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Tax Planning with Capital Gains and Losses

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As the tax year ends for most individuals, some last-minute transactions can lead to tax savings. With the collapse of the financial sector of the stock market, many investors may have tried to clean out their portfolios before their stocks hit new lows. One way to take advantage of capital losses is to offset capital gains.

There are several ways to generate capital gains, but some of them have hidden traps for taxpayers. This article explains one of the traps that could affect entrepreneurs or small businesses.

Capital Gains and Losses

First, taxpayers must understand the definition of a capital asset since only capital assets can give rise to capital gains or losses. Internal Revenue Code (IRC) §1221 defines a capital asset in the negative, actually stating what is not considered a capital asset. A capital asset is any property held by the taxpayer *except*:

- inventory,
- accounts or notes receivable received by a business,
- depreciable property or real estate used in a business, or
- a copyright, literary, musical, artistic composition, letter, or memorandum created and held by the taxpayer.

There are some other less common items identified, but this abbreviated definition covers what is addressed in this column.

Capital gains are fully taxed with one major exception. Under certain conditions, the gain on the sale of the taxpayer's personal residence, which is a capital asset, can be excluded from gross income. The exclusion is up to $500,000 for a married couple who files a joint return and $250,000 for other taxpayers. Other capital gains, such as the gain on the sale of stock or a personal-use boat or car, are included in gross income and taxed.

Capital losses are limited to a deduction of only $3,000 per year and only $1,500 for married individuals who file separate returns. In addition, losses on personal-use capital assets, e.g., a house or boat, are disallowed. In short, capital gains are generally fully taxed, and capital losses, when allowed, are limited to $3,000.

Another aspect of capital gains is that the capital asset must be held for more than one year to receive the special reduced tax rate. Currently, the maximum rate applied to long-term capital gains is 15%, unless the capital asset is deemed a collectible asset (e.g., antique, stamp, art). Then the rate rises to 28%. Capital assets that aren't held for more than one year are taxed as ordinary income, i.e., as if they were wages.

Major Exception: Patents

The last few items in the definition above (copyrights, literary, musical, artistic compositions, letters, or memoranda created and held by the taxpayer) seem to imply that a patent held by a taxpayer would be excluded from being considered a capital asset. Conceptually, a patent seems very similar to a copyright. Yet IRC §1235 explicitly provides for long-term capital gain treatment when a taxpayer transfers (by sale or exchange) all the substantial rights of the patent. The taxpayer can be the creator of the property/process leading to the patent or someone who bought the patent from the creator prior to the actual use of the patented property/process. But the purchaser can't be the creator's employer or related to the creator. This special long-term capital gain treatment applies even if the seller receives payments over a period of time contingent on the use or productivity of the patent.

Who Is Related to the Taxpayer?

Tax law is especially diffuse when one considers that terms like "relative" and "related party" aren't the same. Whether one can receive special tax treatment or have that status disallowed is dependent on properly defining one's status. A relative is a spouse, sibling, ancestor, lineal descendant, aunt, uncle, niece, or nephew (IRC §152(c)(2)). IRC §267 defines related parties to include the relatives listed in §152 except for aunts, uncles, nieces, and nephews, but it also includes much more, such as corporations when the taxpayer and any family member (as defined by §267) own more than 50% of the stock. This is known as direct or indirect ownership. IRC §267 also includes the grantor and fiduciary of a trust, trust beneficiaries, and constructively owned entities. Losses between these related parties are disallowed. If a loss is disallowed under this provision, the party acquiring the property has a dual basis. If the property is later sold, the price paid for the property is the basis for calculating any loss. If the property is sold for a gain, the amount of the disallowed loss can be used as part of the buyer's basis, thereby reducing the taxable portion of the sale.

IRC §1239 has a different set of rules for related parties. In §1239(b), related parties are defined as a person and all entities controlled by that person, a controlled trust, and the executor of an estate. Subsection (c) defines the control aspect as being more than 50% of an entity and includes constructive ownership in the determination. Generally, §1239 disallows capital gain treatment to transfers of depreciable property to persons that are related parties under this section. Subsection (e) specifically treats patents as depreciable property in the hands of the transferee and, thus, brings it under the §1239 umbrella.

IRC §1235 deals exclusively with the sale or exchange of patents and has still another variation on the related party definition.

The Trap

If a taxpayer who holds a patent sells it to an unrelated third party, the gain should be treated as long-term capital gain. IRC §1235(d) redefines a related party. According to IRC §267, a related party can include a corporation where the taxpayer either directly or indirectly owns more than 50% of the outstanding stock. Yet IRC §1235(d) states that "25% or more" shall be substituted for the phrase "50% or more."

This is the situation that arose in the Tax Court case *Garfield v. Commissioner* [TC Memo 2006-267, affirmed by Court of Appeals for the Second Circuit in 2008]. In 1969, Nathaniel Garfield and Thomas McSherry formed a partnership, and McSherry assigned to the partnership the patent rights for an expansible fastener. In 1970, they incorporated Mechanical Plastics Corp. (MPC) with a third investor. Garfield owned 36% of the shares, McSherry owned 38%, and the third investor owned 26%. The partnership transferred all its patent rights to MPC in exchange for a percentage of all future patent revenue. The assignment agreement also specified that if the partnership were dissolved, payments would be made directly to Garfield and McSherry. The partnership was then dissolved. Garfield and McSherry continued to transfer other patent rights to MPC.

In 1972, the U.S. Patent Office granted a patent for the expansible fastener. In 2004, the IRS issued a deficiency notice for the tax years 2000, 2001, and 2003, indicating that payments received by Garfield and his wife weren't capital gains under §1235, but ordinary income. Since Garfield owned 36% of the shares of MPC, then he and MPC are related parties, and, thus, the general rule of §1235 doesn't apply.

Year-End Planning

As the end of the year approaches, there's still time for beneficial tax planning. One method is to use capital losses to offset capital gains. Capital losses alone are limited to a deduction of $3,000 per year, but if a taxpayer has large capital losses resulting from the plunge of the stock market, it could take several years to realize the full benefit. If the taxpayer also has capital gains, an unlimited amount of losses can be used to offset gains.

One of the possible long-term gains comes from IRC §1235, which specifies that money received for the sale of a patent—even over several years—qualifies for treatment as a long-term capital gain. Yet the taxpayer must be careful not to sell the patent to a related party or the benefit disappears. Normally, the taxpayer must directly or indirectly

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own more than 50% of outstanding corporate stock for a corporation to be considered a related party, but a subsection of §1235 changes that percentage to 25%. ■

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