Property Transaction problems
Unit 1: Basis
1. T, a bank, holds a portfolio of mortgage loans whose value is substantially below T's cost. T exchanges the portfolio of loans for a loan portfolio held by another bank.
The portfolios given and received in the exchange have been carefully selected to be as nearly identical as possible in principal amounts, interest rates, maturity dates, nature of the property securing the loans, and other factors affecting value and performance.
Banking regulators have ruled that gain or loss need not be recognized on such an exchange for financial accounting purposes.
Can T nevertheless properly claim a tax deduction for loss realized on the exchange?

Here, T can deduct on loss because the portfolios they hold are substantially the same, but they embody **different legal entitlements --** See *Cottage Savings* (held that exchanged properties are "materially different" if they "embody legally distinct entitlements.") T.R. 1.1001-1(a) also provides that gain or loss is realized from exchange of property for other property **materially** different in kind or in extent is treated as income or loss. In Cottage Savings, the court reads this phase very narrowly to mean different legal entitlements However, note materially become a very low bar due to the existence of 1031 Cf. like-kind exchange:

Meanwhile, this could bring an 1259(c) Short sale against the box issue
- Suppose you purchase apple stock at 100, appreciates to 200
- If you sell it, you have taxable gain of 100
- You can rather do short sale, which in effect getting you out of investment
  - Borrow the stock from someone else, sell it immediately, and buy back the stock and give it back at the end of the period
  - Built-in-gain in stock held

2. T owes $100 as the principal amount of an enforceable borrowing. Having already expended all of her cash, T transfers shares of X stock worth $100 to the lender in satisfaction of the debt. T received the X stock from her employer as a bonus several years ago when the stock was worth $60. What are the tax consequences to T?
Section 83(a) provides that when taxpayer received stocks, it should be included in gross income. Amount realized equals value of stock transferred in exchanged for the release. See U.S. v. Davis: Here, the amount realized is 100. T.R. 1.61-2(d)(2) provides that adjusted basis equals the amount paid for the property (0 here) plus amount included in gross income (60), 60 in total. Under 1001, T has a Gain of 40 = 100-60

3. A owns stock of X Corp. that she purchased five years ago for $200 in cash. B owns stock of Y Corp., purchased two years ago for $300. A and B swap when the X stock is worth $250 and the Y stock is worth $260. What are the tax consequences of the exchange to A and B?
- For: Gain = AR - AB = 260 - 200 = 60
  - 1012 cost basis
  - 1001(b) AR = FMV of the property received

- For B: Loss = AB - AR = 300 - 250 = 50
- Moving forward: A's basis would be 260 and B's Basis would be 250
    - Philadelphia v. US: FMV of the property received
        - Two options of basis: FMV of property received v. FMV of property given up
        - Coordination of 1012 and 1001(b) -- if basis is equal to FMV of property given up, then double tax is subject
- Suppose A purchases Y from B for 250 and B purchases X stock for 250?
    - A pays cash less than the FMV of the property - A can defer 10 gain
        - A: 250 - 200 = 50 gain from X,
    - Good cash deal may gives you more benefits because you don't need to pay the extra
    - But economic substance doctrine for stock transfers may prevent
        - IRC § 7701(o)

Problem: Gifts:

1. A makes a gift to B of an undeveloped parcel of real property, Blackacre, which A had purchased several years ago for $500. Determine the tax consequences to A and B in the following alternative situations:

(a) Blackacre is worth $1000 at the time of the gift.No gift tax is paid.Three months later, B sells Blackacre for $1600.

- A's basis on Blackacre: 500
    - When B receives B, B can take the basis of 500 but the gift would not be included in income
        - 1015(a): carried over basis
        - 102(a): gift excluded from income
    - When B sold Blackacre: Gain: 1600-500=1100
- Hypo: A sold property to B for 600: part sale part gift
    - T.R. 1.1001-1(e): transferor has gain to the extent that Amount realizes exceeds Adjust Basis
        - A has gain of 100
    - B's basis is 600 (FMV)
        - T.R. 1.1015-4(a): basis = greater of amount (600) or carried over basis (500) = 600
        - When Blackacre is sold: Gain 1600-600=1000
- Hypo: A sold B by 200
    - T.R. 1.1001-1(e): A has no loss when Amount Realized is less than Adjusted Basis
    - B's basis is 500 (greater of amount paid or carried over)
        - When B sold, gain = 1600-500=1100

(b) Blackacre is worth $300 at the time of the gift. No gift tax is paid. Three months later, B sells Blackacre for, in the alternative, $200, $800 or $400.

- 1015(a) Basis:
    - Carry over basis

    - Or FMV for the purpose of determining loss if carry over basis is greater than FMV at the time of the gift
- 200: loss of 100 - FMV basis
- 800: Gain of 300 -- usual carry over basis
    - 1015(a)
- 400: no gain or loss
    - T.R. 1.1015-1(a)(2); I.R.C. 1015(a)
    - For purpose of determining loss, FMV basis = 300; AR = 400
        - So there is no loss(300-400)
    - For purpose of determining gain, carry over basis:
        - So there is no gain (400-500)
- Hypo: Suppose donor (A) sold it for 200 -- part sale part gift
    - A does not have gain or loss
        - T.R. 1.1001-1(e)
    - B's basis = 500
        - T.R. 1.1015-4(a): greater or 200 or 500--- then 500
            - For -4(a) flush language for determining loss
        - If you did not pay enough, then you should take the basis of carryover basis
        - For 800: Gain = 800-300=500
            - Still governed
        - For 400
            - For determining loss, use FMV basis of 300 - no loss
            - There is no gain under 1.1015-4(a)
        - For 200: 300-200=100 loss

2. As part of a divorce settlement, H transfers stock with a value of $200 in which he has a basis of $50 to W. W subsequently sells the stock for $250?

- 1041 provides the carryover basis for transfer incident to divorce with no gain or loss recognized.
- 1041(a): H recognizes no gain nor loss
- 1041(b): W's basis = 50 = H's basis
    - Gain = 250-50 = 200

(a) What difference would it make in (2) if H’s basis in the stock had been $300?
- W's Basis = 300
    - Loss of 50
    - There's no distinction between loss and gain. Compare 1015
    - W is better of than 1015 - no limitation to reduce basis to FMV

Problem: Transfer at Death

1. D bought X stock for $100 and held the stock until he died this year. The stock, worth $120 when D died, was bequeathed to B by D's will. Ten months after D's death, the stock is

distributed to B and B immediately sells the stock for $140. To whom is the $40 profit on the stock taxed?

- 1014(a): Give donee step up basis of FMV, meaning there will be no tax on the built-in gain.
  - When B sold, B has gain of 140 -120 = 20
  - No one is paying tax on another 20
- The policy reason: liquidity, transferee may not have the cash to pay the tax otherwise and would be forced to sell the property, not very democratic, to encourage investment in property (but a counter argument could be that it curbs investment/transaction because people will just want to hold on to the property until they die) , can otherwise be seen as a death tax, punishing death.
  - Time value of the money --
- 1014(e): suppose you have a google stock that has appreciated a lot over a year, your mother is really ill, transfer it to her, then get it back when the decedent passes away
  - Basis = Adjusted Basis in the hands of decedent immediately before the death

2. L, a lawyer, billed a client $50 for services rendered, but died this year before collecting. The client pays the lawyer's estate. Who, if anyone, is taxed on the $50

Depending on methods of accounting you use

- Two methods
  - Accrual method: then L is taxed on 50 (50 account receivable would have been included in his tax return in the year he dies)
  - Cash method
    - 691(a)(1)(A): assuming L is a cash method taxpayer, the estate of L is taxed on 50 (he did not receive the cash yet)
    - Right to receive money
- The estate of L might have argued for step up basis at the time of transfer
  - 1014(c): but this section prevents this because it says 1041(a) does not apply to right to receive an item of income in respect of a decedent.

Policy

	Inclusion	exclusion
Deduction	Donor who does not get consumption value	
No deduction	Donor gets consumption value	102 current rule (carryover basis)

Unit 2: Cost recovery

Policy: expensing or capitalization?

Immediate expensing Depreciation Recovery at sale

168k – promote investment
I = C + S
Cary brown immediate deduction – yield exemption equivalence
No tax – 100, doubles in value to 200 sell it =

30% tax, with deduction – 143, double in value to 286
Year 1 – tax benefit of 143 deduction, valued at 43
Year 2: must pay 86 tax, resulting in after tax revenue 200 --- Same as no tax system

Problem: Theory and Stakes:
T is a taxpayer who at all relevant times is in the 35% marginal tax bracket. On January 1 of this year, T buys machinery for a purchase price of $2,000,000 that will be useful in T's business for 5 years. The salvage value of the machinery, that is, the estimated fair market value of the machinery at the end of its useful life, is negligible. T also buys a building and the underlying land for $5,000,000. T will operate his business in the newly-acquired building.
1. May T deduct the full cost of the machinery, building, and land upon acquisition, i.e., today? If not, why not?

- Machinery: 168(k)
  - (k)(1)(A): deduction = applicable percentage of AB of the qualified property
    - 168(k)(6)(A)(i): applicable percentage = 100%
      - Immediate expense deduction on qualified property
    - (k)(2)(A): Qualified property = recovery period of 20 or less years
      - Being able to get a bonus depreciation
      - 168(c): recovery period for 5-year property is 5 years
      - 168(e): To determine what year property is
      - Typically, tangible property has 20 year or less recovery period
        - Could only go over in real properties
  - 168(k)(7) election out: why would anyone not want 168(k) immediate deduction?
    - You may not have enough income -- low tax rate determines your deduction, so you may want to deduct when you have higher income
  - 179(a)&(b): can deduct under this but there is limitation, so better focus on 168(k)
- Building: § 263(a)
  - § 263(a) means you cannot immediately deduct the expense, but you can still capitalize under 167 and 168
- Land: § 1.263(a)-1(d)(5)
  - Cannot immediate expense, should capitalize
    - § 168(k) does not apply here
    - Land is not § 179 property
      - Even if § 179 applies, the limitation would be reduced to 0
  - Also land is not depreciate property -- T.R. 1.167(a)-(2)

2. If T cannot deduct the full cost of the machinery, building, or land upon acquisition, is T entitled to deduct any portion of such cost prior to the disposition of such property? If not, why not?

- Machinery: 167(a), 168
  - You can depreciate
- Building: 167(a), 168
  - You can depreciate
- Land: Not depreciable

Problem: Property Qualifying for cost recovery

Which of the following are depreciable?

(a) Land bought for farming. In its natural state, the land was covered with water. The taxpayer drained the land, exposing a rich organic topsoil that is ideal for farming but will oxidize over time. The topsoil is expected to last for 20 years, after which time the land will not be usable for growing crops and will have a nominal value. Compare Rev. Rul. 68-193, 1968-2 CB 79; Rev. Rul. 2001-60.

- Reg. 1.167(a)-2
  - Depreciation is not applied to land and natural resources
- See *Duda & Sons, Inc. v. U*S, 560 F2d 669 (5th Cir. 1977) (Topsoil is a part of land so cannot be decrepitated)

(b) A painting hung in a doctor's office, acquired and placed in service this year. See Associated Obstetricians & Gynecologists, 46 TCM (CCH) 613 (1983), aff'd per curiam, 762 F2d 738 (6th Cir. 1985); Rev. Rul. 68-232, 1968-1 CB 79.

- Denied depreciation for a painting hung in a doctor's office
  - Lack of wasting: not subject to wear and tear
  - Court cannot decide useful life of artwork
- T.R. 1.167(a)-2: Depreciation allowed for tangible property only to the extent that is subject to wear and tear

(c) Expenditures incurred in organizing a corporation. See §§ 248 & 709.

- § 248(a)(1):
  - Permit expenditures which is equal to lessor of the amount of expenditure or 5k reduced by what the amount exceeds 5k
  - Suppose the corp. has 54,500 expenditure
    - Then 5k-4.5k = 500 is the lessor than 54500
    - 500 can be an immediate deduction
- § 248(a)(2):
  - The remainder (54k) can be depreciated over 180-month period
  - 54000/180 = 300 per month

(d) A commercial office building and the underlying land purchased subject to a 10-year lease at a rent equal to the current fair rental value of the building and land.

- Reg. § 1.167(a)-2:

    - Land cannot depreciate
    - Commercial office building that is subject to wear and tear is depreciable
- Reg. § 1.167(a)-5.
    - Combination of depreciable and non-depreciable properties
    - says "the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time."
    - Depreciable to the extent of lum sum * (value of the depreciable / value of entire property)
- Leasehold
    - If you are purchaser/lessor, you would pay premium if the rent is above FM rental value
    - the point here about the rent at FMV is that your purchase price for the land and building does not include the rental value; --- no real value out of the lease
    - assuming if it's efficient market, even if you buy the land and building without the lease, you can always go out and find something to rent it at FMV rent. So your purchase price paid is solely for the building and land. lease probably has no separate value to lessor
    - In that case, you should determine if it is depreciable or not

(e) A tract of farm land purchased for investment. The land is subject to a lease that will expire in 10 years. The fair rental value of the land is $100 per year and the fair market value of the land, unencumbered by the lease, is $1,000. Assume that the annual rent under the lease is $120 and the purchase price is $1,122 ($1,000 plus the present value of $20 per year for 10 years at 10 percent). See § 167(c)(2); § 197(e)(5)(A). Compare § 171(a).

- Land: can't depreciate
- The Lease: Here, T is paying the premium for lease because the rent is about the FMV
    - 197(e)(5)(A): Leasehold is not an interest which is amortizable intangible property
    - 167(c)(2): no basis for depreciation allowed to leasehold: cant depreciate
        - Special rule for property subject to lease. If any property is acquired subject to a lease—
        - (A) no portion of the adjusted basis shall be allocated to the leasehold interest, and
        - (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.
    - If there is no 167(c)(2): the real value of the lease would be inflated
        - TP would argue that they paid more for rent as opposed to the land on certain property subject to that lease
        - IRS will have difficulty determining the values of lease and land
        - Also tp will always purchase land with a portion of interest carved out and try to take depreciation on that intangible interest (but rly depreciating land)

(f) A owns undeveloped land that he leased to B for 10 years. B built a building on the land. Under the terms of the land lease, the building reverts to A upon expiration of the lease. See Reg. §§ 1.162-11(b) & 1.167(a)-4, but note that these regulations do not reflect IRC § 168(i)(8). See also §§ 109 & 1019; Simmons pp. 75-77 & 81.

- A: No income or depreciation to the change to the basis
  - 109: A cannot recognize any income from building or improvements made by lessee when the building reverts to A
    - Disguised rent: the increased value of building may be reflected on the rent price by reducing the rent, then the increased value can act as disguised rent
      - Shorter the lease period is, it would be more likely disguised rent
      - If lessee is paying at FMV of the rent, then no disguised
      - If lessee is paying under FMV, then the increased value is disguised rent
    - For disguised rent case, the increased value would be taxable income for A under 109
  - 1019: Neither the basis nor AB would be increased or diminished on amount of income derived by lessor due to lessee's improvements.

Prof: what if this is a case of disguised rent, what will be the tax consequences?
The lessor will recognize income at the end of the lease, although the codes is not clear on this. When would the lessor recognize income? Prof: not resolved by the codes yet.

- B: Capital expenditure on the cost of the building – assuming no disguised rent
  - Reg. 1.167(a)-4: lessor or lessee can depreciate
  - Reg. 1.162-11(b): Lessee can depreciate capital expenditure on permanent improvement on the building
  - 168(c) B can depreciate for 10 years under 39 year recovery period then immediately deduct for the remaining years at the end of the lease
    - Recovery: 39 years for nonresidential real property
      - Lessee depreciates the property over 39 years for 10 years
    - 29 remaining years -B may take an immediate deduction for this upon the lease termination

(g) Assume in (f) that the land and improvements are worth $1,000, while the land alone is worth $800 without the building. T buys the land from A subject to the land lease (i.e., T's purchase of the land includes A's position as lessor under the land lease) and, in addition, T buys A's right to reversion of the building. T paid $877. The annual ground rents under the land lease are $80, the fair rental value of the land apart from the building improvement. With the building, the fair rental value of the property is $100 per year.

- ***<u>Geneva Drive-in Theater case</u>***: held that T can only depreciate the building <u>only after the building is actually reverted to T;</u>
  - What about the right to receive the building at the end of the term, it does not subject to wear and tear, does not change in value, so T cannot depreciate it?

- Building: A can depreciate during the lease term, and then depreciate the rest of 29 years when lease ends
- 800 for the land cannot be depreciated
- T is paying 77 premium for the improvements (PV of 20 additional annual rent for any remaining lease period)
    - T can start depreciating 77 only after T gets the building at the end of lease over its useful life
    - Otherwise, con

Problems: Methods of Cost recovery

Problem: Intangibles

On September 1 of this year, T bought the following assets all of which will be used in her business. ***(meet the <u>197(c)(1)(B) connected with trade or business</u>)***. In each case, describe how T should recover her investment in these assets:

a. Goodwill or going concern value. See Reg. § 1.197-2(b)(1) & (2); IRC § 1060.

- 197(d)(1)(A) & (B): 197 intangibles
- Reg. 1.197-2(b)(1) & (2)
- Both goodwill and going concern value is 197 intangible.197(d)(1)(A)&(B). Under 197(a), "The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired"
- E.g. Player's contract --- but IRS ends up lossinh

b. A covenant not to compete in which Z promised not to compete with T for 5 years.

- 197(d)(1)(E): amortizable intangible
    - *<u>Covenant not to compete is section 197 intangible. 197(d)(1)(E) depreciate it over 15 years under 197(a)</u>*, **so long as it was acquired in acquisition of trade or business**; N.B. - cost of covenant will be amortized over 15 years, despite 5 year term of the covenant
    -

(i) Would it be relevant to know that Z had been T's employee for the past 30 years and has now decided to go out on his own. T paid Z $150,000 in a lump sum for Z's covenant not to compete. See Reg. §§ 1.167(a)-3 (<u>15 year useful life for intangible</u>) & 1.263(a)-4(d)(6) (*<u>taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate a covenant not to compete</u>*); Rev. Rul. 68-636, 1968-2 C.B. 92 (*<u>If the covenant is for a period in excess of one year, the purchaser amortizes the covenant over the period covered by the agreement</u>*); Silberman v. Commissioner, 22 T.C. 1240 (1954) (acq.).

- It is not a part of acquisition of trade or business – not 197 intangibles
- **<u>Alternative Depreciation regime: 167 – when 197 does not apply to intangible</u>**
- 197(b): exclusive – 197 intangibles should be governed by 197
- Reg. 1.263(a)-1(d)(3)
    - Core underlying reasons for depreciation for these intangibles is §§ 1.167(a)-3 "If an intangible asset is known from experience or other factors to be of use in the

business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance."

- Then ***Rev. Rul. 68-636*** and ***Silberman v. Commissioner*** says depreciate this 5-year covenant not to compete over 5 years, same time period as the covenant period
- Reg. 1.263(a)-4(d)(6)
  - Amount paid to acquire or create intangibles is capitalized
  - (v)De minimis exception: no need to capitalize if the aggregate amount does not exceed 5k does not apply because 150k
- Reg. 1.167(a)-3: If intangible is to be used in the business for only a limited period, the lengths of which can be estimated with reasonable accuracy, such asset can be depreciable
  - Amortizable for 5-year period of covenant not to compete
  - It is better to be outside of 197 cuz you can depreciate faster under 167 – 197 demands a 15 year recovery period

c. A customer list; or a subscriber list; or insurance expirations, each of which can be predictably expected to be worthless in five years.

- 197(d)(1)(C)(ii): *"business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers*)," the 15-year recovery period under 197(a) applies.
- T.R. 1.197-2(b)(4): insurance expirations: information of the insurance company about when the customers' insurances expire

d. The United States rights to a motion picture. See IRC § 167(g); Rev. Rul. 60-358 (in the Materials); Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 79-285, 1979-2 C.B. 91. How might your answer change if the asset acquired was a copyright with respect to a musical composition? See § 167(g)(8).

- 197(e)(4)(A): any interest in a file, which is acquired in the acquisition of trade or business can be amortized over 15 years
- If not, you can use income forecast method under 167(g)(6) for 168(f)(3) property (any motion picture film)
  - Ex. Purchase price 1M, expected income 2M ,total income 600k for year 1
    - Depreciation = 600k/2M*1M = 300k
    - Try to get a percentage of expected income that was earned that year – 30% of income was earned in year 1
  - Problem: for film, the income would be very front loaded. You are motivated to underestimate the expected income – then you can depreciate more faster
    - 167(g)(2): you have to look back and compensate for you under payment
- Copyright right to a music composition
  - Copyright is in 197(e)(4)(C) if acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion

- If not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion, ie not fall within 197(e)(4)(C)
- § 167(g)(6) says copyright use income forecast method,
- But 168(g)(8) says musical composition is covered under this provision, which provides for a 5-year cost recovery period instead of income forecast – but this provision already sunset after 2011 under § 167(g)(8)(E), - so we are back to 168(g)(6)(B), income forecast

e. A leasehold in real property with 10 years remaining on the lease. See Reg. § 1.162-11(a); IRC § 178; Reg. § 1.197-2(c)(8).

197(e)(5)

- 1.197-2(c)(8): Leasehold is not 197 intangibles
- 1.162-11(a): Lessee can take deduction for the number of remaining lease hold period
  - 178(a): the lease should include all renewal options if less than 75% of such cost is attributable to the period of the term of the lease remaining on the date of acquisition.
    - In determining the amount of the deduction allowable to a **lessee** for exhaustion, wear and tear, obsolescence, or amortization in respect of any cost of acquiring the lease, the term of the lease shall be treated as including all renewal options (and any other period for which the parties reasonably expect the lease to be renewed) if less than 75 percent of such cost is attributable to the period of the term of the lease remaining on the date of its acquisition.
    - If 25% of the income is attributable to renew option (say renew for 5 years), then you will depreciate it not over 10 years (term of the lease) but 15 years (10+5)

2. On January 1 of this year T purchases for $100,000 all the substantial rights to a patent with a remaining useful life of 10 years. How should T recover her cost? Compare IRC § 174; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 79-285, 1979-2 C.B. 19.

- 197(d)(1)(C)(iii): patent is 197 intangibles
  - 197(e)(4)(c): but if the patent is acquired separately, not in a transaction involving acquisition of trade/business, then it is not 197 intangibles
- Alternative: 167 depreciation
  - 1.167(a)-3: depreciable for a reasonable life – 10 years or
  - 167(g)(6)(D): you can use the income forecast method for patents
    - (g) 10 year regardless of reasonable life
      - At 10th year, deduct all remaining basis
    - Faster than straight line method – you can use reasonable life concept here
    - If you deducted all expenses before 10 years, then it's done
      - If you have not, then you can deduct all at 10th year.

            - Income forecast method is not applicable to 197 intangibles

3. Same as (2) except that the purchase price is $40,000 plus T's promise to pay the seller 40% of the annual net profits derived from the patent. What is T's basis in the patent?

40000 cost basis; 40% on net profits

- See Associated Patentees v. Commissioner
    - The patent purchaser can immediately deduct contingent payment
- If patent were acquired in a trade or business: 197
    - 40k is going to be depreciable over 15 years
- If patent were acquired separately: 167
    - T can deduct purchase price and then deduct contingent payment later when it was made
    - 40k can be depreciable using income forecast method
        - Or depreciable for 10 years
    - Reg. 1.167(a)-14(c)(4): Contingent payment can be immediately deducted under Associated Patentees
    - Variable: 1.197-2(f)(2)(i)
        - Amounts added to basis during 15-year period. Any amount that is properly included in the basis of an amortizable section 197 intangible after the first month of the 15-year period described in paragraph (f)(1)(i) of this section and before the expiration of that period is amortized ratably over the remainder of the 15-year period. For this purpose, the remainder of the 15-year period begins on the first day of the month in which the basis increase occurs.

a. This year, the patent earns $25,000 and T pays the seller $10,000 as his share for the year. How should T recover her cost in the patent? Compare Reg. § 1.167(a)-6(a) with Reg. § 1.167(a)-14(c)(4); Rev. Rul. 79-285, 1979-2 C.B. 19.

    - 40k is depreciable using the income forecast method
    - Contingent payment of 10k
        - 167(g)(7) you may include participation and residual into the basis
            - Contingent cost can be included in participation and residual
            - But 167(g)(7)(D)(i): Tp may exclude participation and residual from AB, and deduct it when they are paid.
        - Reg. 1.167(a)-14(c)(4): immediately deduct 10k if the patent were acquired separately

Problems: Tangibles:

1. On June 1 of this year (“year 1”), T, a lawyer, purchases a computer to be used for word processing and keeping records. The computer has no factory-installed software (had there been computer software, it will be not section 197 intangible, 197(e)(3)); T must buy and install all software separately. T pays $100,000 for the computer and expects to use it in her law

practice for three years, at the end of which time she expects to sell the computer for $40,000. T acquires no other depreciable property during year 1.

(a) When can T deduct the cost of such computer (assuming T would like the deduction(s) as soon as possible)?

168(k): T can deduct the entire amount in year 1 --- 100% bonus depreciation
if want immediate deduction, we check 168(k) and 179
First check 168(k) which allows 100% depreciation deduction in first year for "qualified property" defined under 168(k)(2)(A) which requires the property to have a recovery period of 20 years or less,
What is computer's recovery period? 5-year-property includes "qualified technological equipment" 168(i)(2) which in turn includes computer. you will need to know what-year-property it is, and to know that need to know its class life in Rev Pro 87-56, As Prof says before, tangible personal property will usually have less than 20 years of recovery period and so will fit (does the fact that T expects to use it for only 3 years matter? NO).
So can immediate deduct under 168(k)
Then also check 179 -- somewhat similar test
"section 179 property" is defined in 179(d)(1) include "tangible property (to which section 168 applies)", subject to a 1 million dollars cap which is reduced by the amount of ALL "section 179 property" (Prof: not just the one property you are analyzing, ALL section 179 property) exceeding 2.5 million. And here the cost of the computer is 100,000, less than 2.5 million, so the 1 million cap under 179 is not reduced. So under 179 you can immediately deduct the full cost of the computer --- we might consider if there are other 179 properties

What happens at year 3 if T does sell? 40,000 amount realized, over zero basis, 40,000 gain. (ordinary income) – depreciation recapture

(b) Can T choose to recover the costs on a less accelerated basis?

Start with 168(k)(7): you can elect out of 168(k), and you can simply don't elect in 179.
Under 168, 5-year-property includes "qualified technological equipment" 168(i)(2) which in turn includes computer.
Under 168(b)(1), the applicable depreciation method for 5-year property is 200% declining method, under 168(c) the recovery period is 5 years, under 168(d)(1) the applicable convention is half year convention 168(d)(1)
1016(a)(2): if you don't elect any method – basically do straight line method

Years depreciation remaining basis

Year	*Depreciation*	*Remaining basis*
1 (half year)	*20,000*	*80,000*
2	*32,000*	*48,000*
3	*19,200*	*28,800*

4	11,520	16,480
5	10,987 (switch to straight line)	5493
6 (half year)	5493	0

- 168(k): T can deduct the entire amount in year 1
  - Qualified property: property of which the applicable recovery period is 20 years or less
  - Recovery period of computer
    - Rev 87-56: class life of six years → 5-year property → recovery period is 5 years

Downloaded From OutlineDepot.com

    - 168(i)(2): qualified technological equipment
      - 168(e)(3)(B)(iv) 5-year property → recovery period is 5 years
  - Using it for three years or salvage value should not been taken into account under 168.
  - T's AB will become $0 after deduction
    - When T sells if after three years for $40k, she will recognize gain of $40k. – recapturing depreciation
- Alternatively, 179: $1 million limitation should be reduced by the amount that the cost of 179 property exceeds $2.5 million
  - So we should take into account there are other 179 properties
- Among these two codes, 179 becomes less important when 168(k) applies.

(b) Can T choose to recover the costs on a less accelerated basis?

- Default rule is 168(k)
- 168(k)(7): BUT T can elect to be out of the bonus depreciation
  - 168(b): Double declining balance method
    - 168(d): Half-year convention for tangible personal property
  - 168(b)(2)(C): You may choose 150% declining balance method
  - 1016(a)(2): If you don't elect any method, you basically do straight line method. – So this method is permissible whenever

C. Real Property

On October 22 of this year ("year 1"), T, an individual, purchases a hotel building and leases it to a hotel management firm. The purchase price is $415,000 of which $25,000 is allocable to the land. T does not make an election under § 168(g). T sells the property on July 1 of year 3 for $450,000 of which $50,000 is allocable to the land. Determine the amount of T's gain on the sale (but disregard the character of that gain for now).

Year	*Depreciation*	*Remaining basis*
1	*10,000 times (2.5/12) =*	*387,917*
2	*10,000*	*377,917*
3	*5,000 mid-month convention, dispose the property on July 1, so seen as having taken 6.5 months of depreciation, not just 6 months.* *10,000 times (6.5/12) =* *SO year 1 and 3 total take 9 months of depreciation,* *7,500*	*372,917372,500*

Sell for 450,000, 50,000 is allocated to land, so amount realized for the sale of land is 25,000 gain
400k over 372.5k, 27.5k gain, 17.5k gain is 1250 recapture gain ordinary income, 10k gain is capital gain. long term.

- Gain from sale of Land: $50k - $25k = $25k because there is no depreciation for land
  - Reg 1.167(a)-2: Land is not depreciable
- Gain from sale of building: Apportion the purchase price of $390 to building
  - 1016(a)(2): AB should be adjusted for depreciation taken
  - **168(a): To determine the whole amount of depreciation, we have to know applicable depreciation method, applicable recovery period, and applicable convention.**
  - First, this is nonresidential rental property
    - 168(e)(2)(A)(i), (ii)(I) Residential rental property: 80% or more of the gross rental income is rental income from dwelling units, which do not include hotel
  - 168(b)(3)(A): Straight line method applies to nonresidential real property
    - $10k (=$390/39 years) depreciation per year
  - 168(c) Recovery period for nonresidential real property
    - 168(c): 39 years recovery period
  - 168(d)(2)(A): Mid-month convention applies to nonresidential real property
    - 168(d)(3) exception needs not be taken into account
    - Deemed as if it were acquired on October 15, year 1
    - Deemed as if it were sold on July 15, year 3
  - 21 months of depreciation
    - One year + 9 month depreciation = $17.5k
  - Gain = AR – AB = 400 – ($390-17.5) = 400 – 372.5 = $27.5k

168(d)(4)(B):
Y1—2.5 month
Y2—12 month
Y3—6.5 month
Total 7500 over 1&3; 10k over year 2(390/39)

Unit 3: Cancellation of debt

Problems

I. Effect of Financing on Basis

A. In General

In Year 1 T purchased depreciable property ("Blackacre") from S for $200. What is T's basis in Blackacre if T funds the purchase in the following alternative ways (T is personally liable for all borrowings):

(a) by paying the seller $200 in cash from T's own pocket and then borrowing $100 from a bank on an unsecured basis;
The basis of the B is cost basis under 1012. The fact that T has to borrow 100 doesn't matter here.

(b) by paying $100 from his own pocket and paying the seller another $100 that T borrowed from the bank on an unsecured basis;
The basis is still 1012 cost basis as paying part from the pocket and borrowing for other part do not make any difference

(c) by assuming an existing mortgage of $100 encumbering the property and paying $100; or
Here the cost basis under 1012 is still 200 with 100 paid and 100 assumption of mortgage

(d) by paying the seller $100 cash, executing a note for the $100 balance, and giving the seller a purchase money mortgage.
The basis is still 1012 cost basis with 200. 1000 cash and 100 assumption of liability. In terms of recourse liability, whether the lender is seller or a third party does not matter and the liability will be added to basis as long as the loan is recourse liability.

B. Nonrecourse Debt.

Note: Case law, rather than statutory or regulatory material, is at the heart of the nonrecourse debt basis question. We will, therefore, devote more class attention to the cases here than we did in the past two units. We will analyze the Crane case (in the materials) and Estate of Franklin v. Commissioner (Simmons, p. 1207) very closely. Crane is the seminal decision from which virtually all law in this area flows. Franklin involves a prototypical, classic abusive tax shelter of the kind that was widely promoted during the 1970s and 1980s and that ultimately lead to the enactment of §§ 465 and 469 (studied later in this course).

In discussing Franklin, we will first spend time outlining the structure of the transaction. Once you understand the transaction, you will see why a taxpayer like Dr. Franklin, then in the 70% top marginal bracket, found the deal irresistible. The game also can be played with handsome, no-risk rewards, at the lower current federal tax brackets (add state income tax, net of § 164 deduction effects, to that, as appropriate), although it is not quite as much fun.

Questions:

T is contemplating purchasing a building whose (1) expected economic life is in the range of 20-30 years, and (2) value is in the range of $190 to $205. Several alternative forms of the purchase transaction are described below. What would T's basis for the building be under each of them?

(a) The purchase price is $200, payable $100 in cash and $100 by T giving the seller a purchase money mortgage in that amount. T is not personally liable on the mortgage note. The note bears interest at an adequate rate, and interest is payable annually. No principal is due under the mortgage for 20 years, at the end of which time the principal is payable in full. (If T prepays the mortgage during the ninth year of the mortgage term, would the prepayment have any tax consequences?)

If the property's fair market value exceeds non-recourse liability, the liability will be treated as recourse liability and added to the basis. Crane (included in the basis when the FMV greater than the non-recourse liability because the holder has equity and incentive not to walk away). See also Mayerson (Crane doctrine extended to purchase money and agreements). Here, The fair market value of property is 200 and the value of debt is 100. The adjusted basis will be 100 cash adding 100 mortgage assumed. Note that since the life of the building is around the 20-30 years, the holder's incentive to pay back nonrecourse liability decreases as the debts comes due because the value of property would decline in 20 years.
If T repays the mortgage during the ninth year: there will be no effects on tax consequences because the 100 mortgage is already included in the adjusted basis.

(b) The purchase price is $100 plus T's agreement to pay the seller 50 percent of the profits from the building's operations over the next five years. The fair market value of T's deferred payment obligation is $100. See Prop. Reg. § 1.168-2(d)(3).

The facts involved the 50% contingent payment. In Albany car wheel, the court declines to add the contingent payment into the basis right away. However, later in Prop. Reg. 1.168-2(d)(3), IRS add the contingent payment to the adjusted basis to the property for the year the payment and compute the depreciation deduction over the remains.
1.197-2(f)(2)(i) – for intangibles
Can see how it depreciates – 100 over 39 year, mid month convention

(c) The purchase price is $500, payable $100 in cash and $400 by a purchase money mortgage on which T has no personal liability. (Would it make any difference to your answer to this part of the question if the building appreciated in value to $400 five years later? To $500?)

§ 6662(b)(2) provides that if the taxpayer made significant misstatement of value then it would be subject to a 20% penalty.
TO calculate the fair market value of the debt, we look at the Estate of Franklin case. In Estate of Franklin, the court holds that if the debt's fair market value is less than the debt value, it won't be included in the basis. The rationale is IRS being concerned about T and lender inflating the nonrecourse debt as purchase price mortgage while the money could not transfer.
Next, the case laws and relevant regulations have provided two approaches to calculate the adjusted basis. First, R.R. 77-110 provides that under such circumstances the total nonrecourse liability would be disregarded and only cash payment of 100 would be included in the basis. Further, the court in Pleasant Summit holds that the amount of the nonrecourse liability should be included in the basis up to the extent of fair market value of property. Pleasant Summit (when fair market value is less than the nonrecourse liability borrower wont be incentivized to pay off the debt). Note that the scope of this holding may be narrow and only applicable t o the purchase money mortgage because the 3rd party lend won't be interested in lending money of which the amount is way larger than FMV. Under this approach, the adjusted basis would be 200 nonrecourse add 100 cash equals 300.
100 basis (cash) rev. rul 77-110 estate of F
200 basis (FMV of property) + 100 basis (cash) – pleasant summit

Hypo: 500
Once the property appreciates in value, taxpayers would now have incentive to pay off nonrecourse liability. The legal matter is this approach lacks legal authority.

(i) Would it make any difference to your answer in part (e) if the $400 mortgage debt had been a recourse liability (one on which T had personal liability)?
AB=500

(d) The purchase price is $200, there is no down payment, and the entire price is paid by a purchase money mortgage to the seller on which T has no personal liability. For 20 years, interest on the mortgage is payable annually at an adequate rate, but no principal need be paid. The principal is payable in a lump sum at the end of this 20-year period.

This differs Franklin where the nonrecourse liability exceeds the fair market value of debt. However, 20 years have passed so taxpayers might still not be incentivized to pay off at the end of 20 year period considering the use of the building. Crane doctrine may not apply here. So it depends whether the 200 debt would be included in the basis.

(e) Same as (c), except that the purchase price is $250 and the mortgage note offers T the option of satisfying the note in full with a principal payment of $200 during the third year of the note's term. [In analyzing this problem, consider *Mayerson* and the prepayment options

that were available to the buyer in that case. Also, in considering the *Mayerson* tax consequences of the 4th year prepayment of the $322,000 debt (after the "discount" opportunities under the mortgage note had come and gone) for $200,000, read § 108(e)(5) and think about the impact of the $200,000 compromise on basis and depreciation.]

In this case, the nonrecourse liability exceed the fair market value of the debt. So either R.R. 77-110 or Pleasant Summit approach would apply here. First, R.R. 77-110 provides that under such circumstances the total nonrecourse liability would be disregarded and only cash payment of 100 would be included in the basis. Further, the court in Pleasant Summit holds that the amount of the nonrecourse liability should be included in the basis up to the extent of fair market value of property. Pleasant Summit (when fair market value is less than the nonrecourse liability borrower wont be incentivized to pay off the debt). So the adjusted basis would be 0 or the FMV. If the purchase price is lower than FMV, then under Mayerson, the purchase price would be the adjusted basis

II. Dispositions of Encumbered Property

1. During year 1, T purchases a building (but not the underlying land) for its value of $100, of which $50 is paid in cash and $50 is borrowed under a nonrecourse mortgage note from a lender who is unrelated to T and the seller. During year 5, after T has been allowed depreciation deductions of $20 on the building, T borrows an additional $120 without recourse from another unrelated lender, giving a second mortgage on the building as security. What are the tax consequences of the year 5 loan?

In Woodsam Associates, the court holds that the second loan is not considered as income or taken into account of when computing adjusted basis.

Here, T is protected against potentially reduced value of the building since she does not have to pay back.

If T has a property with 0 basis and 100 fair market value, T takes out 100 NR loan

Loan far less than 100: not realized income under <u>Woodsam</u>

Loan close to 100: Once you take out 100 NR on. The property, you are not protected against all downside risks – IRS would be suspicious about this any may treat it as income

Woodsam Associate might not consider this

Look like a sale of property.

2. During years 1 through 6, T in problem 1 is allowed depreciation deductions of $25 (in aggregate) and repays $20 of principal on the second loan. The principal balance on the first mortgage, however, continues to be $50. What tax consequences will follow if T disposes of the building at the beginning of year 7 in one of the following transactions?

(a) T sells the building to B, who pays T $25 in cash and takes the property subject to both of the mortgages on it. Reg. § 1.1001-2(a)(1), -2(a)(4)(i).

Gain = AR – AB = the amount of liabilities discharged + cash - basis = 175 (50from mortgage 1+ 100from mortgage 2 + 25 cash) – (100-25recapture) =100

- T.R. 1.1001-2(a)(1): AR includes the amount of liabilities discharged

- T.R. 1.1001-2(a)(4)(i): sale of property securing nonrecourse liability discharges the seller from liability.

The purchaser's basis here is 175, equals the cash she paid and the mortgages she assumed
Another way to tell is track the cash inflow and outflow:
Income: 100 gain – 25 reduction = 75
Cash out: -50+120-20+25 = 75

(b) T gives the property to her son, who takes the property subject to the mortgages. Reg. § 1.1001-2(a)(4)(iii).

T.R. 1.1001-2(a)(4)(iii) provides that a gift of property or transfer of the property in satisfaction of debt is treated as disposition of property. This is the part sale and part gift issue. T.R。 1.1001-1(e) provides that T would recognizes gain to the extent that Amount realized subtracting adjusted basis. Here the gain is 150AR subtracting 75 basis = 75
T.R. 1.1015-4(a)(1) provides that the sons' basis in the part sale part gift will be the greater of the amount paid by the transferee (15) or the transferor's adjusted basis (75). Here, the son's basis will be 150.

(c) The mortgagees foreclose on the building, and the property is sold in a foreclosure sale for $100, of which $50 is paid in full satisfaction of the first mortgage and $50 is paid to the holder of the second mortgage in satisfaction of one half of its claim.

In Tufts, the court held that the amount realized includes the full amount of nonrecourse debt assumed. Similarly, T.R. 1.1001-2(b) provides that the fair market value is irrelevant for purposes of determining the amount of discharge of liabilities. Here, the amount realized is 150 and the basis is 75. Leaving the 75 gain.

(d) T voluntarily transfers the building to the mortgagees in lieu of foreclosure. Because the property is worth only $100, each of the mortgagees takes an undivided one half interest as tenant in common.
A voluntary transfer in lieu of a foreclosure and abandonment of property subject to non-recourse debt is treated as a disposition of property. Freeland (treat voluntary transfer as foreclosure sale). Here. The gain is 105 mortgage assumed – 75 basis = 75

3. T purchases a tract of undeveloped land for investment for $200, paying $50 of the price in cash and borrowing the remaining $150 from a lender unrelated to T or the seller. T is personally liable on the mortgage note. A few years later, the land's value drops substantially because of changes in the community that destroy the prospects for developing the land. What tax consequences result to T in the following alternative transactions?

(a) T defaults on the mortgage, whose principal balance is still $150, and the mortgagee forecloses, realizing only $100 in the foreclosure sale. T pays the mortgagee $50 in satisfaction of its deficiency claim.
T.R. 1.1001-2(a)(2) provides that AR does not include the COD from the recourse liability. So here AR only includes the FMV of the land (like you sell at 100 and pays 100 to the lender). The amount realized here will be 100. The basis is 1014 cost basis so 200. Here, T has 100 loss.
If it had been nonrecourse debt, the amount realized will be the discharged debt 150 so you would have 50 loss.

However, T would prefer the nonrecourse treatment (you don't want to a 1 loss to save 33 cents)

(b) Same as (a), except that the parties settle by T paying the mortgagee $30 in full satisfaction of the deficiency claim.
Under 61(a)(11), T had additional liability of 50 after the foreclosure sale but only paid 30, this would be a 20 COD ordinary income.
Like a, with the recourse debt, T would have 100 loss from the foreclosure sale. The 20 COD ordinary income can offset the loss.
1.1001-2(a)(2), -2(c) ex 8

Hypo: if T voluntarily transfers the land and pays 30 in satisfaction of liability, T would get 20 COD.

But without foreclosure sale, we would not know the FMV

What amount of FMV would T report? To eliminate the ordinary income from COD

T would like to reduce capital loss to erase the ordinary income (since ordinary income is taxed at higher rate)

So T would report FMV at 120 in order to wipe out the COD income

(c) Same as (b), except that instead of $30 in cash, T delivers to the mortgagee shares of publicly traded stock that are worth $30 but have an adjusted basis to T of $10, and T is hopelessly insolvent.

Similarly, there is a 100 loss from the foreclosure sale.
108(a)(1)(B) provides the insolvency exception for the cancelation of debt income. 108(d)(3) provides that the insolvent amount is the liabilities assumed subtracting the FMV of the assets.
Ghel v. Commissioner, the court decides the exclusion for on solvency only applies to COD income. 61(a)(11) COD
108(b): reducing tax attributes for compensating this exclusion of income

(d) Same as (b), except T is a fully solvent real estate developer who bought the land, not for investment, but to build a shopping center as part of T's business activities. T's other assets at the time of discharge consist of cash, bulldozers, backhoes & other heavy construction equipment, land held for future development, and a building T uses to conduct its business operations (including storage and maintenance of equipment). What if T did not own the building, but only leased it?

Same from above with 100 loss from the foreclosure sale.

On its face the 20 COD might qualify the 108(a)(1)(D) qualified real property business indebtedness exception. The code has provide two exceptions, 108(c)(2)(B) provides that exclusion is limited to the aggregate bases of depreciable real property. If the building is a leased property, then there is no basis under 167(c)(2) so the T would prefer owning it instead. 108(c)(2)(A) also provides that the exclusion shall not exceed the excess of the remaining principal amount of debt(150) over the (100) = 50 Here, COD is 20 so we don't need to go over the limitation.

(e) Same as (b), except T is a fully solvent individual and the property involved is T's principal place of residence.
108(a)(1)(E) qualified principal residence indebtedness exception has already sunsets on Jan. 1. 2018. SO the 20 COD is still ordinary income
108(h)(1)

(i) How would your answer to (e) change if the lender reduces the debt to $130 and allows T to retain ownership of the residence while T makes future payments on the reduced debt?
Applying the Mayerson holding the basis of the property will be reduced by 20. But the problem is the property now is the reresidence. Since the property is for personal use

4. T purchases equipment for $200 in cash, $150 of which is borrowed from a bank which is given a nonrecourse chattel mortgage on the equipment to secure the debt. Over the next few years, T uses the equipment for business purposes and is properly allowed cost recovery allowances totaling $75. At the time of the following alternative events T's adjusted basis in the equipment is $125, and the principal balance of the note is still $150. What are the tax consequences to T in each case?

(a) When the equipment is worth $100, the mortgagee forecloses and repossesses the equipment.
Amount realized is still the not amount, i.e. 150. The basis here is 125. The gain here is 25. Tufts

(i) What if the mortgage were recourse rather than nonrecourse and the $50 balance of the debt was cancelled?
Here the amount realized is the fair market value of the debt instead of the 150 pricipal note. So we have a loss of 125 basis – 100 AR = 25
This would have a COD income of 50 (cancellation of debt because you assume the 150 debt with 100 FMV)

(b) When the equipment is worth $175, the lender compromises the $150 nonrecourse note for $120. Following the compromise, T holds the equipment free and clear.
Similarly, 30 COD income R.R. 82-202

(i) Why would the lender be willing to compromise the note, given that the security is worth more than the principal balance of the debt?
Even if the lender loses on interest payment, repayment earlier would still be better. If the original interest is below market rate of return, then the lender would be better of reinvesting the repayment.

(c) Same as "(b)" except the equipment is worth $120.
Still 30 COD income

(d) Same as "(c)" except that the note evidences purchase money debt (the original purchase of the equipment was seller financed).
108(e)(5) provides the purchase price adjustment treatment. the codes illustrates that under this circumstances T would not have COD income but instead reducing the basis by the discharge amount. So her the AB will reduce 30 to 95

(i) What if the seller of the equipment had sold T's note to X and X compromises the $150 note for $120?
R.R. 92-99 provides that this situation would not be considered as purchase price adjustment but as COD income of 30 because the reduction was made by a third party.

Unit 4: Capital assets

Problems

Policy reasons for preferential rate: Increase Savings; Inflation; Lock-in effect; Bunching
Against:
Ordinary rate for all capital gains? Tax every year on accrual gains
Con: Horizontal Equality; distortionary; Vertical Equality; Complexity

1. T, an unmarried taxpayer, is in business for herself. This year, T has $400,000 of taxable income without regard to the transactions listed below. The character of this $400,000 is entirely derived from ordinary income transactions (e.g., fees for services, sales of inventory, interest, etc.).

On June 1 of this year, T also engages in the sales transactions described in the questions below. For each question, where relevant, determine the amount of T's taxable income that is (1) subject to the tax rates set forth in § 1(c), as amended by § 1(j), and (2) subject to the preferential tax rates of § 1(h). Also, where relevant, determine the amount of any capital loss carryovers. Ignore Sec. 1(j)(5)(C).

(a) T has the following gains and losses from sales:

(i) T sold shares of IBM stock that T had held for investment for three years at a gain of $40,000;

(ii) T also sold shares of AT&T stock that T had held for investment for two years at a loss of $5,000;

(iii) T also sold shares of Microsoft stock that T had held for investment for ten months at a gain of $16,000; and

(iv) T also sold shares of Intel stock that T had held for investment for one month at a loss of $1,000.

- 1(h)(1) has been revised by 1(j)(5)
  - Net capital gain (NCG) under 1222(11)
    - NCG = excess of net long term capital gain (NLTCG) over net short term capital loss (NSTCL)
    - Long term v. short term: 1 year holding period.
    - (i) stock for investment for 3 years: LTCG 40k
    - (ii) stock for two years: LTCL 5k
    - (iii) Stock for 10 months: STCG 16k
    - (iv) stock for 1 month: STCL: 1k
    - So, NLTCG = 35k; NSTCL = 0
    - NCG = NLTCG – NSTCL = 35k – 0 = 35k
      - Note. That more short term capital gain > capital loss

- 1(h)(3) Adjusted NCG (ANCG) = NCT here because there is no unrecaptured 1250 or collectable gain.
- TI= Ordinary income + capital income (NSTCG) + NCG = 400k + 15k + 35k = 450k
  - 1(h)(1)(A): 415k (including 15k NSTCG) is taxed at ordinary rate – **greater** of
    - (i) TI reduced by NCG (415k) or
    - (ii) lessor of TI taxed below 25% (157.5k) or (TI-NCG) (415k)
      - 1(j) did not make the corresponding change made for 1(B)(i)
      - However, the secondary authority would say that this is a mistake, and we should go within using TI below the maximum zero amount
      - See ordinary bracket 1(j)(2)(C) – 157.5k
    - 15k NSTCG is added to 400k TI because NSTCG is ordinary income
  - 1(h)(1)(B): Exemption on Adjusted NCG as does not exceed the excess of
    - (i) below the maximum zero amount (38600) over
      - 1(j)(5)(A)(i)
      - 1(j)(5)(B)(i) TI below the maximum zero percent amount: 38600
    - (ii): TI reduced by ANCG = 415k
    - Aka, (38600) – (TI-ANCG = 415) < 0
    - Here, there is no excess
    - So the amount taxed at 0% is 0
  - 1(h)(1)(C): 15% of the lessor of
    - (i)ANCG as exceeds the amount on which tax is determined under (B) exemption (0) = 35k, or
    - (ii)(I) the excess of TI below the maximum 15% rate amount over
      - 1(j)(5)(A)(ii)
      - 1(j)(5)(B)(ii): maximum 15% = 425800
    - (ii)(II) sum of amounts on which tax is determined under (A) and (B) = 415k + 0 k = 415k
    - 425800 – 415k = 10800
    - Here, the lessor is 35k, but the maximum amount was provided as 10800, filled up.
    - So 10800 will be taxed at 15%
  - 1(h)(1)(D): 20% of the ANCG in excess of the amounts under (B)and (C)
    - Here, 35k – 10800 = 24200
    - IF the TI is less than ANCG, use TI instead of ANCG
- Instead of amending 1(h) directly, 1(j) is adopted which would sunset in 2025.

(b) Assume the same facts as in part (a) above, except that T also received $1,000 of dividend income this year from the shares of each corporation ($4,000 in total).

- Here, TI is increased by 4000 dividend income
- 1(h)(11) provides the qualified dividend income that should be treated as NCG
  - Whether the dividends are qualified
    - (B)(iii) provides that the Should be held for at least **60 days**

        - So intel stock, held for only one month, is not qualified for qualified dividend income
        - So 1000 should be added to ordinary income
        - Note that 1(h) 11 also requires the dividends be from domestic corps.
  - Policy reason: Economically, T is in the same position if selling it at a price reduced by the amount of dividends
    - Purchased stock at 1000, 100 dividend, sold it at 900
    - If there is no holding requirement, get capital gain treatment for dividends as qualified dividends and get short term loss which T could offset short term gain which would be ordinary income
- Policy reasons for granting preferential tax treatment
  - Equity between investing on stocks (dividends) and investing on loan (interest)
  - If treating ordinary income, the burden is heavy for the money invested for corporation.
- The rest 3000 should be included in NCG
  - Will be taxed at 20% since we already exhausted the 15% bracket for 10800
  - So additional NCG of 3000 is taxed at 20%
- 1(h)(1)(A): TI = 454k, NCG = 38k
  - 416k is taxed at normal rate
- 1(h)(1)(C): 9800 is taxed at 15%
  - Lessor of 38k or (425800 – 41600) = 9800
- 1(h)(1)(D): 38k-9800 = 28200 taxed at 20%

(c) Assume the same facts as in part (a) above (but no dividends), except that the loss on the AT&T stock in (ii) was, alternatively, $50,000, or $75,000.

- 50k loss
  - Can take the full amount of loss (as it's long term capital loss) first against LTCG and then against NSTCG
  - Losses are netted first against gains of a like character, then netted against other groups, moving from the highest rate to the lowest rate.
    - LTCL of 50k are first netted against LTCG – remaining = NLTCL
    - NLTCL can then be used against NSTCG
      - NLTCL = 50k – 40k = 10k
      - NSTCG = 16k – 1k = 15k
      - NLTCL against NSTCG = 5k NSTCG
    - NCG = NLTCG – NSTCL = 0 – 0 = 0
  - TI = 405k = 400k + NSTCG 5k + NCG 0 = 405
    - 405 is taxed at ordinary rate
- 75k loss
  - Netting losses first
    - First against LTCG and then against NSTCG

        - NLTCL = 75 – 40= 35k
        - STCG = 15k
        - NLTCL against STCG = 0
        - NCG = 0
        - Leaving 20k NLTCL to carry over
    - TI = 400k + NSTCG 0 + NCG = 0 = 400k
    - Next question: how much of the remaining 20k (part of NLTCL does not offset any other income) can we deduct from ordinary income
        - Lower of 3000 or the excess of losses over gains (20k) (1211(b)(1))
        - So here use 3000 against ordinary income
    - 397k is taxed at ordinary rate
    - 1212(b) provides that the 17k can be carried over indefinitely

(i) How would your answer to part (c) above change if T sold the AT&T stock at a loss of $50,000 and T also sold a painting that T had been holding for investment for four years at a gain of $15,000?

- 1(h)(5) collectible gains/loss = 28% gain
    - Gain from a painting that is held for more than one year
    - 408(m)(2)(a)
- NCG = NLTCG – NSTCL = (40k + 15k – 50k loss from painting) – 0 = 5k
- Under 1(h)(3): ANCG = NCG reduced by 28% of the gain (15k) = 0
- TI = 400k + 15k NSTCG + 5k NCG = 420k
    - (1)(A): 415k taxed at ordinary rate
    - (1)(B)(C)(D): 0
    - (1)(F): 5000 NCG taxed at 28%

Variation on (c): facts of (a) plus painting for 15000

Same as (a) except for taxing 15000 at 28%

(d) How would your answer to part (a) above have changed if, in addition to the stock sales described in part (a), T had also sold an undeveloped parcel of land that T had been using in her business over the past several years? The land was sold by T for $30,000 at a time when T's basis in the land was $20,000.

- Land:
    - Land is not a capital asset under 1221, so governed by 1231
    - 1231gain: any recognized gain on the sale or exchange of property used in trade or business and was held for more than 1 year
        - (a)(1) 1231 gain > 1231 loss = LTCG and LTCL
    - 1231 gain =10k = LTCG
        - Taxed at 20% because we exhausted 15% amount already

(i) Alternatively, assume that T's basis in the land at the time of sale had been $90,000.

- This would generate 1231 loss
    - 1231(a)(2): 1231 gain< 1231 loss = ordinary gain and loss
- Loss = 90k basis – 30k – 60k ordinary loss
- TI was originally 450k and now 390k
    - (A) ordinary income is 355k (390k – 35 NCG) ---- taxed at ordinary rate
    - (C) 35k is lesser amount—taxed at 15%
        - i) ANCG as exceeds the amount on which tax is determined under (B) exemption (0) = 35k or
        - ii)(I) the excess of 425800 over
        - ii)(II) the sum of amounts on which tax is determined under (A) and (B) = 390k
    - 1231(c)L recaptured provision: if you had losses in the past 5 years and you took them as ordinary, and if you then have gains, you also treat gains as ordinary

(e) How would your answer to part (a) above have changed if, in addition to the stock sales described in part (a), T had also sold some machinery that T had been using in her business over the past several years? The machinery had been purchased by T for $100,000. Up to and including the time of sale, T had properly taken $60,000 of depreciation deductions with respect to the machinery (no § 179 election had been made by T and § 168(k) had not been applicable). T sold the machinery for $125,000.

- Machinery
    - 1221(a)(2): the depreciable property used in trade or business is not considered as capital asset
    - 1245(a)(3): 1245 property = depreciable and personal property
- 1245 Recapture depreciation
    - How much of the 85k (125-40) gain is recognized as ordinary income
    - If 1245 property is disposed of the amount by which the lower of recomputed basis or FMV exceeds the AB, it shall be treated as ordinary income
    - 100k (recomputed basis) – 40k (AB) = 60k is treated as ordinary income
        - We let the tp take the depreciation from the ordinary income even if the value of the property did not go down – so taxing it back at ordinary rate
        - Don't want the double benefit (deduction is taken at ordinary rate)
- 1231 would apply to remaining gain of 25k
    - 25k is treated as LTCG under 1231
        - This is taxed at 20% as we filled up all the brackets for 15%
    - TI – 460k + NSTCG (15k) + NCG (35k+ 25k) = 535k
        - (A) 475k is taxed at ordinary rate – greater of
            - (i) TI reduced by NCG – 475k or
            - (ii) lessor of TI taxed below 25% (157500) or TI-NCG (47500)
        - (C) None because the lessor of ANCG (60k) or 425800 – 47500 = 0
        - (D) 35k is taxed at 20%

(i) Alternatively, what if T had sold the machinery for only $25,000?

Still governed by 1231 – when there is loss, 1245 does not apply – 15k loss will be ordinary loss – TI down to 435k

- (A): 400k at ordinary income
- (C)L 25800 (425800 – 400k) taxed at 15%
- (D) rest 9200 is taxed at 20%

(f) How would your answer to part (a) above have changed if, in addition to the stock sales described in part (a), T had also sold an office building that T had been using in her business over the past several years? T had purchased the property for $415,000 of which $25,000 was allocable to the underlying land. Up to and including the time of sale, T had properly taken $20,000 of depreciation deductions with respect to the office building. T sold the property for $450,000 of which $50,000 is allocable to the land.

- Gain from the land: 50k – 25k basis = 25k
  - 1231(a) LTCG
  - Taxed at 20%
- Gain from the disposition of the building: 400k – 379k (415-25-20) = 30k
  - 1250(a)(1)(A): applicable percentage (100%) of the lower of the portion of additional depreciation or (AR-AB) shall be treated as ordinary income
  - 1(h)(1)(E): why do we tax under this rather than 1250
    - Real property is accounted for under straight-line method
    - 1250(b)(1): restricting application of 1250 to depreciable property of which the depreciation is faster than straight line method
    - So 1250 will not apply
  - 20k of the gain which matches the depreciation (=unrecaptured 1250 gain) taken is taxed at 25%
  - The remaining 10k gain is taxed at 20% as 1231(a) LTCG

2. In each of the following alternative situations, determine whether the properties being sold are capital assets in T's hands:

1221 capital assets does not include properties that are held for sale to consumers (inventory are not capital assets)

(b) T is always on the lookout for land to buy, usually holds about 40 tracts, is always willing to listen to offers to buy her land, and makes about six sales in an average year. Ten years ago, T bought an undeveloped tract of land with the intention of holding it for appreciation. The land was rented to a farmer, but the rents were barely sufficient to cover the real estate taxes and interest on a mortgage T took out to finance the purchase. This year, T sold this still-undeveloped tract of land at a substantial gain.

- May not be capital asset and generate ordinary income
  - Suburban Realty: frequency and continuity of the sale that matters – against capital gain

        - T has fairly high frequency, average of six sales every year, holding 50 tracts
        - Renting on land does not seem to be the principle business of T
        - T seems to buy and hold the property only for investment, did not develop the land at all, also held for 10 years.
    - Factors for capital gain: T has "investment" intent for the land to begin with, then sells it, is this passive "liquidation of investment", did not actively market it nor develop it, so it will be capital gain like Farley case? And the fact that T held it for 10 years before selling
    - <u>Here, most likely to excluded form capital asset because of the volume of sales</u>
    - 1237 safe harbor only applies to subdivision of a whole land
        - Here, there is no subdivision
    - Even if you may be kicked out of the capital asset treatment, you can go to 1231. But here, 1231 does not apply.
        - 1231(b)(1)(B): does not include property held for sale to customers.

(c) T is a public school shop teacher. Last spring, he bought a residential lot. Over the summer, he and two other teachers, who worked as T's employees, built a house on the lot. T sold the house and lot in October. T has never done anything like this before, and although he sold the property at a profit, he has no definite plans for building any more houses.

- Unclear whether this property is held primarily for the sale to customers
    - Capital asset
        - Here, there is only one customer
    - S&H v. Commissioner : ordinary income
        - The absence of frequent sales doesn't establish capital asset status
        - Involving singular transaction
            - S&H constructed a building and sold it to customer according to preexisting contract
        - Cf. here, there is no preeexisting contract
    - Ordinary
        - But T built a house with other labors – so the only purpose of constructing the building is to sell it to the customer

(a) T's full-time occupation is trading in securities. She spends her days researching stocks and bonds, talking on the telephone with brokers, and keeping records of her trades. Last year, she made 253 purchases of stocks and bonds and 362 sales. In thinking about this question, consider what is it about the nature of their activities that distinguishes "traders" in securities (who generally receive capital gain or loss treatment) from, say, retailers, e.g., the local grocer, whose inventory sales produce ordinary income? Compare the result under § 475(f)(1) & (d)(3).

- Question of Dealer (holds stocks for sale to the customers – ordinary gain) v. Trader (for investment – capital gain)
- 1221(a)(1): excluding from capital asset, stock in trade held primarily for sale to customers

- Here, T may be trader not a dealer so likely a capital asset
    - Because here T did not sell to customers
    - R. 1.475(c)-1(a): definition of dealer in securities
        - T, in the ordinary course of the T's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction
    - Merely having dealer status does not preclude you from holding capital asset status
    - Dealers – Sec 475(a)(2), (d)(3) – mark to market treatment
- Suburban Realty may be misleading here—frequency may not matter under this situation
    - Frequency: here, T made frequent purchases and sales
    - Cf. If the relevant property were real estate, this is frequent enough to make it ordinary income
- Why would give capital asset status to the stocks and securities even if they are frequently traded? To encourage investment
    - Prof: say the taxpayer has a property with a built in LTCG of 3k, a 2nd property with a built in LTCL of 3k, he would dispose the loss property this year and get 3k LTCL to deduct ordinary income, and dispose the gain property next year (defer) and then get capital gain treatment on the gain
- 475(f)(1): Trader can elect mark to market taxation where all gains/losses are treated as ordinary
    - But under mark to market taxation, timing game is not available here
    - Why might trader elect mark to market transaction to be treated at ordinary rate?
        - Good to have ordinary losses on the sale of their property
        - But the cost is ordinary gain
            - Why not worry?
            - If they are making frequent sales, because short term gain is already taxed at ordinary rate, this does not make any difference

3. On January 1 of year 1, B pays S $100 for an option to purchase a tract of undeveloped land for $1,000 at any time during year 1 or year 2. What are the tax consequences to the parties if, alternatively:

(a) B exercises the option during year 2;

- For B, Rev. Rul. 78-182
    - B will capitalize 100 when buys the option
    - B's basis in land when he exercises the option – 1100 (land and the option)
    - When B exercises the option, it does not have any income, but only has basis
        - B exercises the option only if the value of land is above 1000
- For S, does not recognize any gain or sale of the option

    - Once S receives 100, he cannot risk it anymore
        - So maybe more logical to include that as an income
    - But S would recognize AR of 100 when the option is exercised
- Hypo: B pays S 1000 for the option to purchase the land at 100
    - The option price is really high compared to the purchased price
        - If S has built-in gain for the property, we are worried that S would use the option as mere form of deferring taxes
        - Because the sale of the option itself is not taxable transaction
    - So this would give rise to extra tax-avoidance suspicion.

(b) B sells the option to A for $75 during year 1, and A exercises the option during year 2; or

- For S, same as (a), does not recognize any gain or loss
- For A, R.R. 58-234
    - Basis = 75 + 1000 = 1075 when exercises the option
- For B, 1234(a)(1) sale or exchange of an option
    - Loss of 25 (100-75)
    - Character of option is decided by the character of underlying property
    - If we assume that undeveloped land (underlying property) is capital asset, we will get capital loss status for loss from the sale of option – holding the option for less. Than 1 year – so assuming not held for trade or business is correct here
        - Short term capital loss
        - Reg. 1.2438-1(a)(1)

(c) B neither transfers nor exercises the option, which expires at the end of year 2?

- For B: 1234(a)(2) lapse of a call option is treated as sale or exchange at the expiration
    - Loss of 100
    - B held it for more than 1 year – so long term capital loss
        - Character decided by the underlying property
    - B would prefer STCL to LTCL because able to offset against STCG, which is taxed at ordinary rate
- For S: 1234A
    - Gain or loss attributable to cancellation of option shall be treated as gain or loss from the sale of a capital asset
    - So long term capital gain of 100
    - Cf. 1234(b) does not apply here because the applicable property does not include land
        - If it were an option to purchase stock, then this would apply, and S would realize short term capital gain in this case.

4. T manufactures baseball bats. The principal raw material for the business is ash lumber. T has occasionally suffered losses when the prices for ash lumber unexpectedly rose. One of the means T uses to protect against these possible losses is to purchase futures contracts in pine lumber. Pine futures are purchased because (1) no futures market in ash lumber exists and (2) the spot prices for pine and ash lumber tend to move in parallel. Since T has no desire to acquire a stock of pine lumber, the futures contracts are always closed out by cash settlements.

(a) Are the gains and losses on the futures contracts capital or ordinary under Corn Products & Arkansas Best?

- Corn Products & Arkansas Best this would be treated as capital asset
- Why would this be ordinary asset
    - 1221(a)(1): serving as inventory
    - Which should come out as ordinary income
    - Otherwise we might allow T to convert ordinary income to capital income
- Ex: 10 for a bat, cost of lumber 5 and cost of other products 2
    - 3 profit at ordinary rate
    - T can be engaged in future contracts, so T could purchase lumber for 5
    - When the price of lumber at delivery is 6
        - Cash settlement T can say if you don't want to deliver lumber, then you have to pay 1 – preferential
            - 1 profit at capital rate because this is gain on the future
            - You purchase lumber at 6 in the market – 2 profit at ordinary rate
            - 2 ordinary and 1 capital income
        - Physical delivery: accepting delivery of lumbers and T pay 5 to the lumber company
            - 3 of ordinary income
    - If the price of lumber at delivery is 4
        - Physical delivery—preferential
            - 3 ordinary income
        - Cash settlement: if T don't want to receive lumber: T has to pay 1
            - 1 loss at capital loss
            - You purchase lumber at 4 in the market, 4 profit at ordinary rate
            - Tradeoff – capital loss is less valuable
    -

(b) Does the transaction qualify as a hedge under § 1221(a)(7), (b)(2) and Reg. § 1.1221-2(b), (c)(2) as a definitional matter? If so, what must T do mechanically to perfect qualification?

1221(b)(2): this is hedging transaction
- Transactions entered into by T to manage risk for price changes
- 1221(a)(7): **identification** requirement for the transaction excluded from capital asset
    - Here, same day identification is not met

- We do not want T to decide between ordinary and capital after the transaction
  - Other wise, T could want capital gain and ordinary loss

(c) Would your answer in (b) change if T expects to need 100 units of ash, but buys 1,000 units of pine futures?

- 1221(b)(2): primarily to manage risk of price changes
  - Prof: "primarily" is used in the definition of definition of "hedging transaction" in 1221(b)(2)(A)(i), here does not look like "primarily" to hedge risks,
- Here, T bought 1000 units of pine futures whereas T only needed 100 units of ash
  - T is only concerned about price fluctuations regarding 100 units of ash
  - So this may not be property hedging transactions
- Two answers possible: no direct authority to resolve this issue
  - None of the 1000 units of pine futures is considered as hedging transactions
    - Because this is single transaction, this may not be treated as managing risk of price changes
  - Treating 100 unites as hedging transactions, and remaining 900 unites as non-hedging

(d) Assume that the purchase of pine futures in (c) above is held not to be a hedge, but T identified it as a hedge anyway. What are the consequences of the identification if these futures contracts are closed out at a gain? At a loss?

- 1221(b)(2)(B)
- T.R. 1.1221-2(g)(1)
  - (i)identification is binding with respect to gain – ordinary gain
  - Identification does not matter with respect to loss
    - If the transaction is not in fact hedging – capital loss
    - Ordinary gain + capital loss. treatment
  - (ii) but if this were inadvertent error, you can get capital gain result

5. Motorola plans to build a new semiconductor manufacturing facility in Virginia at an anticipated cost of about $300 million. The project will get under way in about a year, and will take about 3 years to complete. The company will finance the project by issuing 15-year notes that are expected to carry an 8% interest rate, based on today's rates. Public sales of the debt will not begin for about 6 months. Motorola wishes to lock in the interest cost on the notes at today's rates and sells short $300 million of 15-year, 8% U.S. Treasury bonds at par.

Interest	fall	rise
Treasury bond	rise	fall
Short position	fall	rise
Company's interest cost	fall	rise

(a) How does the short sale of the Treasury bonds lock in today's rates with respect to the anticipated debt issue? [Hint: An obligation that pays $1,000 at the end of 15 years and

$80 per year in the interim has a present value of $847.88 when discounted at 10% compounded annually, and a present value of $1,192.25 when discounted at 6% compounded annually.]

- When interest rate goes up in the market, bond would not yield attractive reutrns, so the value of the bond would go down
- The short position value would go up when the value of underlying property goes down
  - Here, M borrows the Treasury bonds, sells short, planning to buy back
- M needs to pay the market value when issuing bonds – so interest cost will go up when interest rates go up
- Value of short position goes up which benefits T, interest cost going up harms T – because this is offsetting, M would want to be in short sale

(b) If Motorola's short sale results in a loss, does that short sale of Treasury bonds qualify as a hedging transaction under § 1221(a)(7) and Reg. § 1.1221-2? See also Reg. § 1.446-4(e)(4).

- Regarding the interest rate fluctuation hedging
  - 1221(b)(2)(A)(ii) and Reg. 1.1221-2(b)(2): interest rate fluctuation
  - Reg. 1.1221-2(a)(2) short sale = hedging transaction
  - But, Reg. 1.1221-2(d)(5): may not be hedging transaction
    - This trumps other provisions
    - The purchase of debt instrument is not hedging transaction
    - Not clear whether hedging of treasury bonds would fall into this exception.

For reference:
short sale locks in the gain because basically Moto borrows 300million of 8% bonds and then sell it for whatever price it is and get the proceeds, but under the short sale rules no tax recognition at this point, Reg 1.1233-1(a); then when time to give back the 8% treasury bonds came (also the time when Moto will issue its own bond), Moto buys treasury bonds from the market to give back, if market interest rate has risen, ie the 8% treasury bonds become less valuable, Moto has a gain because it will cost Moto less to buy back the shares to return to lender; but that also means the Moto bonds has to be issued at rate of more than 8%, more than its original expectation and this is a loss to Moto since it has to pay more interest (or the other option is still issue Moto bonds at 8%, which means the sale price will be less than face value and thus Moto is getting less proceeds from the issuance of the bonds), this loss from higher interest rate in its own issued bond offset the gain in buying back treasury bonds to return;

vice versa, if market interest rate drops, then there is a loss in returning the treasury bonds since they are now more expensive to buy; but that means Moto bonds can be issued at lower interest rate, good for Moto since it pays less interest, this gain offsets the loss (or the other option is still issue Moto bonds at 8%, which means the sale price will be more than face value and thus Moto is getting more proceeds from the issuance of the bonds).

6. A owns 1000 shares of Microsoft stock that she purchased 10 years ago for $2000 (i.e., $2/share). The stock is currently worth $100,000. A believes that the stock may drop in value as a result of various antitrust suits that are pending against Microsoft. To protect herself from this possible loss, on November 15th of this year, A sells short 1000 shares of Microsoft, i.e., she "borrows" 1000 shares of Microsoft from her broker and sells the shares on the open market for $100,000. Whether the stock goes down in value (as A suspects it will) or the stock goes up in value, A expects to "cover" the loan with her broker by transferring her original 1000 Microsoft shares to her broker. On February 5th of next year, this is precisely what she does: she transfers her Microsoft shares (then worth $90,000) to her broker to close out her short sale. What are the tax consequences (including timing considerations) to A as a result of these transactions?

- 1259
  - (c)(1) shall be treated as having made a constructive sale of an appreciated financial position if T enters into a short sale of the same or substantially identical property
  - (a) shall recognize gain of 98k when sells short – long term capital gain
    - To prevent T from deferring gain when it is engaged in short sale
- When T closes out by delivering her shares to her broker
  - No tax consequence
- Netting against LTCG and STCG --- relevant?
  - If she has LTCL and STCG in the same amount in year 1, she wants to recognize Microsoft gain (LTCG) in year 2 because if she recognizes in year 1, then she has to net LTCL against LTCG and then pay on STCG at higher rate whereas if she recognizes LTCG in year 2, she would have netted LTCL against STCG in year 1 and get preferential rate tax on LTCG in year 2

7. L is the owner of a tract of land on which a Building is situated. L executed a 50-year lease of the land and the Building to T. The annual rent (payable in monthly installments on the first day of each month) is $24,000 per year. T in turn subleased the Building to X for a 10 year term at an annual rental of $36,000 (payable monthly on the first day of each month). During the current year, the following alternative transactions occur. What is the character result for each transaction?

a. X pays T $10,000 to cancel the unexpired portion of his sublease for the Building. T then relets the premises to Z for the unexpired portion of X's term at the same rent.

- That 10k is substitute for rental payment that would have been ordinary
  - Holt v. Commissioner : landlord-tenet situation
  - Here: Sublessor-sublessee
- So it should be ordinary income like rent with no basis offset

b. L pays T $50,000 to cancel the unexpired portion of the long-term lease from L to T on the Building.

- 1241 amounts received by cancellation of lessee (T) is treated as capital income
- Exchange of lease: assuming that lease is capital asset and none of 1221 exception applies
- LTCG probably
- T's position is being terminated, L might realize the low rent he is giving T and wants to cancel and renegotiate with someone else.

(i) Suppose instead that X makes the above payment to T for the cancellation of T's lease in order to eliminate T so that L can lease the Building directly to X.
It does not matter whether the payor is the landlord or X—capital income

(ii) Suppose instead that T purchased a lottery ticket, won the lottery, and became entitled to receive $10,000 per year for six years. After receiving the second payment, T sold the right to the remaining four payments to A for a lump-sum amount of $35,000.

- Whether the asset is categorized as ordinary or capital
- Vertical cave out v. horizontal carve out
  - Vertical: transferring a portion of right
  - Horizontal: transferring all remaining right
- Right to earn income v. Right to earned income
  - Right to earn income = capital
  - Right to earned income = ordinary income
    - Income is already earned when you win the lottery

Unit 5: Loss

1. General Loss

Problems: In the following questions, H is W's husband.

1. W purchases 100 shares of the stock of X Corp. for $500. What are the tax consequences of each of the following alternatives?

(a) The stock declines in value to, alternatively, $100 or $0.

Section 165(c) provides that the loss deduction for individuals is limited to certain situations. The loss will be allowed if the transaction is one for profit. Here this transaction is on for profit. R. 1.165-4(a) provides that no deduction will be allowed solely on account of declining in the value of stock owned by T. As a matter of fact, if the stock price decreases to 100, there will be no loss. Moreover, there is no realization event occurs here because there is no sale/exchange. However, when the value of stock declines to 0, then the asset becomes worthless under 165(g). This loss will be treated as the loss from sale/exchange of capital assets and thus allowed

(c) W sells the stock to her brother, B, for $100, its fair market value, and five months later, B sells the stock to an unrelated person for, alternatively, $75, $125 or $525.

For W, 267(a) provides that no deduction for loss from the sale or exchange property between related persons will be allowed. With pursuant to the 267(c)(4), brother is members of family and thus 267(a) applies here. Note that brother's spouse is not a related party but there will be joint account/factual arguments by IRS. Regardless, W will not be able to take the loss.
Next, for B, 267(d)(1) provides that when transferee sells the property at a gain, the gain shall be recognized only to the extent that it exceeds the disallowed loss of transferor under 267(a). We already know that the disallowed loss of transferor is 400.

If H sells the stock for 75. In this transaction H has 25 loss. This is a profit-seeking transaction under 165(c) and 25 will be allowed accordingly.

If H sells the stock for 125. On its face the gain is 25. However, it does not exceed the 400 disallowed loss therefore no gain will be recognized.

If H sells the stock for 425. The gain is 425 and will be recognized to the extent of 425 subtracting 400 disallowed loss. B will recognized 25 gain

(b) W sells the stock to H for $100, its fair market value. Five months later, H sells the stock to an unrelated person for $125.

For W, H is her spouse and thus 1041(a)(non-recognition) applies here. This means there will be no gain and loss for W from transferring the stock to the spouse. Section 267(g) provides that when 267(a) does not apply here when 1041(a) applies.

With that being said, 1041(b)(2) provides that the H would take a transferred basis of 500 when getting the stock. When H sells the stock to an unrelated person for 125. This is a one for profit seeking transaction and thus H can have a (500 -125) = 375 loss

(d) W sells her X stock to Y Corp. for $100. In the aggregate, W and all persons related to her own less than one percent of X's outstanding stock. Assume alternatively the stock of Y is held as follows:

i) 100 percent by H,

The issue here is whether Y is a related person. Section 267(c)(2) provides that W is considered to own stocks owned by her family members. Since H owns 100 percent of Y and W is treated constructively owning Y Corp. through H. Section 267(b)(2) provides that corporates and individuals who owns more than 50% of the corporate's equity are related parties. Accordingly, Y corp. and W are related parties. Then 267(a) triggers and disallows deduction for W's losses.

ii) 100 percent by Z Corp., whose shares are owned 50% by H and 50% by H's sister.

Similarly, we still need to look whether W and Y are related. Section 267(c)(2) provides that W is considered to own stocks owned by her family members. Since H owns 50 percent of Y and W is treated constructively owning 50% Y Corp. through H. 267(c)(1). However, W does not constructively own 50% of Y Corp. through H's sister as 267(c)(5) prevents the <u>double attribution</u> for family members. Here, H's sister's stock is not attributed to W. In this case, W owns only 50% of the Y Corp, failing the more than 50% test provided under 267(b)(2). Therefore, the loss is allowed.

(e) W sells the X stock to C, the wife of W's brother, for $100, its fair market value, and (in the alternative)

i) C sells it back to W 20 days later for $105. If C's resale to W is for $95, is C's loss disallowed?

1. for 105

For W, this set of transaction triggers the wash sale rule promulgated under 1091(a). Section 1091(a) provides that no loss will be allowed if there is purchase of substantial identical stock/securities within 30 days after the sale. [policy?] Here, C sells the stock within 20 days, triggering 1091(a). section 1091(d) provides the basis of the purchased stock will be the basis of the old stock adjusted by increase/decrease of difference between the purchase price and the sale price. Here, W bought back the stock with an extra five thus the original 500 basis shall be increased to 105 accordingly.

2. for 95

Similarly to W, the loss will not be allowed and the basis is 495.

For C, C will have a 95 loss. (the cost basis 100 subtracting amount realized 95). This does not trigger the wash sale rule as C has never owned the substantial stock before.

ii) At the time of W's sale to C, W and C agree that W will repurchase the stock in six months for a price equal to the stock's fair market value at the time of the repurchase.
In this case, W and C formed a contract. 1091(a) provides that no loss is allowed of the parties have entered into a contract to reacquire. Note that the language of the code clearly indicates that there is no such time limitation so the six month agreement is irrelevant.

iii) There is no agreement between W and C regarding repurchase, but W in fact repurchases the stock from C after two months at its then fair market value.
Although there is no contract and the repurchase occurs two month after, the hypo is similar to the Fender v. U.S. In Fender, the court says even if there is no explicit contract, the fact that the close relationship between the buyer and the seller makes it not a bona fide loss since there is no real risk of not being able to buy back the stock. With that being said, under Fender, even if this falls outside of bounds of 1091, W still may not claim loss
Fender: useful check that even you slip 1091 and 267 you still have to ask whether this transaction is really a bona fide loss.

(f) W sells her 100 X shares for $100 in a transaction effected on a stock exchange, and W's brother, B, buys 100 X shares 20 days later in an exchange transaction for $105.
The situation differs in the way that the transfer from W to W's brother B is indirect. But note that 267(a) also covers indirect sales. (language: directly or indirectly) Also, in McWilliams, the court is skeptical that the parties might be acting in concert. Similarly, the court will be suspicious that there might be an agreement that W first sells to a third party and B buys back from the third party. If the court makes such determination, then under 267(b)(1) and 267(a), the loss is disallowed.

2. What are the tax consequences of the following transactions if all of the parties to the transactions are individuals who use the cash method of accounting and are, except as noted, unrelated?

(a) W, who is not in the business of lending money and is not a dealer in promissory notes, loans $100 to D, an individual. D's obligation to repay the loan is evidenced by a negotiable promissory note in the face amount of $100, payable in five years and bearing interest at 10%, payable annually. The note is not registered and does not have interest coupons attached. Fourteen months later, W sells D's note to an unrelated buyer, A, for $90.
First, since W is CODng profit-seeking activity under 165(c)(2), W will recognized 10 loss (90 amount realized subtracting 100 basis) as long-term capital loss.
The issue here is whether the 1221(a) applies here. However, the note is not held in W's inventory nor sale to the customers, 1221(a) capital asset exclusion does not apply here.
For D, nothing really changes because D's obligation to repay the loan is bound to the note holders. D does not bear any tax consequences here.

(b) Same as (a) except that D is A's son.
The situation is still the same for W. but for D, note that if D had bought the 100 note back from W for 90. It's equivalent that the 10 margin is treated as cancellation of indebtedness under 61(a)(11). We now knew that D's A's son. Section 108(e)(4)(A) provides that for determining income of debtor from cancellation of indebtedness, if D's related person had acquired the debt, then it's treated as if D had bought back the notes. Accordingly, D is treated as if he had bought back the note and will be subject to 10 ordinary income.

(c) When the promissory note in (a) comes due, D (again an unrelated party) is unable to pay in full, but does pay $85, which A accepts in full satisfaction of the debt.
To D, as an unrelated party, D is has an 15 cancellation of indebtedness income under 61(a)(11). However, D is unable to pay in full so the insolvency exception under 108(a)(1)(B) might apply here depending on whether D is insolvent or not.
TO A, the issue is what is his amount received under this transaction. 1271(a) provides that the amount received by the holder of debt instruments equals the amount received in the exchange of the instrument. So here A's amount received is 85. Since A's basis is 90. A would get a 5 loss.
The next question is how to characterize the loss. 166(a)(2) provides that deductibility to the partially worthless debt. Under T.R. 1.166-3, such loss from business debt will get ordinary loss treatment. However, in our case the promissory note is not a business debt since W is not in the business of lending money and not a dealer in promissory notes. The 5 loss will be long term capital loss since the note is payable in five years.
166(d)(1)(B)

2. at loss
At Risk and Passive Loss Limitations

Problems:

1. T, an individual, is a doctor. For Year 1, T has net income from the medical practice of $90,000 and investment income from marketable debt securities (taxable interest) of $50,000.

On January 18 of Year 1, T purchased a small office building in an arm's length transaction for $500,000. T paid $40,000 in cash from unborrowed funds and issued a nonrecourse note, secured by the property, to the seller for the remaining $460,000. The note bears adequate stated interest payable annually; principal is due in one payment in 5 years.

The building generates $65,000 in annual rental income. Assume the annual cost recovery deduction is $30,000. T pays $49,000 in interest on the note, $10,000 in real property taxes, and $16,000 in maintenance annually. Also, T spends $30,000 during Year 1 on repairs (not subject to capitalization) needed to put the building into top flight shape for renting. T pays for

these repairs on the last day of the year by borrowing an additional $30,000 from the seller of the building and increasing the first nonrecourse mortgage on the building to $490,000. T hires a rental and management agent for the building and is not personally involved in its management.

How much must T include in his gross income for Year 1 in respect of the building activity? What deductions is T allowed in Year 1 in respect of the building activity? Regs. §§ 1.469 1T(d)(1) thru (3), (e)(3), (e)(6); 2T(d)(1) thru (6), (8).

The numbers are tabulated here:

Rental income	$ 65
Expenses:	
Maintenance expenses	$ 16
Real property taxes	10
Depreciation	30
Repairs	30
Interest on mortgage	49
Total expenses	$135

Here, the total expenses is 135 while the rental income is 65. So at first glance TP would have a 70 loss. Then we need to look at if there are any loss limitations to this 70.
T.R. 1.469-2T(d)(6) provides some sort of roadmap, i.e., applying 465 at risk loss limitation first and then looking at 469 passive loss limitation. (something disallowed under 465 won't be calculated under 469 and some allowed under 465 might be disallowed under 469.)
Section 465(c)(3)(A) provides that at-risk activities include activities of carrying a business. Further, § 465(b)(1), (2) specifies that amounts considered at risk includes amount contributed by T to the activity and amount borrowed with regard to such activity but only to the extent that T is personally liable. This means the 40 cash paid will be included while the nonrecourse debt secured by the property (460 first and 30 second) will not be included. The maintenance expenses, real property taxes and interest on mortgage are real cash paid out of T's pocket and thus should be calculated. However, cost recovery (i.e. depreciation are not net cash out and should not be considered for 465 purposes). Here, T received 65k cash while the expenses will be 75 in total—granting a 10 allowed loss. In all, under 465(a)(1), T would have a total of 50 loss would be allowed for 465 at risk loss limitation purposes.
It doesn't necessarily mean the 20 will be disallowed because we need to look at 469 passive activity next. !!!!! it'd different this year'
Don't carried already disallowed activities 465 taxes under 469 to avoid double accounting (1500) – or it's because at risk basis is different from passive activity basis

Problem II.1

135K expenses/ded.
1.469-2T(d)(6) - 465 first, 469 second

465 Analysis
Sec. 465(a)(1)(A)
Sec. 465(b)(1)

Amount at risk:
$40,000 initial cash contribution
$16,000 maintenance
$10,000 real property tax
$49,000 interest
-$65,000 rental income
$50,000 at risk

Bottom line (465(a)): $20K disallowed

469 analysis

Sec. 469(c)(1)
Sec. 469(c)(2) - passive activity

Sec. 469(d)(1) - $70K

Reg. 1.469-2T(d)(2)(vi) State tax - 10K
Reg. 1.469-2T(d)(6) 465 - 20K

Supposing 40K of passive activity losses: $10K deductions

Reg. 1.469-2T(d)(6)(iii)
Real answer: passive activity losses are $41,500, T deducts $8,500

year.

(iii) ***Proration of deductions disallowed under at-risk limitation.*** If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing -

(1) The amount of the loss from the activity that is disallowed for the taxable year; by

(2) The sum of all deductions from the activity for the taxable year.

(iv) ***Coordination of basis and at-risk limitations.*** The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

41500 = 70k-10k-20k+10k*(20k/135k)

2Td(6)说了 465 算上的就不是 passive activity 了

(a) How would your answer to Question (1) change if the initial $460,000 nonrecourse borrowing, as well as the $30,000 nonrecourse year-end loan, had been borrowed from Citibank? IRC § 465(b)(6); Reg. § 1.465-27.

This change of fact will alter the 465 analysis as 465(b)(6) provides that the qualified nonrecourse financing is treated as amount at risk. Citybank as a commercial bank is activity and regularly engaged in lending business, thereby meeting the qualified person requirement under 49(a)(1)(D)(iv). Note that in original question T got the nonrecourse loan from the seller, not a qualified person. However, this analysis will not change the outcome of the case as 469 would still kick in and negating the total 70k loss

2. An individual, T, sells a building held for rental to an unrelated buyer for $1.2 million. For the year of the sale, T has no income or expenses relating to the building apart from gain or loss on the sale. T's adjusted basis for the building is $900,000, losses previously

suspended under § 465(a) are $20,000, and losses previously suspended under § 469 are $40,000. T also has $100,000 of passive losses from Activity # 2. What are the consequences of the sale? § 1231; Reg. § 1.469 2T(c)(2), (3)(i), (4), (7); Prop. Reg. § 1.465-12(a); cf. Prop. Reg. § 1.465-66 to 68.

The first issue is the characterization of the sales income. T.R. 1.469-2T(c)(2) provides that gain form the sale or exchange in a passive activity is passive activity income. Here, amount realized is 1200k and the basis is 900k, thus having the 300k gain.
The next question is whether the previous loss could be carried forward. 465(a)(2) loss is 20k does not exceed the 300k gain. T is able to carry over the full amount and take the 20k deduction. The 40k loss form 469 will also be able to carry forward because in the current year T has 100k passive loss from activity 2. 469(b). But note that under 469(d)(1) the 40k passive loss can only offset the passive income.

3. Same as Question (2), except the selling price for the building is $800,000; there is no § 465 suspension; the previously suspended § 469 losses are $40,000; and Activity # 2 yields passive income for the year of $90,000. See Reg. § 1.469-2T(d)(5)(i)(A).

The factual assumptions of Questions (2) and (3) may be summarized as follows:

	Q 2	Q 3
A/R	1,200	800
A/B	900	900
Gain (Loss)	300	(100)
§ 465	(20)	-
§ 469	(40)	(40)
Passive Activity # 2	(100)	90

So here we have a loss from disposition of the building. We have 100 passive loss on the building, 40 from the previously suspended 469 loss and 90 from passive income. This is similar to T.R. 1.469-1T(d)(1) Ex. (i). Regs position is that the only effect of section 469 and the regulations thereunder is to disallow a deduction for the taxpayer's passive activity loss for the taxable year but the taxpayer's capital loss for the taxable year is allowed because the capital gain from passive activity is taken into account under section 1211 (b) in computing the taxpayer's allowable capital loss for the year.
Likewise, in our case, the 10k capital loss is able to be deducted against capital gain. 469(g) also provides that if T disposes of his interest in any passive activity, the excess of loss from the activity over any net income from all other passive activity should be treated as loss from non-passive activity. Thus, the excess of 140 over 90 passive income should be treated as loss from non-passive activity which is not disallowed.
Therefore, 50k loss is allowed.

4. T and X, who are unrelated, are the partners of a general partnership engaged in the business of constructing and selling single family homes. For a particular year, T's distributive share of the partnership's net profits from this business is $25,000. T also is a limited partner in an equipment leasing partnership that sustains a loss of $60,000 for the same year. T's distributive share of this loss is $25,000. What is T's passive activity loss for the taxable year? Assume alternatively:

(a) T and X each spend 110 hours during the year on the construction activity. The partnership has no employees or contractors who work on its construction projects. Reg. § 1.469-5T.

For T’s limited partnership, 469(h)(2) provides that the interest in the limited partnership is passive activity per se. This means the 25k loss is passive activity loss from 369 and thus disallowed

For the general partnership, T.R. 1.469-5T(a)(3) provides that if individual participates with the activity for more than 100 hours and such individual’s participation is not less than any other individual, then such individual is considered as materially participating in such activity. Here, T spent 110 hours (the same as X, which means not less too) and with no other employees or contractors is involved. This means T is materially participating in the partnership and the income is not passive accordingly. Then the 25k gain from the general partnership is not passive income.

Overall, since there is no passive income but 25k 469 passive loss. The 469 passive loss will be disallowed.

(b) X spends 115 hours during the year on the construction activity, and T spends only 110. Reg. § 1.469-2T(f).

T.R. 1.469-5T(a)(3) provides that if individual participates with the activity for more than 100 hours and such individual’s participation is not less than any other individual, then such individual is considered as materially participating in such activity. Here, T participates less than X and thus won’t be considered as material participation. However, T.R. 1.469-2T(f)(2) provides that the amount from significant participation with passive activity shall be treated as non-passive activity if passive activity income exceeds the passive activity deduction. Here the passive activity income is……… and so the 25k income is treated as non-passive income

5. T, who has substantial salary income and income from portfolio investments, purchased a motel at the beginning of Year 1, financing the purchase with a small down payment and a mortgage loan on which T has personal liability. Sometimes customers stay for as much as three nights (over a long weekend), but only rarely do they stay for as long as four nights. T incurs losses of $10,000 and $15,000, respectively, from the motel in Years 1 & 2, but has an $8,000 profit in year 3. Ignoring § 469(c)(7), what is the application of § 469 to the losses if:

(a) T's husband works full time (2,000 hours) as manager of the motel from the time of T's purchase, or

Although the rental activity is per se passive activity, T.R. 1.369-1T(e)(3)(ii) provides that rental activity for a very short period is not considered as rental activity. Here, T's husband materially participated by working more than 100 hours (2000 hours full time) in rental and qualifying the material participation test under T.R. 1.469-5T(a). Section 469(h)(5) provides that the spouse's material participation can be attributed to their spouse. Thus, the 25k loss from year 1 & 2 will be non-passive loss which is not disallowed. Note that they can still offset passive income in year 1 & 2 under T.R. 1,469-1T(d)(1) Ex. (i).

(b) The motel is managed during Year 1 by T's son, who proves to be so incompetent that T's husband takes over as full time (2,000 hours) manager at the beginning of Year 2? See Reg. §1.469 1T(e)(3); § 469(f)(1); § 469(c)(7).
In year 1, the question is whether the son's participation could be attributed to T. There ain't any attribution rules under current statutes and thus T does not materially participated in rental business. This would award a 10k disallowed loss under 469 and being carried forward to next year under 469(b).
In year 2, Here, T's husband materially participated by working more than 100 hours (2000 hours full time) in rental and qualifying the material participation test under T.R. 1.469-5T(a). Section 469(h)(5) provides that the spouse's material participation can be attributed to their spouse. This would make the activity non-passive and no loss is disallowed --- T is free to take 15k loss.
In year 3, T has a 8k passive income from the activity. T's disallowed 10k disallowed income is able to carried forward under 469(b). 469(f)(1) provides that the former unused deduction from former passive activity will be used to offset against income from such activity. Therefore, T can deduct loss up to 8k and the rest 2k will be carried forward to next year.

Year 1- passive activity
Year 2 – active
Year 3 -- active

Unit 6: Like-kind exchange

Problems

Cottage Savings come into play, same does Philadelphia Park. --- basis of exchange rule

1. T owns a tract of undeveloped land, Blackacre, which he holds for investment, with a basis of $50 and a fair market value of $75. X owns a tract of land, Whiteacre, that is also held for investment and is also worth $75, but has an adjusted basis to X of $80. In each of the following alternatives, what amounts of gain or loss are recognized by T and X, and what basis do they have for the property received?

(a) T and X exchange properties, and each holds the property received for investment.
1031(a) provides that no gain or loss is recognized on the exchange of real property for real property when both real properties are held for investment are like kind. The definition of like-kind is provided under T.R. 1.1031(a)-1(b), which means the nature or the character of the property are like kind. Under T.R. 1.1031(a)-1(c), this is interpreted very broadly with regards to the exchange of real property transactions. Here, T does not recognize gain and X does not recognize loss.
The basis will be carry over basis provided under 1031(d). T's basis in W is 50 and X's basis in B is 80.

(b) Same as (a) except that X (an individual in this variation) immediately begins construction of a house on the land received from T and uses the house as her personal residence when it is completed.
If the real property is not held for investment purpose such as used for personal residence, then it would not qualify for 1031 like-kind exchange. See, e.g., Click v. Commissioner. Here, since 1031 does not apply/ X should recognize a loss of 5 (75FMV – 80 basis). X's basis in the transferred property B is the cost basis of. 75 FMV.
For T, there is no tax consequences.

(c) Same as (a) except that X is a taxable corporation and T owns 60% of X Corp.'s outstanding stock. Eighteen months after the exchange, X Corp. sells Blackacre for $85. What if, one year after X Corp. sells Blackacre, T sells Whiteacre for $82?
The issue here is X and T are related parties as defined under 267(b). 1031(f)(1) provides that there is no nonrecognition of gain and loss if the exchange was between related parties and the received property was disposed by related party within less than 2 years. Here T owns 60% of X and thereby being the related party. The disposition B would ruined the 1031 nonrecognition for both parties. Thus, at the disposition of B, T would recognize a 25 gain. T would take a 75 cost basis in W. For X, X would realize the 5 loss. However, since X and T are related parties, the

loss would trigger 267(a)(1) loss disallowance rules. This means the 5 loss will be disallowed. X would Still take the cost basis in B of 75.
When T disposes W for 82 later. T would have a gain. Here, under 267(d), T would recognize gain only to the extent that it exceeds the disallowed loss. So even on disposition T would have 82AR – 75 basis = 7 gain. 5 disallowed loss. So T would recognize 2 gain.

Hypo: T owns 100% of X and X after original exchange sells B for 75
Here T and X have the same interest and essentially are the same person. If we get nonrecognition status for the exchange, then X would get the basis in B of 80 and then recognize a 5 loss on the sale. This would be problematic because T and X can agree to exchange so the X who has higher basis can recognize higher loss. E.G. if T had sold B under this, T would have recognized a gain of 25. 1031 is designed to prevent this.

(d) T sells his land to X for $75 in cash and simultaneously buys X's land for $75. Section 1031, in theory, is not elective. Since the exchange of property for property in (a) produces non-recognition for both T and X, they must be seeking to ensure that § 1031 does not apply (by structuring the transaction as two separate sales, rather than a single exchange having the same bottom-line result).

1031 still applies here. Under R.R. 61-119, The IRS may look through the form and look to the substance if they are mutually dependent , then they may be treated as a single taxable transaction and ne collapsed into a single integrated transaction and will not get out of 1031. Here,
IRS would not necessarily respect them as two separate cash transactions if the two is easy to integrate into a single transaction. Here, the exchange does not bust 1031.
Reasons for avoid non-recognition
X has loss
If T has low income in the earlier year, T may want to pay lower tax.
Look both respected & unrespected outcome

(e) T sells his land to X's partner, Y, and simultaneously buys X's land from X. X furnished the funds used by Y to purchase T's land, but T is not aware of this fact when the transactions occur. T is also not aware that Y is X's partner. Here again, T, by selling to a third party, Y, for cash apparently is not interested in non-recognition treatment under § 1031. Whether or not the two-party arrangement in (d) is swept within § 1031, does addition of the third party, Y, in this part "bust" § 1031 treatment?
If parties in the transaction hold the business purpose for structing the transaction in the way that could get a better price to an independent 3rd party, then it may fall outside 1031 treatment. See Bell Lines (TP did not know the these two parties were partners working together). Here, Bell Lines should apply and this falls outside of 1031 treatment.
For T, this would be a simple sale and purchase. From sale of B, T realize 75-50 =25 gain and that gain will be recognized

For X, however, X falls within the 1031. See Redwing Carriers (sale by aprent corporation and purchase by its subsidiary of truck constitutes 1031). SO X will not be able to recognize the 5 loss. X's basis in B is provided under 1031(d) carried over basis and will be its basis in B, 80.

2. T owns an apartment building that he would like to exchange for a building owned by X. T's building is worth $150 and has an adjusted basis to T of $100. X's building is worth $400. To even up the exchange, T also transfers corporate stock worth $250 whose adjusted basis to T is $300. What are the tax consequences of the exchange to T? What is her basis for the new building? See Reg. § 1.1031(d)-1(e), Example.

This is the situation that in a **like-kind exchange taxpayer received some boot**. The code provides that if taxpayer pays more than just like-kind property in. the exchange, then the transaction should be bifurcated from taxpayer's end. Reg. § 1.1031(d)-1(e). Taxpayer would be treated as giving up like-kind property for fair market value of that property, and giving up other property for its fair market value. The like-kind portion gets non-recognition treatment and the other portion will get recognition treatment under 1001. The 50 of gain in like-kind portion (150-100) gets nonrecognition treatment under 1031(a) but the 50 loss in the stock portion will be recognized under general principals of 1001.
The basis in the new building under 1031(d) will be 100 basis in T's building + 300 AB of stock transferred – 50 loss recognized on the stock. = 350. The 50 built-in gain will be preserved.

Q2a. How would your analysis change if X's building was located **outside the U.S?**
The exchange between real property located in US and one located in other country is not like-kind exchange. 1031(h). Here, T will recognize gain of 50 and recognize loss of 50. T's basis in the new building will be 400 cost basis

3. X, the other party to the exchange in the preceding problem, has an adjusted basis of $50 (after having taken $300 of prior depreciation deductions) for the building transferred to T in the exchange. What are the tax consequences of the exchange to X?

1031(b): Gain recognized in an mount of the FMV of the other property (boot)
Up to 250 of the corporate stock
Realized gain of 350 = 400 – 50
So 250 among 350 is recognized.
100 is deferred
Allocation Basis of X:
1031(d) provides that basis will be 50 basis of the property exchanged + 250 gain recognized = 300. The basis is allocated to the permitted property (T's building) and to the non-permitted property (boot), and the basis is allocated to the boot should be the fair market value at the date of the exchange. The basis in the corporate stocks will be 250 FMV. The basis in T's

building will be the remaining 50. (the building is with 150 FMV so the built-in gain will be 100 which X did not have to recognize on the exchange of the building)

4. T is anxious to exchange his farm worth $75 for an apartment building of similar value owned by Y. T seeks non-recognition treatment under § 1031. Y is interested in selling his property, but only for cash. X wants to purchase T's property for cash, but T would prefer an exchange with Y.

a. Since no one can figure out a better way to do it, T sells his farm to X for cash, and then uses the proceeds to purchase Y's property.

Bestjon v. Commissioner

Under R.R. 61-119, The IRS may look through the form and look to the substance if they are mutually dependent , then they may be treated as a single taxable transaction and ne collapsed into a single integrated transaction and will not get out of 1031. Hand the transaction been taken place between only T and X, 1031 might still apply. But Here, T gets cash from X in exchange of farm and gets apartment buildings from X in exchange of cash. Unlike 61-119. There's actual three parties so it is uncertain which exchange is like-kind exchange. T might not get 1031 treatment. Since T did not intend to use the apartment received by X for purpose of investment, it's hard to get 1031.

b. As T's counsel, what alternative sequence of transactions might you suggest to accommodate all the parties involved, while providing T with a more favorable tax result? Should T consider hiring an "intermediary" to facilitate an exchange?

When X only acts as a transitory owner of the apartment, T may get the like-kind exchange treatment. See Baker v. Commissioner, R.R. 77-297 (the cash was never received by the taxpayer neither under constructive receipt or actual receipt doctrine and the taxpayer never has control of cash). The transaction should look like X receives the apartment from Y in exchange of cash, and receives from T in exchange of the apartment. Here, X did not intend to used the apartment received by X for purposes of investment thus disqualifying the 1031 treatment.

Step1 :Y sells to X for cash,

Step 2: X and T engages in like-kind exchange

Alternatively though, Y could act as transitory owner of the farm.

The next question is whether X would be a qualified immediately. Reg. 1.1031(k)-1(g)(4)(iii) provides the requirements for intermediary. The agreement has to be written and X should acquire and transfer the relinquished property and acquire and transfer the replacement property. But here X did not transfer the relinquished property because X wanted to hold the farm. So X would not be qualified intermediary. T should consider hiring a qualified intermediary if X does not want to own the apartment building even for the transitory period.

1.1031(b)-2

c. T exchanges his property for X's promise to deliver an apartment building acceptable to T within one year. If X is unable to locate an acceptable property within the one year period, X will pay T $75 plus interest from the date of the original exchange.
This would not necessarily negate the 1031 status so long as T ends up receiving another property from X and the requirement under 1031(a)(3) is met. 1031(a)(3) mandates that received property should be identified within 45 days after the transfer and exchange should be completed within no more than 180 days after the transfer

d. Suppose T wishes to acquire a specific apartment building before T finds someone interested in acquiring his farm. Would a § 1031 transaction be feasible under these circumstances?
Rev. Proc. 2000-37 provides a safe harbor rule for reverse exchanges. If the property is held in a qualified exchange accommodation arrangement (QEAA), the replacement property identified within 45 days after the transfer and the accommodating party hold relinquished property only for 180 days. The transaction would satisfy 1031 requirement for nonrecognition.

5. X owns an apartment building that he would like to exchange for a building owned by Y. Both buildings are encumbered by mortgages, and in any exchange, each party would take subject to the mortgage on the acquired property. Three alternative sets of adjusted basis, value, and mortgage figures are given below. With each alternative set of figures, determine the gains and losses that would be recognized if X and Y exchanged properties, even up in alternatives (a) and (b) and with $10 of cash boot paid by Y in alternative (c). What basis would each party take for the property received under each alternative? See Reg. § 1.1031(d)-2.

	Alternative		
	(a)	(b)	(c)
X's building			
Fair market value	$70	$80	$70
Adjusted basis	50	50	50
Mortgage	40	50	30
Y's building			
Fair market value	$70	$70	$70
Adjusted basis	30	30	30
Mortgage	40	40	40
Cash boot paid by Y to X			$10

T.R. 1.1031(d)-2 provides that when one party transfers property with liability, then the debt release would be treated as boot. When two parties transfer properties with liabilities, liabilities would offset with each other.

(a)

For X: two ways to decide

i) AR = 70 (FMV of Y's building) + 40 (liability assumed by Y) – 40 (liability assumed by X) = 70

Gain realized = 70 -50basis = 20

Gain recognized = 0 because liabilities would offset with each other, 1031 transaction with no other boot.

ii) AR = 70 FMV of building + 40 liability assumed by Y

Gain realized = 110 – basis(50 + 40 liability assumed by X) = 20

Gain recognized is still 0

May be more sensible because it's hard to say X is transferring with a building with a basis of 90

X's basis in Y's building = 50 T.R. 1.1031(d)-2: transferor's basis + liability assumed by X – liability assumed by Y = 50

For Y: basis in X's building is 30 – basis transferred is 30

(b):

Reg. 1.1031(d)-2

For X

AR= 70; Gain realized = 70 + 50 – (50+40) = 30

Gain recognized = 10 (50 debt relief – 40 debt assumed) as boot

Basis = 50 + 40 – 50 + 10(gain) = 50

This is correct since X has 30 built-in gain of which 20 was not recognized yet.

For Y:

Y does not recognize any gain or loss because Y is taking more debt than the debt relief so Y has no cash boot in 1031—no gain

Basis = 30 + 50 – 40 = 40

The debt assumed is added to the basis

(c)

For X

AR = 70

Gain realized = 70 + 30 + 10 – (50 +40) = 20.

Under T.R. 1.1031(d)-2, the consideration received in cash or property is not offset by the liability Y assumed. X recognized 10 gain. (cash)

Basis here is 50 + 40 – 30 (debt taken on) – 10 (cash received) + 10 (gain recognized) = 60.

For Y

Gain is the net debt relief = 10.

1.1031(d)-2 provides that cash boot given offsets the net debt relief. So here, Y is treated as not receiving any boot at all.

(if the net debt relief is 20, then Y should recognize gain of 10)

Y's basis is 30 + 30 – 40(debt relief) + 10 (cash paid) = 30

6. T Corp. recently constructed a new factory building for use in its business. Construction costs, which totaled $250, were initially financed by a construction loan of $225 and $25 from T's general cash resources. When construction was finished, T sold the building to an insurance company for $225 and leased it back for 40 years for an annual rental of $23. Under the lease, T is required to pay the expenses of maintaining the building and all real property taxes on it. What are the consequences of the sale and leaseback to T? Is your answer affected by:

(a) Whether the agreement with the insurance company was made before construction begins or when the construction loan was about to come due?

(b) If the agreement was made before construction begins, whether construction costs were then expected to exceed $225?

(c) The fair market value of the building when it was sold to the insurance company? The parties' expectations when the agreement was made as to what the building would be worth when completed?

Here, T wants to get the sale treatment and recognize loss of 25 (250 – 225)
T.R. 1.1031(a)-1(c) provides that exchange building with a leasehold of more than 30 years qualifies for like-kind exchange status so T cannot recognize loss.
Alternatively, government can refuse respecting sale and lease back?
Case law have provided different situations:
Jordan March Co. and Leslie: 1031 treatment depends on FMV of the building when it was sold (concerned with reciprocal exchanges)
Century electric: whether or not the buildings was sold at FMVL

If the building at the FMV, then no exchange of like-kind and just sale

Because by paying FMV, the transaction is gone

So regardless of the length of leasehold, this is a sale

If the building were sold below the FMV, then the lease would contain some capital value to the extent of the other portion – so exchange of like kind – creating artificial kind of transaction,

SUM: to be treated as like-kind exchange, leasehold should be more than 30 years and the buildings is sold below FMV

(a)(b) will not be different makers but (c) might,

Unit 7: Deferred Payment Sales

Policy Concern: liquidity problem: seller does not have enough cash to pay the tax at the sale when the payment will be received later.

1. S sells stock in a closely held corporation to B on July 1 of year 1 for $100, of which amount $10 is received at the time of the sale and $90 is payable in nine equal annual installments (starting in July of year 2) of $10 each plus interest at 12 percent per annum. B's obligation is secured by a pledge of the stock. S's basis in the stock is $20.

a. When is S's gain reportable? In answering this question, do you need to know:

Here, under this arrangement, the selling price is 100 and S's basis in stock is 20. The Gross profit for the purpose of 453(c) is 80. Since the total contract price means the selling price subtracting the qualified indebtedness assumed by the buyer, which does not exceed seller's basis. § 15A.453-1(b)(2). Here the price is 100. The Gross profit ratio under § 15A.453-1(b) is Gross Profit/Total Contract price. Here the Gross profit ratio is 80%. Under 453(c), the income recognized will be Payment * Gross profit ratio for each year. Here B is going to pay 10 a month, applying the formula. It means S would recognize 8 income for each of the 10 years. The remaining $2 will be a recovery basis thus rendering $20 basis in the stock after 10 years.
The 12% interest payment should be treated as ordinary income.

i. Whether S uses the cash or accrual method of accounting,
the method of accounting does not matter because 453(a) applies to both cash methods and accrual methods

ii. The value of the installment obligation, or
No, we only consider the stated amount for the installment obligation consideration. Values of the installment obligation doesn't matter.

iii. Whether the installment obligation is represented by a separate promissory note or is only embodied in the contract of sale?
This does not matter because 453(b) does not distinguish from two instances. 453(f)(3) provides that current payment does not include promissory note as evidence of indebtedness. And 453(f)(4) provides that if the note is readily tradable, then it could be considered as a payment and S should included the whole payment as income in year 1.

b. How does your answer to (a) change if the stock is traded on the New York Stock Exchange?
Section 453(k)(2**) excludes stocks** traded on established securities market from installment sales. Here, all 80 gains will be recognized in year 1.

c. How does your answer to (a) change if the selling price is only $15, payable $5 down and $10 in future installments?
Here, we have a loss.

The loss here is 20 basis subtracting 15 amount realized, i.e., 5. Note that § 453(a) does not specify anything to do with the loss. The language provides the income from installment sales without regard to the loss. Therefore all gains of 80 should be recognized in year 1

d. How does your answer to (a) change if the property is, alternatively,

i. Land (value $10, basis $15) and building (value $90, basis $5)?

R.R. 68-13 provides that the pro rata allocation of each payment will be applied here. The question comes to how much gain/loss will be attributed to each property. Here, the land has a loss of 5 (15 basis – 10 fmv) while the building has a 85 gain (90 fmv – 5 basis)
Accordingly, in year 1, $10 cash gain will be allocated based on relative values of each asset. The value is 1:9, accordingly, $1 gain will be allocated to land and $9 to the building. In the following years, the rest 90 deferred payment will be allocated the same. $9 to land and $81 to the building.
Note that § 453(a) does not specify anything to do with the loss. So on the building part, we have gross profit of 85 with the contract price at 90. The Gross profit ratio under § 15A.453-1(b) is Gross Profit/Total Contract price. Here the Gross profit ratio is 85/90= 94%. Under 453(c), the income recognized will be Payment * Gross profit ratio for each year. Here B is going to pay 10 a month, applying the formula. It means S would recognize 8,5 income for each of the 10 years. Note the loss on the land is recognized in year 1, therefore rendering the 5 dollar loss. On year 1, S recognizes a total 3.5 gain (8.5 from building subtracting 5 from land)

ii. Equipment that originally cost $40 and on which S had taken $20 of depreciation?
Section 453(i)(1)(A) provides that the 20 depreciation recapture is not governed by installment method, and recognized in the year of disposition. Since the equipment depreciation is personal property depreciation, it qualifies 1245 depreciation. Thus the 20 recapture income will be treated as ordinary income under 1245 and thus should be recognized in year 1.
Section 453(i)(1)(B) provides that any gain in excess of recapture income shall be takin into account under the installment method. The Gross profit ratio under § 15A.453-1(b) is Gross Profit/Total Contract price. The contract price is 100 and the gross profit is 60 (100 amount realized subtracting 40 basis). Here the Gross profit ratio is 60/100= 60%. Under 453(c), the income recognized will be Payment * Gross profit ratio for each year. Here the gain recognized will be 10 * 60% = 6 per year for the following 10 years.

2. How does your answer to problem 1(a) change if, alternatively,

a. S receives 50 shares of the stock of XYZ Corp. worth $10 in lieu of the cash down payment of $10?

The answer would remain unchanged as T.R. 15A.453-1(b)(3) provides that payment may be received by cash or other property including foreign currency and marketable securities.

b. The installment obligation is an obligation of X rather than B, the buyer from S, and the obligation was first transferred by X to B in an unrelated transaction in which X purchased property from B?

Both 453(f)(3) and 15A.453-1(b)(3) indicates that payment does not include the receipt of evidence of indebtedness of B, but includes the receipt of evidence of indebtedness of another person, which is X in this case. Therefore, full gain of 80 should be recognized in year 1.

c. B's note is not secured, but is guaranteed by G?
453(f)(3) provides that the payment does not include the evidence of indebtedness as B's note regardless of whether it's guaranteed by G. Here, the answer remains the same.

d. B's note is secured not by a pledge of the shares, but, alternatively, by

i. A letter of credit issued by B's bank on which S can draw only in case of default by B, or
T.R. 15A.453-1(b)(3)(iii) provides that a standby letter of credit is treated as a third-party guarantee. Therefore, it is not a payment but treated as installment obligation. If B defaults and S steps into B's shoes through the standby letter, the same installment treatment will be given to S

ii. A certificate of deposit issued by B's bank?
15A.453-1(b)(3)(i) says this will be treated as receipt of payment and thus S should recognize all gains in year 1.

3. S sells a tract of undeveloped land, acquired years earlier for $20, to B on July 1 of year 1 for $100. When is S's gain reportable in the following alternative cases?

a. The land is subject to a mortgage (incurred several years ago) of $20 due in a single balloon payment in 10 years. B assumes the mortgage, gives S a cash down payment of $30, and agrees to pay the remaining $50 in 5 annual installments (starting in July of year 2) with interest at 12 percent per annum.

The first question here is whether the mortgage is qualifying indebtedness. 15A.453-1(b)(2)(iv) provides that qualifying indebtedness means The term "qualifying indebtedness" means a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property. Qualifying property does not include obligation incurred incident to the disposition of property. Here, the mortgage was incurred several years ago. This makes the mortgage qualifying indebtedness and will be absorbed by T's basis in the property.
Next, 15A.453-1(b)(3)(i) tells how to. Take into account the qualifying indebtedness into the payment. The regs say we should include the amount of payment only to the extent that it exceeds the basis of property. Here, the 20 mortgage does not exceed the 20 basis. Therefore, it will not be included in year 1's payment.

Last, we go back to §453 to calculate recognized gain. The contract price here equals the selling price subtracting qualifying indebtedness assumed which does not exceed the seller's basis. So we have 80. The gross profit here is 80 also. (100 AR – 20 basis). Therefore, the gross profit ratio under 15A.453-1(b) is 100%, making all cash payments treated as gain in each year. According to the payment plan. In year 1 there will be 30 (down payment) gain and the next 5 years will have 10 gain.

i. What if S had owned the property free and clear and placed the mortgage on the property shortly before the sale to B?
15A.453-1(b)(2)(iv) provides that if the debt is taken on with consideration of disposition of property or property that is incident to the disposition of property, then the debt will not be treated as qualifying indebtedness and will be considered as cash payment.
Here, since S had owned the property free and clear and placed the mortgage on the property shortly before the sale, it would not be qualifying indebtedness and will be treated as cash payment in year 1.
The 50 cash payment in year 1. We don't need to subtract qualifying indebtedness from selling price to get contract price. So the Gross profit ratio = 80/100 =80%. So in year 1, we need to recognize 50 * 80% income = 40.
For the installment payment, from year 2 to year 6. S would have 10 * 80% gain

b. Same as (a) except the mortgage is $40, the cash down payment is $30, and the installment obligation is $30.
Reg. 15a.-1(b)(3)(i)
The contract price here is the selling price (100) subtracting qualifying indebtedness which does not exceed seller's basis (20). The gross profit ratio = gross profit / contract price = 80/80 = 100%. In year 1, qualifying indebtedness that exceeds the basis is 20 which is included in 50 cash payment. Since the gross profit ratio, all 50 payment will be recognized. Similarly, from year 2 to year 6 total installment payment is recognized

4. S owns shares of X Corp., a closely held corporation, which she acquired years earlier for $20. She sells the stock to her daughter, B, on July 1 of year 1 for $100, payable $10 down and the remainder in nine annual installments (starting in July of year 2) of $10 each plus interest at 12 percent per annum. B sells one-half of the stock to an unrelated buyer on March 1 of year 2 for $45 in cash, and makes all payments to S as they fall due. When is S's gain reportable?

Here, S & B are <u>related parties</u> by receiving $100 in year 2 and does not have to pay full amount until year 10. In order to resolve this potential tax avoidance, congress implemented section 453(e) which provides under the transaction between related persons, the second disposition should occur not more than two years after the first disposition to get the installment sales treatment. The gross ratio here is 80%.
Reason: get the basis without paying the money yet

Year 1: B's sale as income to S to the extent it exceeds what S has already reported, the 20. But Section 453(e)(3) restricts that the amount shall not exceed the excess of lessor of amount realized with respect to the second disposition (45) or total contract price for the first disposition (100) over (the sum of aggregate amount treated as received for prior taxable years) = 45 – (20+0) =25.
In addition to the year to income of 10, S will also have 20 (80* 25 = 20)
So S is treated as receiving 20 from installment and 10 from B, 30 in total.
In year 3 & 4, the aggregate subsequent payment received is 20 under 453(e)(5), which does not exceed the amount treated as received under 453(e)(1) (which is 25). SO S does not recognize gain at all.
In year 5, S shall be treated as receiving 5 under 453(e)(5) and recognizes gain of 80% * 5 = 4
In year 6-10, the aggregate subsequent payment already exceeded 25, so the whole payment is treated as payment received by S. with $10 annual payment, S will recognizes gain of 8 under the standard installment method.
Note that 453(e)(7) provides that if neither the first nor the second disposition has tax avoidance purpose (like related person transaction), then 453(e) does not apply at all

5. S owns an apartment building (current basis $20) that she has held several years for investment. S sells the building to B Corp., a corporation wholly owned by S's spouse, on July 1 of year 1 for $100, payable $10 down and the remainder in nine annual installments (starting in July of year 2) of $10 each plus interest at 12 percent per annum. When is S's gain reportable? Assume that B Corp. will hold the apartment building for several years after its purchase from S.
This hypo brings the issue of 453(a). Section 453(g)(1) provides that gain will be recognized in the year of disposition when installment sale of depreciable property between related persons. 453(g) three defines the related parties and here They are related through the controlled entities with regard to the related person.Therefore, S should recognize gain of 80 (100 -20) in year 1. Note that congress did provide an exception to 453(g)(1) if section 453(g)(2) is met. That would mean that the purpose of transaction was not the avoidance of tax and installment method under 453(a) could apply accordingly.

6. S sells unimproved land, acquired years earlier for $20, to B (an unrelated buyer) for $100, payable $10 at the time of the sale and $90 in 9 annual installments (starting in July of year 2) of $10 each plus interest at an annual rate of 12 percent. What tax consequences result if one of the following transactions occurs?

a. S sells the installment obligation to a dealer for $80 a few weeks after the sale.
Under 453(B)(a), if an installment obligation is satisfied at other than its face value or distributed, or sold, gain/loss will be recognized to the extent of difference between basis of the obligation and amount realized in case of satisfaction/sale or exchange or FMV of obligation in case of the disposition. Here, the gain recognized is 80

453B(b) provides that the basis will be the excess of face value over amount of income which would be recognized where. The obligation satisfied in full. Here, basis will be 90 – (90&80% gross profit value)) = 18
Therefore, the gain recognized will be 80 – 18 = 62

b. S accepts $80 from B in full payment of the obligation a few weeks after the sale.
The result will be same under 453(B)(a). “satisfaction at other than at face value”, the direct language trigger 453B(a), so recognize gain of the difference between AR 80 – basis 18 = 62 gain.

c. Shortly before the first payment is due, S gives the note (then worth $80) to S’s daughter.
Under 453B(a), this is disposition rather than sale or exchange, so we will use the fair market value for the purpose of gain computation. Basis will be 18 under **R.R. 79-371**. The basis of the property for the daughter will be carryover basis, which means S’s daughter will have a stepup basis of 80, which is in contradiction to section 1015(a), which prevents double counting of gain for tax purposes. gain is 80 – 18 = 62.

7. S sells a work of art held for investment for $10 million, payable in 10 annual installments (starting in the year after the sale) of $1 million each. In addition, the buyer's obligation bears interest at an annual rate of 12 percent payable semiannually. S's adjusted basis for the artwork is $4 million. Assume the interest rate on underpayments under § 6621 is 10 percent. By what amount does the sale increase S's tax for the year of the sale? For the following year?
Sec. 453A, (b)(1) (b)(2) threshold problem
This triggers the issue under 453A(b) when any obligation arising from disposition under the installment method and the sales price exceeds 150k. When 453A(b) kicks in, interest shall be paid in deferred tax liability under 453A(a). If there is any obligation outstanding as of the close of the taxable year, the tax liability shall be increased by such interest under 453A(c)(1). The calculation of interest is provided under 453A(c)(2), i.e. interest equals the applicable percentage of the deferred tax liability multiplying the under payment rate in effect under 6621 (10% here). The calculation of applicable percentage is provided under 453A(c)(3): Applicable percentage equals the aggregate face amount outstanding subtracting 5M dollar divided by the aggregate face amount outstand. The calculation of deferred tax liability is provided under 453A(c)(3): deferred tax liability equals the amount of gain not recognized as of the close of taxable year multiplying the maximum appropriate tax rate.
Deferral tax liability is applying the highest rate

In year 1: the applicable percentage is (10M-5M)/10M = 50%. The deferred tax liability is (10M – 4M) * maximum appropriate tax rate. Here the investment is a work of art. With pursuant to 1(h) the appropriate tax rate should be 28% (note that land/building is 20%). So the deferred tax liability here is 6M * 28% = 1.68M
The interest is 50% * 1.68 * 10% - 84k and S’s liability will be 84k accordingly

In year 2, the applicable percentage remains the same at 50%. Appropriate tax rate is still 28% but we need to calculate the recognized gain. We will use the gross profit ratio here as the 1M installment * (6M gross profit/10M contract price) = 600k. So the amount of gain not recognized is 6M – 600k = 5.4M and the deferred tax liability = 5.4 * 28% = 1.512M
The interest is 50% * 1.512M *10% = 75600 and S's liability will be 75600

Unit 8: Leasing

I. Introduction: Alstores Realty Corp. v. Commissioner

I.R.C. § 167(e) Property, particularly real property, may be placed on the market before the owner is ready to vacate the premises, in part, at least, to avoid having to carry the property for an extended period after moving out while waiting to find a purchaser. Similarly, a purchaser may be willing to commit to purchase property before actually needing it, to assure its availability when needed. The interim period may be viewed as a current sale of a future interest in the property, or as a current sale of the property, with a leaseback, usually rent free. Drawing the line between the two is not easy, particularly when the parties do not expressly focus on the tax consequences, and do not expressly provide which of these two approaches they intend to employ. The Alstores case draws the thin line for parties who were not careful enough to specify what they meant, and who took inconsistent positions.

Steinway sold a property for Alstores for 750k where FMV is 1M with an agreement providing that S could occupy a portion of the warehouse for 2.5 years rent free

Consider the transaction in Alstores:

1. How did Alstores characterize the transaction? Why?

A's characterization of transaction: substance

- Conveyance of future interest from S to A with S reversing a term of 2.5 years.
- So, S is not a lessee of A, but a legal owner of a reversed term
- Try to avoid rental income from S

2. How did the government characterize the transaction? Why?

Gov't characterization of transaction: Form

- A actually purchased the whole property and leased back to S
- S actually pre-paid rental income to A

3. The court accepted the government's position. Why?

- S did not have burden on ownership arising from potential for damage to the property
  - A still controlled the property and paid for the maintenance
  - S did not have legal right to alter S or assign the interest to the other party

- They made arrangement that S would be compensated from A if

Key points:

- Leasing bears similarity to temporary ownership
    - Tenant gets use of property that it is leasing
- A and S wrote a contract that sale and lease form would be evident
    - Form of the transaction would be the evidence what the parties intended for the transaction
- Very hard for taxpayer to win a substance v. form argument when the taxpayer is involved in the form creation

If you had been the lawyer who structured the transaction, what would you have done differently?

- Change the form of the transaction
- Seller/Steinway to remain the owner (purchase price arrangement) since you don't have an actual lease, net lease different person pays then bears the burden.
- Have Seller/Steinway insure the building for the next two years.
- Lack of limitations on interim use (or fewer limitations) so require Steinway give the building to Alstores in a certain manner. Interim Operating Covenants are common in M&A.

II. Real Estate

B Corp. finances the acquisition of a new building to be used in its business by taking the prearranged steps listed below. Except as otherwise noted, all parties are unrelated.

1. B finances the physical construction of the building with internal funds of $10 million.

2. B enters into a contract with C Corp., a newly created single purpose corporation, to sell the building to C for $10 million, its fair market value. As part of the same agreement, C leases the building back to B on a net lease basis for an initial term of 30 years with options to renew for 46 years more. C's sole shareholder is P, a promoter.

3. C borrows $10 million from L Corp., an insurance company. C gives L a mortgage note in the face amount of $10 million, secured by an assignment of C's rights under the lease with B. C uses the loan proceeds to pay B the purchase price for the building. The mortgage note is payable in 30 equal annual installments of $1.2 million each. During the initial 30-year term of the lease, B's rental payments are also $1.2 million per year. During the renewal periods following these 30 years, the annual rental is $100,000.

4. Shortly after the sale and leaseback transaction is effected, C transfers its interest in the building to a newly created limited partnership, X, whose general partner is P. The building is X's sole asset.

A Corp., a widely-held corporation, has been approached by P as a potential investor in the partnership. The prospectus for the investment states that the partnership expects to raise $200,000 through the sale of limited partnership interests and that this amount will be paid to P "for services rendered." (Ignore any partnership issues.)

a. Why is B engaging in this transaction? L? P?

For C:

- Depreciation deduction for building – straight line
  - 10 M/ 39 years (recovery period of nonresidential real property)
- 163(a): C can take deduction on interest payment for loan from L
  - Cannot take deduction on principal
  - If interest rate is 11.5% (assumed), C can take interest deduction of 1.15M on the first payment. As you pay off principal, you would pay less interest, so lower the deduction you would take later
    - This would offset C's rental income

For B: can get rental payment deduction

For L: debt investment – interest payments on debt

For P: Benefit to X flows to P

b. Will the parties be able to accomplish their goals?

The transaction would not be respected under Hilton

- Hilton: The form of sale and lease back was not respected most likely
  - Frank Lyon: Hilton contrasts it with Frank Lyon where there exist genuine business purpose having this step transaction as opposed to straight up ownership by entity that constructed the building
  - the taxpayer took title to a building being constructed by Worthen Bank and Trust, and leased the building back to Worthen. Financing of the purchase price was provided by a third party. The Supreme Court concluded the sale-leaseback would be respected as such. As a result, the taxpayer could claim both depreciation and interest deductions
  - Here, this case is more like as Hilton
  - Section 7701(o)
    - Recourse debt v. nonrecourse debt
    - What really could C lose?
- It is not clear why B gave up ownership to C other than tax avoidance
  - B can renew the lease for another 46 years after 30 years – B is essentially holding the building for its useful life
- It is not clear why C would be engaged in this transaction other than tax avoidance
  - C did not have real economic loss potential
    - C is playing as conduit here
    - Rental payment exactly matches interest payment.

Problem： Debt-financing, abandonment with capital asset

Robert has realized a $270,000 loss on the abandonment of the apartment building. Before turning to the characterization issue, let's review the determination of gain or loss in this situation. Because the property is subject to a nonrecourse loan, the full amount of the loan balance is included in the amount realized. Treas. Reg. §§ 1.1001-2(a)(1) & 1.1001-2(a)(4)(i); Tufts v. Commissioner, 461 U.S. 300 (1983). As a result, Robert has a loss of $270,000 ($2,250,000 amount realized minus $2,520,000 adjusted basis). This loss makes sense from an economic perspective because Robert invested an initial amount of $600,000 in the apartment building plus an additional $150,000 in reducing the loan from $2,400,000 to $2,250,000. Because he has only recovered $480,000 of his investment for tax purposes through depreciation deductions, he should have a loss for tax purposes on abandonment of $270,000 ($750,000 total investment minus $480,000 recovery of investment).
With respect to the characterization issue, the capital asset, sale or exchange, and holding period requirements under §§ 1221 and 1222 must be considered. First, the apartment building is a capital asset in Robert's hands under § 1221. It is important to note that the exclusion from capital asset status under § 1221(a)(2) is not applicable in this instance because it applies only to real property used in the taxpayer's trade or business, not to real property held for 253 investment purposes. See Treas. Reg. § 1.1221-1(b) ("Property held for the production of income, but not used in the trade or business of the taxpayer, is not excluded from the term 'capital assets' even though depreciation may have been allowed with respect to such property . . . .").

Hypo: with recourse debt
The only difference if the loan had been recourse instead of nonrecourse would be the amount of the loss. The issue of characterization would be analyzed in precisely the same manner.
Had the loan been recourse rather than nonrecourse, Robert would only have had to include the fair market value of the property in the amount realized, resulting in a loss of $720,000 ($1,800,000 amount realized minus $2,520,000 adjusted basis). Treas. Reg. § 1.1001-2(a) (2).
However, if the lender forgave the remaining portion of the recourse indebtedness, Robert would have $450,000 of discharge of indebtedness income ($2,250,000 outstanding loan balance minus $1,800,000 fair market value of the property). Ignoring any difference in the characterization of the loss and the income, this combination of a loss of $720,000 and income from the discharge of indebtedness of $450,000 would result in a net loss of $270,000, which is the same as the loss in the nonrecourse setting. Of course, differences in characterization, i.e., capital loss treatment on the disposition of the apartment building and ordinary income treatment with respect to the discharge of indebtedness income, distinguish the recourse and nonrecourse settings. With respect to the characterization issue, the only difference in the

analysis would be with respect to the sale or exchange requirement. It is much easier to conclude that a sale or exchange arises when the loan is recourse than when it is nonrecourse because the taxpayer is relieved of personal liability for the recourse loan, at least to the extent of the 254 fair market value of the property securing the loan. The $720,000 realized loss if the loan had been recourse would be characterized as a long-term capital loss.

Problem: Depreciation with capital gain

Otis, a calendar-year taxpayer, owns a server farm that consists of 1,000 computer servers he uses solely in his business. The server cluster supplies server functionality far beyond the capability of a single machine. Otis paid $2,000,000 for the server equipment on March 15, Year 1, and has taken the maximum allowable depreciation deductions under section 168. The servers are five-year property, but Otis elected to use section 179. You may assume the income limitation of section 179(b)(3) does not apply to the purchase.

(a) What result to Otis if Year 1 was 2018 and he sells the servers to Buyer on November 15, Year 3 for $2,600,000?

[This problem provides a good review of material covered in previous chapters—i.e., Chapter 9 (depreciation), Chapter 17 (capital gains and losses), and Chapter 18 (quasi-capital assets). The second set of review problems in Chapter 21 will also help solidify these concepts.]

Amount of gain: The sale of the server equipment is a realization event within the meaning of section 1001. Otis's amount realized on the sale is $2,600,000, the amount of money received. IRC §1001(b). Otis's initial cost basis in the equipment of $2,000,000 (IRC §1012) was decreased for depreciation allowances (IRC §1016(a)(2)). The facts do not tell us what the depreciation deductions were, but we can figure them out. Under the Code applicable to year 2018, Otis would have deducted all of his basis under section 179 and section 168(k). Thus, his basis would be zero.

(Section 179 permits a deduction of up to $1,000,000. IRC §179(b)(1). In 2018 through 2023, Section 168(k) permits 100% bonus depreciation (in this case after the application of section 179). IRC §168(k)(6)(A)(i).) Because Otis' basis is zero, all $2,600,000 of his amount realized is gain. The first $2,000,000 is ordinary income under section 1245. This leaves $600,000 for characterization under section 1231.

The amount treated as ordinary income under section 1245 is generally the lower of: (1) recomputed basis minus adjusted basis; or (2) amount realized minus adjusted basis. Here recomputed basis minus adjusted basis is lower.

2M recomputed basis (cost recomputed by adding back the depreciation) – 0 adjusted basis = 2M under 1245(a)(2)(A)

The next issue is the character of the $600,000 of gain not characterized as ordinary by section 1245. Otis would like the gain to be characterized as long-term capital gain to receive preferential rate treatment. A long- term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year. IRC §1222(3). The equipment is not a

capital asset within the meaning of section 1221, because it is depreciable business property. Instead section 1231 applies to initially characterize the gain as “section 1231 gain”? Section 1231 gain is defined as recognized gain on the sale or exchange of property used in the trade or business. IRC §1231(a)(3)(A)(i). The term “property used in the trade or business”means property used in the trade or business of a character subject to the allowance for depreciation, held for more than one year. Therefore, this equipment is section 1231 property, and the gain is section 1231 gain to be placed in the section 1231 principal hotchpot to be netted with other section 1231 gains and losses to determine the ultimate character.
Assuming no other section 1231 transactions during the year, the $600,000 of section 1231 gain would be characterized as long-term capital gain. IRC §1231(a)(1).

(b) Same as (a) except that Otis gives the server equipment to his daughter, and she immediately sells the servers for $2,600,000.

Section 1245 comes into play only when section 1245 property is “disposed of,” a broad term that encompasses many transactions.
However, certain transactions are excluded. For example, section 1245 does not apply to dispositions by gift. IRC §1245(b)(1). If Otis did not sell the equipment, but instead gave it to his daughter, section 1245 would not apply to Otis.
However, when his daughter later sells the equipment, she will be required to recapture as ordinary income any gain attributable to the depreciation deductions claimed by Otis. This is because “recomputed basis” is Daughter's adjusted basis (same adjusted basis Otis had at the time of gift per section 1015) plus “all adjustments reflected in such basis on account of deductions,” including adjustments made by Otis. IRC §1245(a)(2)(A). In short, Daughter will have $2,600,000 gain realized and recognized ($2,600,000 amount realized minus $0 adjusted basis). IRC §1001. $2,000,000 of the gain will be recaptured and characterized as 227 ordinary income under section 1245. $600,000 of the gain will be characterized as long-term capital gain (gain from the sale or exchange of a section 1221 capital asset).

(c) What if the purchase by Otis occurred after 2027 and section 168(k) is no longer on the books and Otis still elects to apply section 179 and to take the maximum allowable depreciation deductions with respect to the property? As in part (a) section 179 will reduce his basis by $1,000,000 in Year 1.
His remaining basis of $1,000,000 then is subject to the regular rules of section 168.
The equipment was depreciable property in Otis's hands, because the servers are subject to wear and tear and was used in Otis's trade or business. IRC §167. To determine the allowable deductions under section 168, we must determine the applicable convention, the applicable recovery period, and the applicable depreciation method. IRC §168(a).
The applicable convention for the equipment is the default half-year convention (let's assume that Otis did not place a substantial amount of depreciable property in service during the last quarter of Year 1). IRC §168(d)(1), (d)(4)(A). The applicable recovery period is an arbitrary five years since the equipment is five-year property per the facts. IRC §168(c).
The applicable depreciation method is the 200% declining balance method, since the facts state that Otis has taken the maximum allowable depreciation deductions (that is, he did not elect to

use the 150% declining balance method or straight line method). IRC §168(b)(1). Using Revenue Procedure 87-57, referenced in Chapter 9, we can determine the following depreciation allowances for Years 1–3:
Depreciation Allowances
Year 1L 1M * 0.4 * ½ = 200k
Year 2: 800k * 0.4 = 320k
Year 3: 96000 (480k * 0.4) * ½ = 96k
Total 616000

Otis's adjusted basis in the equipment for purposes of determining gain or loss is $7,680 ($2,000,000 – $1,616,000 = 384,000). Otis's gain realized on the sale of the equipment is $2,216,000 ($2,600,000 amount realized, minus $384,000 adjusted basis). The gain realized is recognized per section 1001(c).
The amount treated as ordinary income under section 1245 is generally 228 the lower of: (1) recomputed basis minus adjusted basis; or (2) amount realized minus adjusted basis. Here recomputed basis minus adjusted basis is lower.
2M recomputed basis (384k adjusted basis plus 161600 = 2M(- 38400 adjusted basis = 161600 IRS 1245(a)(2)(A)
This part of his gain is ordinary income under section 1245. As in (a) the remaining gain of $600,000 is characterized under section 1231.

(e) What if in Year 3 Otis takes a server home and converts it from business use to personal use. Although this conversion from business use to personal use would not trigger section 1245 recapture, it would trigger section 179(d)(10) recapture if a section 179 deduction was taken with respect to the Server.

IRC §179(d)(10); Treas. Reg. §1.179-1(e). The amount included in ordinary income would be the benefit Otis derived from electing section 179 treatment. The benefit derived from making a section 179 election is not necessarily the full cost of the server of $20,000. Rather, the benefit is the deduction he took under section 179 minus the deductions he could have taken under sections 167/168 if a section 179 election had not been made. Treas. Reg. §1.179-1(e)(1). This amount would be added to the basis of the equipment at the time of conversion. This brings up a planning point. Section 179 is elective and the taxpayer may pick and choose which assets he wants subject to section 179 and the amount. IRC §179(c). Here we would need more facts. But Otis could pick a server from among the 1,000 he purchased to convert to personal use that was not subjected to a section 179 deduction. This would avoid any recapture.