly), it is not necessary to calculate the gain; none of it will be taxable. Loss on the sale of a residence is not deductible. For more information, see the Selling Your Home section in Publication 17.

CAUTION If the taxpayer used the home for business purposes or as rental property, refer them to a professional tax preparer. The taxpayer cannot exclude the part of the gain equal to the depreciation allowed or allowable as a deduction.

Selling Price

The selling price is the total amount taxpayers (the seller) received for their main home. It includes money, all notes, mortgages, or other debts taken over by the buyer as part of the sale, and the fair market value of any other property or services that the seller received.

If the taxpayer received Form 1099-S, Proceeds from Real Estate Transactions, use it to report the selling price. Box 1 shows the date of sale (closing) and box 2 shows the gross proceeds received from the sale of the home. For taxpayers who did not receive a Form 1099-S, use sale documents and other records.

Use the gross selling price on Form 8949. Selling expenses are discussed below.

TIP If the taxpayer can exclude the entire gain from the sale of a main home, the person responsible for closing the sale (i.e., a real estate broker or settlement agent) generally will not issue Form 1099-S. If Form 1099-S is issued and you determine that the gain is excludable, the sale should be reported on Form 8949 and Schedule D to notify the IRS of the exclusion.

TIP If the taxpayer has a loss on the sale of a main home for which Form 1099-S was received, the taxpayer *must* report the loss on Form 8949 and Schedule D even though it is not deductible. Enter an adjustment to zero out the loss (nondeductible loss that will show as code L on Form 8949).

Basis

The basis in a home is determined by how the taxpayer obtained the home. If a taxpayer bought or built a home, the basis is what it cost the taxpayer to buy or build that home. If the taxpayer inherited the home, the basis is its fair market value on the date of the decedent's death, or on the later alternate valuation date chosen by the representative for the estate.

CAUTION Alternative valuation issues and determining the adjusted basis of property received as a gift can be very complex and are outside the scope of this training. Advise taxpayers to seek assistance from a professional tax preparer if they do not know the basis and the correct holding period.

CAUTION Determining the basis of property inherited in 2010 is complex and outside the scope of the VITA/TCE programs. Taxpayers who sold such property should be referred to a professional tax preparer if they do not know the basis and the correct holding period.

Adjusted Basis

The adjusted basis is the taxpayer's basis in a home increased or decreased by certain amounts.

Increases include additions or improvements to the home such as building a recreation room or adding a bathroom. In order to be considered an increase, the improvement must have a useful life of more than one year. Repairs that maintain the home in good condition are not considered improvements and should not be added to the basis of the property.

Decreases to basis include deductible casualty losses and gains a taxpayer postponed from the sale of a previous home before May 7, 1997. Decreases can also include depreciation during the time the home was used for business purposes or as rental property. If any of these decreases apply, the taxpayer should be referred to a professional tax preparer.

Adjusted basis = Basis + Increases - Decreases

TIP To figure the adjusted basis of a home, use Worksheet 1, Adjusted Basis of Home Sold, in Publication 523.

Selling Expenses

Selling expenses reduce the gain or increase the loss. Selling expense may include commissions, advertising fees, legal fees, and loan charges paid by the seller, such as points, courier charges, and many other expenses. Selling expenses would not include items such as proration of homeowner fees, property taxes, interest on the loan to the date of sale, among others. Some items may be claimed as itemized deductions (property taxes and qualified home mortgage interest). Others are never deductible because they are personal expenses.

Report the total selling expenses as an adjustment (code E). Do not reduce the gross proceeds. Use the gain after the selling expense adjustment to determine the amount of exclusion available, if any.

How much of the gain from a home sale can a taxpayer exclude?

Once you've determined the gain or loss on the sale of a taxpayer's main home, next figure the exclusion and any taxable gain from the sale.

If all the requirements are met, an individual taxpayer may exclude up to $250,000 of the gain from taxable income; taxpayers who use the Married Filing Jointly filing status and some surviving spouses may exclude up to $500,000.

TIP Publication 523 contains Worksheet 2, Taxable Gain on Sale of Home, which may be used to figure the gain or loss, the exclusion, and the taxable gain from a sale.

CAUTION Taxpayers who claimed the first-time homebuyer credit may be required to repay the credit in the year of sale. The repayment is limited to the amount of gain on the sale. This situation is out of scope for VITA/TCE. Refer taxpayers to the Form 5405 Instructions or to a professional tax preparer for more information on how to adjust the basis of the home and exceptions to the repayment rule.

Gain from the sale or exchange of a main home is not excludable from income if allocable to periods of nonqualified use. Generally, nonqualified use means any period in 2009 or later where neither the taxpayer nor spouse (or former spouse) used the property as a main home (with certain exceptions). A list of exceptions to a period of nonqualified use can be found in Publication 523. To figure the portion of nonqualified use, multiply the gain by the following fraction:

$$\frac{\text{Total nonqualified use during period of ownership in 2009 or later}}{\text{Total period of ownership}}$$

This issue can be complex. Refer taxpayers with “nonqualified use” issues to a professional tax preparer.

Where do I report any taxable gain from the sale of a home?

Proceeds from the sale of a main home that meets the ownership and use tests must be reported only if the gain is greater than the taxpayer’s allowed exclusion; only the excess must be reported. Gain from the sale of a home that is *not* the taxpayer’s main home will generally have to be reported as income.

In both cases, the gain is taxable gain. The sale must be reported on Form 8949 and Schedule D. Adjustment code H is used to claim the allowable exclusion. Enter both code E (for selling expenses) and code H (for the excluded gain) and the aggregate amount of both as an adjustment. If the home was used for business purposes or as rental property, the gain would be reported on Form 4797 and the taxpayer should be referred to a professional tax preparer.

If the amount realized is less than the adjusted basis, the difference is a loss, which cannot be deducted. However, taxpayers who received Form 1099-S for a loss on the sale of a main home must report the loss on Form 8949 and Schedule D even though it is not deductible. Reporting the transaction should prevent the taxpayer from receiving a notice from the IRS.

Tax Software Hint: To review information related to the software, go to the Volunteer Resource Guide, Tab D, Income, for software entries on the Sale of a Home.

How do I report a nondeductible loss if taxpayer received Form 1099-S on the sale of a main home?

If the taxpayer has a loss on the sale of a main home for which Form 1099-S was received, you must report the loss on Form 8949 and Schedule D even though it is not deductible. Adjustment code L is for a nondeductible personal loss. Enter both code E (for selling expenses) and code L (for the nondeductible loss) and the net amount of both as an adjustment to zero out the loss.

Taxpayer Interview and Tax Law Application

Jeremy and Janice Smith checked the "Yes" box for selling some real estate on the intake and interview sheet. The volunteer asks for details.

SAMPLE INTERVIEW

VOLUNTEER SAYS...	JEREMY RESPONDS...
Did you sell a home during this tax year?	Yes, I was going to mention that to you because I should get a tax break on that.
Well, you may be able to exclude all or part of your gain from that sale, but to find out, I have to ask you a few questions. First, how long did you own the home?	Three and a half years.
And was it the main place you lived for at least two years of that time?	Yes, we lived there the whole time.
Great, you meet the ownership and use tests. During the two years before you sold the house did you claim an exclusion on a gain from another house?	No, this is my only house.
Did you receive Form 1099-S?	No, but I do have my paperwork from the sale. My real estate broker said I wouldn't need that form because I was within the limits.
Your paperwork shows a selling price of $360,000. Do you have anything that lists the basis in the home, that is, the cost of the home at the time you bought it?	Yes, I bought it for $280,000 and put in $20,000 of improvements – mostly new bathrooms.
With a basis of $300,000, your gain from the sale is $60,000. As a married couple who meets the ownership and use tests, you can exclude up to $500,000 from the sale, so you don't have to report the sale on your return. [Indicate Jeremy's responses to these questions on the intake and interview sheet.]	

What is the Five-Year Test Period Suspension?

Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on "qualified official extended duty" as a member of the uniformed services or Foreign Service of the United States, as an employee of the intelligence community, or as an employee or volunteer of the Peace Corps. This means that the taxpayer may be able to meet the two-year use test even if the taxpayer and/or spouse did not actually live in the home during the normal five-year period required of other taxpayers.

Taxpayers are on qualified official extended duty if they serve at a duty station at least 50 miles from their main home or live in government quarters under government order. Taxpayers are considered to be on extended duty when they are called to active duty for more than 90 days or an indefinite period.

Period of Suspension

The period of suspension cannot last more than ten years. Together, the ten-year suspension period and the five-year test period can be as long as fifteen years. The suspension can be used on only one property at a time.

For more information about the suspension of the five-year test period, see Members of the Uniformed Services or Foreign Service, Employees of the Intelligence Community, or Employees or Volunteers of the Peace Corps, in Publication 523.

CAUTION This extension of time can apply to taxpayers who have recently left the military.

example

For the 2014 tax year: Peter bought a home in 2004 and lived in it for 2½ years. Beginning in 2007, he was on qualified official extended duty in the U.S. Army. He sold his home in 2014 and had a $12,000 gain. Peter would normally not meet the use test in the five-year period before the sale (2009-2014). Because of the suspension, Peter's test period is the five years before he went on qualified official extended duty.

EXERCISES (continued)

Question 4: In this exercise, John purchased a home in 2003. Through your interview process, you discover that he sold his main home in 2018. John had not lived in the home for six years. Which of the following conditions would allow John to exclude his gain?

A. John went on sabbatical for four years and backpacked through Europe.

B. John lived with a co-worker for four years and let his brother occupy his home.

C. John was deployed to Europe on official extended military duty for five years.

D. John married and his bride had her own home. The couple chose to live in the wife's home and rent out John's home, until it was sold.

Summary

This lesson covered how to report the sale of capital assets and the sale of a principal residence. In most cases, a taxpayer must use Form 8949 and Schedule D to report capital gains and losses on the sale of assets. You learned how to identify the asset's holding period, adjusted basis, net short-term and long-term capital gains or losses, the taxable gain or deductible loss, and the amount of capital loss carryover.

Qualified taxpayers may be able to exclude a portion of the gain on the sale of their main home if they meet the ownership and use tests. Taxpayers can choose to have the five-year test period for ownership and use suspended during any period the homeowner (either spouse if married) served on qualified official extended duty as a member of the uniformed services or foreign service of the United States, as an employee of the intelligence community, or as an employee or volunteer of the Peace Corps. A loss on the sale of a principal residence is not deductible but must be reported if the taxpayer received Form 1099-S.

The worksheets in Publication 523 help you figure the taxable gain from the sale of a home using the selling price, amount realized, basis and adjusted basis, along with the maximum allowed exclusion.

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who have sold any assets other than stock, mutual funds, or a personal residence
- Taxpayers who trade in Bitcoin or other virtual currencies, options, futures, or other commodities, whether or not they disposed of any during the year
- Determination of basis issues:
  - Basis of any asset acquired other than by purchase or inheritance, such as a gift or employee stock option, unless the taxpayer provides the basis and holding period
  - Basis of inherited property determined by a method other than the FMV of the property on the date of the decedent's death, unless the taxpayer provides the basis and holding period
- Like-kind exchanges and worthless securities
- Form 1099-B, boxes with entries for any of the following: Bartering; Profit or (loss) realized on closed contracts; Unrealized profit (loss) on open contracts – prior year; Unrealized profit or (loss) on open contracts – current year; or Aggregate profit (loss) on contracts; Proceeds from collectibles; or FATCA filing requirement
- Reduced exclusion computations/determinations for the sale of a home
- Married homeowners who do not meet all requirements to claim the maximum exclusion on the sale of a home
- Decreases to basis, including:
  - Deductible casualty losses and gains a taxpayer postponed from the sale of a previous home before May 7, 1997
  - Depreciation during the time the home was used for business purposes or as rental property
- Taxpayers with "nonqualified use" issues
- Sale of a home used for business purposes or as rental property

TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the comprehensive problem or practice exercise(s) for your course of study on TaxSlayer.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L&LT.

You may not be able to complete the entire exercise if some of the technical issues in the exercise are not covered until later lessons in the training. In these instances, complete as much of the exercise as you can. Come back later to finish the exercise after you cover all the technical topics.

EXERCISE ANSWERS

Answer 1: *A. Never change the sales price.*

Answer 2: *A. Only Marriah sold stock and received Form 1099-B.*

Answer 3: *Yes. Emily meets the ownership and use test because she owned and lived in the home for at least two years of the five-year period ending on the date of the sale.*

Answer 4: *C. The only circumstance that will allow John to exclude the gain is if he can extend the five-year period due to official extended military duty.*

Notes