**Taxation of Property Transactions**

Fall 2020 – Nam

**I. Basis, Realization, & Recognition:**

a. Purchase & Sale:

* § 1001(a): Accession to wealth is not enough to produce income. Must have a “dealing in property” or a “realization event.”
	+ Alternatives to realization requirement:
		- Mark-to-market;
		- Hauge-Simions definition of income
	+ Benefits of Realization Requirement:
		- Able to investment money that would otherwise be paid to the government;
		- Value: risk-free rate
		- Deferral benefit
	+ Policy:
		- Justice: the wealthy probably benefit more from realization req.
		- Efficiency: is it distortive on behavior?
		- Liberty
		- Complexity: would a mark-to-market system be less complex?
		- Administrability.
* Property exchanged must be materially different.
	+ § 1.1001-1(a): the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.
		- This is a low bar to clear – almost always get this.
		- *Cottage Savings*: bank exchanged mortgages that were similar according to banking regulators but were nevertheless materially different for tax purposes.
			* Properties are different in the sense that is “material” to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent and as long as they embody legally distinct entitlements.
		- *US v. Phellis*: property that is exchanged between different states constitutes material difference and triggers realization event.
* Section 83: Property exchanged in connection with the performance of services is included in gross income.
	+ § 1.61-2(d)(2): The FMV of the property at the time of compensation.
* Gifts and Bequests not realization event but affects basis (see below)
* Satisfaction of Claims: Property transferred in satisfaction of debt is equivalent to sale of property for cash + proceeds to pay the debt within meaning of 1001(a).
	+ *Davis*: The use of property to satisfy a claim is a realization event. The AR = the amount of the claim.
		- It can be presumed that the FMV of the property is the amount of the obligation/claim – the FMV would be the AR.
			* *See Int’l Freighting*.

b. Basis:

* General Rule – Cost Basis under § 1012:
	+ Exceptions:
		- Gifts 🡪 Code 1015(a): Basis of gift = donor’s basis (“carryover basis”)
		- Bequests 🡪 Code 1014: Basis of bequest is stepped up to FMV of property at time of decedent’s death.
	+ Legacies 🡪 Reg. 1.661(a); Gain or loss realized by legatee when bequest of property is satisfied by distribution of other property.
	+ Property received for compensation for services = FMV of property.
	+ Reg. § 1.675(a)-5:
* Substituted Basis:
	+ Bargain Purchase Exception: when property is exchanged in arm’s length transaction and there is a disparity in value, the cost basis becomes the FMV of the property received, not the value of the property given in exchange. (*Philadelphia Park*; § 1012)
		- Does not apply to cash
		- If cost is not determinable of the property given, FMV of the property received will be presumed to be the FMV of the property if was an arm’s length transaction. (Barter Equation Method of Valuation – *Philadelphia Park*)
	+ Transferred Basis: Gifts and Bequests.
* Section 83 (Property rec’d as compensation for services): basis is FMV at time of grant or when property no longer subject to substantial risk of foreclosure.
* Adjusted Basis - § 1011(a) = basis as adjusted in §1016
	+ Start with cost basis
	+ § 1016: depreciation
	+ No inclusion for lease improvements by lessee: § 1019 – basis and AB are not affected by income received by lessor which is excludable under § 109 (improvements by lessee on lessor’s property).
		- If T didn’t pay anything for the leasehold improvements (e.g., because lessee did), do not include in basis.
* Gifts:
	+ Basis is original donor’s basis (§ 1015(a)). Include holding period of donor to determine character (tacking - § 1223(a)).
		- If FMV is less than donor’s basis at the time of the gift, use FMV at the time of the gift (§ 1015(a)). LOOK TO TIMING OF WHEN THE GIFT WAS MADE.
			* If FMV at the time of the gift is < AB 🡪 use FMV as basis;
			* If FMV at time of gift is > AB 🡪 use donor’s basis (§ 1015).
			* If the donee subsequently sells the property and the FMV is between the two above bases, no G/L will be recognized.
				+ 2 step process: 1) calc. with gain basis; 2) calc. with loss basis.

If neither result in the correct result, no gain/loss results.

* + Part Sale/Part Gift:
		- Treas. Reg. § 1.1001-1(e):
			* Gain: if AR exceeds donor’s basis, donor recognizes gain equal to the difference of AR – Basis.
				+ No recognition of losses to the transferor.
			* Gift: the difference between the FMV over the AR.
			* Loss: AB to the transferee shall not be less than FMV of property at the time of the transfer.
			* AB for Donee:
				+ *Greater* of (i) amount donee paid (cost) or (ii) donor’s AB for property at time of transfer; PLUS
				+ any gift tax paid by donor.
			* Example: If A sells property to his son for $60K, his AB in the property is $30K, and FMV of the property is $90K, A has a gain of $30K (AR 60K – ab 30K), and A has made a gift of the remaining $30K. His son’s basis is $60K. Treat gift portion as subject to gift rules (§ 1015).
	+ Charitable Donation:
		- § 1011(b): Allocate basis to sale portion and gift portion, and then do AR – AB for the sale and for gift. No G/L recognized on gift, and recipient takes donor’s basis in that portion (§ 1015). Basis to recipient on sale portion be cost basis (§ 1012).
		- Deduction for gift amount under § 170 (different than for a straight gift).
		- Reg. §1.1011-2.
	+ Amounts transferred incident to Divorce:
		- Transferor does not recognize G/L on property transferred incident to divorce.
		- Spouse receiving the property takes the transferor spouse’s basis.
			* Even when basis exceeds FMV – allows donee spouse to take the loss on a subsequent sale.
	+ Property Transferred at Death:
		- § 1014 – appreciated property transferred at death receives a stepped-up basis to the FMV at the date of death.
			* Unless the property was acquired within a year of the decedent dying – then the recipient receives the decedent’s AB.
		- Do not get a stepped-up basis in IRD - § 691; and subject to income tax.

c. Amount Realized:

* § 1001(a): G/L on sale or other disposition of property = AR – AB.
* § 1001(b): AR = all of the consideration received (cash + FMV of other property rec’d).
* Timing: recognize G/L in taxable year of sale or disposition - § 165(b).
* Lease: Do not include value of real property improvements on leasehold interest as gross income to the lessor when the lease terminates - § 109.
	+ § 1019 denies the lessor a stepped-up basis for the income so excluded.
* Gifts & Bequests: § 102 🡪 gross income does not include value of property acquired by gift or inheritance – except employee gifts.
* Liabilities: Reg. § 1.1001-2 🡪 AR includes the amount of liabilities transferor discharges as a result of the sale/disposition.
	+ *Davis*: marital rights are equal in value to property for which they exchanged.
	+ Exception for Divorce: § 1041(a): no g/l recognized on transfer of property from an individual to a spouse, or former spouse (if the transfer is within 1 year and incident to a divorce). Use transferor’s basis as recipient spouse’s basis.

d. Gains & Losses

* Gains:
	+ Code & Regs:
		- § 61(a)(3): gains from dealings in property are includable in gross income.
		- § 1001(a): gain or loss is the difference between the AR and the AB.
		- § 1001(c): entire amount of gain is realized unless another statutory provision says otherwise.
			* E.g., 1031.
		- Reg. § 1.1001-1(a): gain or loss not realized on property for property exchange *unless* the property received differs materially either in kind or in extent from the property given in exchange. (*Cottage Savings*: low bar to clear).
	+ Character: Ordinary vs. Capital
		- See below
* Losses:
	+ § 165(a) 🡪 ordinary losses generally allowed as a deduction, but § 267(a)(1) limitation 🡪 no deduction allowed for losses due to sale or exchange of property between related persons or corporations.
		- Basis for determining amount of the deduction for the loss is the AB of property under § 1011.
	+ No loss to donor who makes a gift - § 1015.

**II. Cost Recovery:**

a. Theory & History:

* Old system: Depreciation deduction = (Cost – Salvage Value)/Useful Life
* New System = § 168 ACRS

b. Property Qualifying for Cost Recovery /Depreciation

* Property that is subject to wear and tear
	+ Tangible Property:
		- § 1.167(a)-2: The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical developments added to it.
			* This would preclude depreciation for the topsoil on land as well.
		- Cannot depreciate a painting: lack of wasting/lack of a useful life – *Associated Obst.*
	+ Intangible Property:
		- Does not include leases for personal property.
	+ Business Organization Expenses:
		- Expenses incurred organizing a corporation:
			* § 248(a)(1): allows a deduction for the taxable year the corporation begins for the lesser of: (i) The amount of the org. expenses; or (ii) $5,000, reduced (but not below zero) by the amount which such expenditures exceed $50,000.
				+ The remainder is allowed to be deducted ratably over the 180-month period beginning in the month in which the corporation begins business.
		- Expenses incurred organizing a partnership:
			* § 709: general rule: no deduction allowed.
			* Exception - § 709(b):
				+ May elect to deduct expense like for a corporation above.
	+ Land & Building/Fixture: apportion purchase price between land and building, then depreciate only the building - § 1.167(a)-5.
	+ Leases:
		- Improvements during lease: the person making the improvements (Lessee) gets the deduction at the end of the lease term. Until then, just continues to depreciate. (*Geneva Drive-In Theater*).
			* If the tenant builds a building – it is a capital expenditure. Takes depreciation during the lease. Once lease ends, is able to deduct the remaining amount.
				+ Make sure that the construction of the building is not disguised rent – e.g., below market rent to build the building.
			* Owner of land/Lessor: § 109 – does not recognize income when land reverts back at end of lease term. § 1019 – no basis in the building.
		- Person with incidence of ownership can claim depreciation deduction (even if purchase price not fully paid).
			* Legal title to the property;
			* Legal obligation to pay for property;
			* Responsibility to pay maintenance/expenses;
			* Risk of loss if property is destroyed.
		- § 167(c)(2):
			* No portion of AB is to be allocated to the leasehold interest
			* All of AB is taken into account with respect to the property itself (e.g., owner of building depreciates his cost basis in the building but does not adjust basis for the leasehold interest if he rents it out).
				+ *Exception*: acquisition of leasehold:

If a leasehold is acquired for a business purpose, purchaser may amortize coast over number of years in lease.

Reg.§ 1.162-11(a): ratable amortization over life of the lease.

This is likely a moot point because most leasehold purchases are amortized ratably as rent. But if one lump sum purchase, this section applies.

§ 178(a): if the value of renewal options exceed a certain amount, must take them into account for the life of the lease.

* + - Timing: No depreciation until the taxpayer has the right to the property.
			* Ex: T purchases property from A for $877 that is leased to B. B has built a building on the property that will revert back to T on the expiration of the lease. Land & Building worth $100; Land only: $800; Rents $80.
				+ T will be able to depreciate the building once it reverts to him; he will have a reversionary interest valued at $77.
* Methods of Cost Recovery:
	+ Intangibles:
		- Start with § 197 and then go to § 167 if § 197 does not apply.
		- § 197(a): a taxpayer is entitled to an amortization deduction with respect to any amortizable § 197 intangible.
			* Amortizable § 197 Intangible: is any § 197 Intangible *acquired by the taxpayer* which is *held in connection with trade/business or production of income*.
				+ Used property does not qualify here – go to § 167(a).
				+ Does not apply to any amount that is immediately deductible under another provision (e.g., advertising costs deductible under § 162).
			* § 197 Intangibles: § 197(d):
				+ Goodwill, going concern value, workforce in place including its composition and terms and conditions of its employment, business books and records, operating systems and other information bases (including lists or other information with respect to current or prospective customers), patent, copyright, formula, process, design, pattern, etc., any customer-based intangible, any supplier-based intangible, any license/permitted granted by the government, any covenant not to compete ***entered into in connection with an acquisition****,* any franchise, trademark or trade name.
				+ Exceptions:

Self-created intangibles (unless created in connection with asset acquisition constituting a trade or business or a substantial asset acquisition) 🡪 § 197(c)(2).

Created if T incurs payments or costs for creation, production, development, improvement (other than depreciation costs) 🡪 § 1.197-2(d).

§ 197(e) exceptions – § 197 Intangible does not include:

Financial interests in business;

Computer software;

Property not acquired in connection with an acquisition of assets transaction (interest in film, sound recording, video tapes, books, or similar property, interest in a patent or copyright, rights under a contract with a fixed duration of less than 15 years);

Interest under an existing lease or any existing indebtedness (e.g., a mortgage);

Look at lease exceptions above.

Mortgage servicing;

Fees for professional services and transaction costs.

* + - * **Mechanics**: *amortize basis of § 197 Property ratably over 15 years* beginning with the month in which the intangible was acquired.
				+ Property not eligible for amortization in the month of disposition.
				+ First short year: base amortized on the number of months in the short year.
			* Special rules:
				+ For film/video/TV shows/similar property *not acquired in transaction of trade/business*: § 167(g)(6)(8) authorizes IFM.

RR 60-358: use income forecast method

CY Income/total expected income X Basis = deduction

Calculation above is depreciated over the useful life

Salvage value 🡪 value on sale after use.

* + - * + Covenant Not to Compete entered into in connection with the acquisition of a T/B- § 197(f)(1)(B):

Amortize over 15 years regardless of when CNC ends.

*If not in connection with acquisition of T/B*, go to § 167 and amortize over useful life (if known) or 15 years 1.263(a)-4(d)(6)(i)(C) & § 1.167(a)-3.

* + - § 167 (Default for when § 197 doesn’t apply):
			* Two Methods:
				+ 1) Straight Line

Ratably over useful life (Cost/Useful life)

Traditional SL

(Cost – Salvage Value) / Useful Life

Don’t worry about salvage value here.

* + - * + 2) Income Forecast:

Current year’s income / total expected Income X Basis = Deduction

* + - * Reg. § 1.167(a)-14:
				+ Rules for amortization of intangibles excluded from § 197:

Computer software: (b)(1): use straight line method with 36 months as the useful life beginning on the first day of the month software is placed into service.

Patents/Copyrights: (c)(4): if purchase price is payable on annual basis as fixed amount of % of revenue, deduction equals purchase price paid during the year. Otherwise basis of patent is depreciated using income forecast or straight-line method.

*This is only if it was not acquired in connection with a T/B – not a § 197 Intangible*.

* + - * § 174 Special Rules:
				+ Acquisition of a lease:

Reg. § 1.162-11: if a lease is acquired for a business purpose for a specific sum, the purchaser may take depreciation deductions based on the cost over the number of years the lease has to run (ex: 10 year leas = 1/10 price each year).

Leasehold interest is not a § 197 intangible - § 197(e)(2).

* + Tangibles – § 168 & § 179 Election:
		- § 168 Depreciation deduction for any tangible property shall be determined by using:
			* The applicable recovery period – § 168(e)(1)(A); and
			* The Method of Depreciation – § 168(b);
				+ DDB is default for tangible property that isn’t real property;
				+ SL is always available – § 1016(a)(2).
			* The applicable convention – § 168(d).
		- Steps for Analysis:
			* First, determine whether property is eligible for § 168(k) Bonus Depreciation or if the taxpayer has or has reason to elect out.
				+ § 168(k) allows for 100% deduction of the cost in year of purchase for qualified property. § 186(k) applies unless tp elects out.

*Qualified property (§ 168(k)(2)*: property with a recovery period of < 20 yrs. & original use begins with tp.

* + - * + Election Out: § 168(k)(7): If a taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, paragraphs (1) and (2)(F) shall not apply to any qualified property in such class placed in service during such taxable year.
				+ When to elect out:

If you will have more income in later years, you would want to use the depreciation in those later years rather than up front.

The value of the deduction depends on your marginal rate – would be lower for lower tax brackets.

You want the deductions when you have higher income.

The value becomes more valuable – tracking progressivity of income tax.

Code allows the TP to pick which method would be best for it.

* + - * Second, determine whether taxpayer has elected to use § 179 expensing.
				+ § 179 treats the cost of § 179 property as an expense.

*§ 179 Property (§ 179(d)(1)*): tangible property which § 168 applies or computer software that § 167 applies to.

Limitations: (1) Aggregate cost cannot exceed $1MM; (2) reduced (not below 0) by the amount of § 179 Property placed into service which exceeds $2.5MM.

* + - * Then use DDB or Straight-Line Depreciation. (DDB is the default method; Real Property uses SL)
		- Steps for Double Declining Balance Method Under § 168:
			* 1) Is the property subject to wear and tear? If yes, depreciable.
			* 2) Determine class life of property - § 168(e):
				+ Look to § 168(e)(3) to determine class life.
				+ Most tangible personality = 5-year property.

Plane = 9 years

Default property class is 7-year property if not classified.

* + - * 3) Choose applicable Method – § 168(b):
				+ If real property (either residential or commercial), use straight line

Recovery period for commercial property: 39 years;

Recovery period for residential property: 27.5 years.

* + - * + If other property, use DDB:

200% for all 3, 5, 7, and 10-year properties;

150% for all 15 and 20-year properties.

Calculation

Calculation = %/Recovery Period (ex 200/5)

Same percent each year (ex: 200/5 = 50%; so 40% of AB each year for 5 years.

Must subtract depr. Amt. from prior year’s basis to get new AB each year.

* + - * 4) Determine applicable recovery period – § 168(c):
				+ Most personalty = 5 years
				+ Table from § 168(c) + § 168(e):

|  |  |
| --- | --- |
| **Class Life** | **Recovery Period** |
| 4 or less | 3 years |
| 4 > 10 | 5 years |
| 10 > 16 | 7 years |
| 16 > 20 | 10 |
| 20 > 25 | 15 years |
| 25+ | 20 |
| Comm. Realty | 39 |
| Res. Realty | 27.5 |

* + - * 5) Choose applicable convention (applies to S/L & DDB) – § 168(d):
				+ Mid-Month: nonresidential real property and residential real property.
				+ Half-Year: all other property (get ½ year’s worth of deduction in 1st year).

Mid-Quarter: only for property placed into service in last 3 months of tax year (not for residential or nonresidential real property).

To Use This: all bases of § 168 property placed into service during last 3 months must exceed 40% of total depr. Bases placed into service that year.

Assume start date for depreciation is midway through quarter of purchase (e.g., 11/15 for last quarter)

Remaining months in year/12 = Rate

Ex: 11/15 🡪 1.5/12 = 12.5%

Ex: 5/15 🡪 7.5/12 = 62.5%

* + - * + Convention applies to acquisition ***AND*** sale.

Ex: if selling property with 5-year recovery period in Y3, use ½ year convention in year of purchase & sale to determine depreciation for year of purchase and year of sale.

* + - * 6) Determine when to use Straight-Line:
				+ When SL gives you a higher amount of depreciation than DDB, switch to SL.
				+ When you switch, calculate remaining cost over remaining useful life.
				+ For 5-year property, the DDB & SL method will always be the same in Y4. Still have to use DDB in Y4, but switch to SL in Y5.
	+ § 179 Election to Expense:
		- 3 Requirements:
			* Property is tangible property subject to § 168 depreciation (or computer software under § 167.
			* Property is § 1245 Property
				+ Only personalty, not realty
				+ Subject to wear and tear
			* Must be acquired by purchaser.
				+ Can be used, but cannot be a gift/bequest.
		- If it is 179 Property, TP can make an election to deduct the full amount of purchase price in the year of purchase.
		- Limitations:
			* § 179(b)(1): can only deduction up to $1M.
			* § 179(b)(2): aggregate cost of § 179 property cannot exceed $2.5M for any tax year.
			* § 179(b)(3): can’t take more of a deduction than total taxable income from t/b.
			* Doesn’t matter if TP borrowed some of the purchase price.
		- Must reduce basis by amount of § 179 deduction, then calculate depr. Under § 168.
	+ § 168(k) Bonus Depreciation:
		- 100% deduction for Qualified Property in year of purchase.
		- Qualified Property – § 168(k)(2)(A):
			* § 168 Property with recovery period of 20 years or less (or computer software).
				+ Not realty because recovery period is 39 or 27.5.
			* Must meet the original use requirement under § 168(k)(2)(A)(ii) or the acquisition rules under § 168(k)(2)(E).
				+ Original Use: must be new property, not used.
				+ Acquisition Rules:

Property was not used by TP prior to acquisition;

Property qualifies under § 179 requirements above.

* + - Election out of § 168(k) Bonus Depreciation:
			* It is mandatory unless TP elects out.
				+ § 168(k)(7): election out of bonus depreciation.
			* Then use default method for depreciation – DDB or SL

**III. Effects of Mortgages on Basis & Amount Realized; Cancellation of Indebtedness:**

General Rule: § 1012 🡪 Basis = cost; unless: acquired by bequest - § 1014: FMV at death; acquired by gift - § 1015: donor’s basis at gift.

a. Effect of Financing On Basis:

* § 1012: the basis of property is the cost basis. It does not matter whether the funds used to purchase the property were borrowed.
	+ Recourse Debt (personal liability):
		- You can borrow the full purchase price; assume the mortgage and pay cash; paying cash and taking a loan; pay cash and execute a note to the seller for the purchase.
		- Generally, recourse debt is always included in basis.
	+ Nonrecourse Debt (no personal liability; only secured by the property):
		- Mortgage debt must ≤ FMV.
			* Bloated purchase price:
				+ *Estate of Franklin* & RR 77-110: look at the FMV and whether debt is within that range. Ignore the debt if it is over FMV.
				+ *Pleasant Summit*: include value of debt up to the FMV of the property.
			* This problem arises when it is seller financed. If there was a 3rd party, the 3rd party would not lend the bloated amount.
				+ A seller who is financing the purchase doesn’t have its own cash on the line. If the buyer defaults, gets the property back and doesn’t lose cash. A 3rd party would lose the difference between the FMV of property and the amt. of the loan.
			* Unsettled between the 2 methods.
		- Contingent Payments:
			* *Albany Car Wheel*: obligations must be certain; if too uncertain, add basis to basis as payments are made.
			* Prop. Reg. § 1.168-2(d)(3): add contingent payments to basis and depreciate over the remaining useful life.
		- Exercising an option to prepay the debt:
			* Prepayment in full is not a taxable event.
			* Prepayment for a reduced amount:
				+ § 108(e)(5): No COD income if the debt is reduced by the seller in a seller-financed transaction. It is treated as a purchase price adjustment.
	+ Additional Borrowing:
		- No effect on basis; not a sale or disposition 🡪 *Woodsam*.
			* Taking on additional debt is not considered income.
				+ Taking on nonrecourse debt is like a sale, but when your debt approaches exactly the FMV of the property it is almost exactly like the sale. The IRS would likely recharacterize the transaction given the substantive nature.

b. Dispositions of Encumbered Property:

* Amount Realized:
	+ Reg. § 1.1001-2(a)(1): The amount realized from a sale or other disposition includes the amount of liabilities from which the transferor is discharged as a result of the sale/disposition.
		- Don’t include COD income in AR.
			* Reg. § 1.1001-2(a)(2): The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and §1.61-12(b)(1).
	+ Reg. § 1.1001-2(a)(4)(i): the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability.
		- Reg. § 1.1001-2(a)(4)(iii): A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject; *(treatment as though this was a part sale/part gift)*
			* Donee would take a basis as the greater of amt. paid (assumption of debt) or the FMV of property.
	+ *Tufts*: *points* out that because we allowed you to include the full amount of debt in basis in the beginning we need to include the full amount of debt upon disposition; otherwise you will have gain upon which you are not actually taxed.
	+ What counts as a sale/disposition:
		- Normal sales;
		- Involuntary Foreclosures;
			* *Freeland*: foreclosure sale is considered a sale.
		- Voluntary transfers in lieu of foreclosures.
	+ Cancellation of Indebtedness:
		- § 61(a)(12) includes income from discharge of indebtedness (COD income).
			* RR 82-202: Discharge of indebtedness; prepayment of mortgage balance at discount. An individual taxpayer realizes discharge of indebtedness income under section [**61(a)(12)**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWEw2QlJSRzVHVkcwP2pjc2VhcmNoPWlycyUyNTIwcmV2JTI1MjBydWw4Mi0yMDIiXV0--2ad1a85580179b8319fbecaebb1ca6bb5d077a81/document/1?citation=26%20usc%2061(a)(12)&summary=yes#jcite) of the Code upon the discounted prepayment to a lender of all or a portion of mortgage indebtedness. The amount of the discount is includible whether the mortgage note is recourse or nonrecourse.
			* RR: 91-31: The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under section 61(a)(12) of the Code.
		- Exceptions:
			* § 108(a): excludes from gross income certain cancellations of debt:
				+ the discharge occurs in a title 11 case,
				+ the discharge occurs when the taxpayer is insolvent,
				+ the indebtedness discharged is qualified farm indebtedness,
				+ in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or
				+ the indebtedness discharged is qualified principal residence indebtedness which is discharged—

Must be discharged before 1/1/2021; or evidenced in writing before 1/1/2021.

* + - * § 108(e)(5): exception for seller-financed debt – treated as purchase price adjustment.
		- Effect of Exceptions to gross income inclusion of COD Income – § 108(b):
			* (b)(1): amount excluded from GI under (a)(1-3) shall reduced (in this order per (b)(2)):
				+ Any net operating loss;
				+ Any tax credit;
				+ Any net capital loss;
				+ The basis of the property as to T.
			* (b)(3): provides applicable amount of reduction.
				+ Would have to reduce basis on other property by the same amount

This is deferral: if you have just the exclusion, that is the full value to T, but if you have an exclusion with a basis reduction, when you recover your basis you don’t get to recover your basis by that amount.

The benefit of having additional basis is gone.

* + - RR 92-99 If the principal amount of an undersecured nonrecourse debt that arose out of the purchase of property is reduced by the holder of the debt who was not the seller of the property, the debt reduction may not be treated as a purchase price adjustment (in the absence of an infirmity that clearly relates back to the original sale) but results in discharge of indebtedness income under section 61(a)(12) of the Code.

**IV. Characterization:**

a. Preferential Rates:

* Capital Gains – § 1(h)(1):
	+ 0% if taxable income below the 25% bracket;
	+ 15% if taxable income is between the 25% bracket and the highest marginal rate bracket;
	+ 20% if taxable income is in the highest marginal rate bracket.
* Collectible Rate – §1(h)(4):
	+ 28% if the sale is of a collectible as defined in § 408(m), excluding ¶ (3).
* Unrecaptured § 1250 Gain – § 1(h)(6):
	+ 25%

b. Capital Gains Analysis:

* 1) Is it a Capital Asset?
	+ Look to § 1221 – see analysis below in Capital Asset Section.
		- Property held by a taxpayer (whether or not connected to a T/B) but not:
			* Stock in trade normally included in inventory;
			* Depreciable property;
			* Patent, copyright, etc.;
			* Accounts receivable or notes payable acquired in the ordinary course of business;
			* Commodities derivatives instrument;
			* Hedging transaction;
			* Supplies regularly used in business.
* 2) What was the holding period?
	+ 1221(1), (2) 🡪 NO = short-term capital asset
	+ 1221(3), (4) 🡪YES = long-term capital asset
* 3) Calculate NCG (§ 1222(11)): excess of NLTCG over NSTCL
	+ 1) Find NLTCG/NLTCL:

LTCG

(collectible cap. Gain)

§ 1231 Gain

(LTCL)

NLTCG

* + 2) Find NSTCG/NSTCL:

STCG

(STCL)

* + 3) Find NCG:

NLTCG

(STCL)

* 4) Find the Adjusted Net Capital Gain – § 1(h)(3):

NCG

(28% Gain)

(25% Gain)

Qualified Dividend Income

ANCG

* 5) Find the Taxable Income captured at Ordinary Rates:

Base Income from problem

NSTCG

Not QDI

(§ 1231 Loss)

Ordinary Income

* 6) Run Through Cap Gains Brackets:
	+ § 1(h)(1)(A): Amount Taxed at Ordinary Income Rate
		- Take all income and subtract ANCG
		- Shortcut: do calculation above in (5).
		- Use this amount for calculations below.
	+ § 1(h)(1)(B): Excess of Maximum 0 rate amt. over TI reduced by ANCG:
		- $38,000 (§ 1(j) indiv. Rate) – OI = amt. taxed at 0 %
	+ § 1(h)(1)(C): Excess of 15% rate amt. over TI – ANCG:
		- $425,800 – OI = amt. taxed at 15%
	+ § 1(h)(1)(D): 20% rate Bracket:
		- ANCG – sum of excess in B & C = amt. taxed at 20%
* Qualified Dividend Income:
	+ Under § 1(h)(11) “Qualified Dividend Income” means dividends received during the taxable year from domestic corporations, and qualified foreign corporations. The QDI requirements coordinate with § 246(c) but use 60 days for the holding period under § 1(h)(11)(B)(iii)(I).
		- (b)(iii): holding period requirements.
			* Look to § 246(c);
			* Must hold the stock for 61 days during the 121-day period with ex-dividend date in the middle.
* § 1245 Recapture:
	+ § 1245(a)(1): The amount the lower of (i) the recomputed basis; or (ii) the amount realized exceeds the adjusted basis of the property shall be treated as ordinary income.
	+ § 1245(a)(2): recomputed basis = AB + depreciation adjustments.
	+ The difference between the gain and the recapture is the § 1231 gain.
* § 1250 Recapture:
	+ The lower of the depreciation deductions or the excess of the AR over the AB shall be treated as OI.
		- If you look at 1250 itself, it restricts the amounts captured to amounts depr. Faster than straight line, but currently, real property cannot be depreciated faster than straight line.
		- But 1(h)(6) revises this; instead include all depreciation taken.

c. Capital Loss:

* LTCL first sets off against LTCG then sets off STCG.
	+ **1212(b)(1)(A) —** the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and
	+ **1212(b)(1)(B)** — the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.
* § 1211(b): If there is a remaining NLTCL, an individual can use $3,000 of the loss to offset OI in the current year. The remainder is carried forward as LTCL.

d. What is a Capital Asset:

* Must be excepted under the list from § 1221, otherwise capital asset.
* **1221(a)** 🡪 property held by the taxpayer **but does not include:**
	+ (a)(1): \*stock in the trade of T or \*other property of a kind to be included in the inventory of the T if on hand at the close of the tax year, or \*property held by T primarily for sale to customers in the ordinary course of his trade or business.
		- **Stock for trading**
			* Stock for trading (hobby/no customers) 🡪 stock = capital. Even if very frequent.
			* Dealer in Stock (day job/broker with customers) 🡪 stock = ordinary
			* Frequent trader if no customers 🡪 capital
		- **Inventory**
			* **Property held primarily for sale to customers in ordinary course of T/B** (e.g., real estate developer has ordinary income)
				+ REAL ESTATE 🡪 Factors to determine whether it’s a capital asset (*Suburban Realty*)

Purpose of Acquisition

Frequency or substantiality of sales

Developmental activities and improvements

If T is subdividing for profit (not just based on market changes), looks ordinary.

Solicitation/Advertising

Hiring of brokers, personal efforts

*Bynum*: T farmed land but became a dealer in realty when he subdivided land and made substantial improvements to the lots to sell (income = ordinary)

There is inherent value in subdividing lots. Subdivision looks ordinary. Different than holding lots of separate lots and letting the market changes increase their value (capital).

* + - *S&H*: There is no “one bite rule;” even if you sell to just one customer, you don’t automatically get kicked out of 1221(a)(1) for that reason.
			* This case’s primary role is to respond to the fact that T is only selling one property.
	+ (a)(2): Property used in T’s trade or business that is subject to depreciation under 167
	+ (a)(2): Real property (e.g., a building, land) used in T’s trade or business
	+ (a)(3): Copyright, literary, musical or artistic composition held by T whose personal efforts created such property . . .
	+ (a)(4): Accounts or notes receivable acquired in ordinary course of T/B
	+ (a)(7) any hedging transaction identified as such before the close of the day it was acquired, originated, or entered into
* **Takeaway** 🡪 If gains come from market appreciation, should be capital. If gains come from improvements or personal efforts, looks more ordinary.
* **§ 1231 – General Rule**:
	+ The term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section [167](https://www.bloomberglaw.com/ms/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTRUSDg_amNzZWFyY2g9SVJDJTI1MjAxMjMxIl1d--819d5d9467f58b87700089d6a6f608834e1d4a5e/document/1?citation=26%20USC%20167&amp;summary=yes#jcite), held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not—
		- 1231(b)(1)(A) — property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,
		- 1231(b)(1)(B) — property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,
		- 1231(b)(1)(C) — a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section [1221(a)](https://www.bloomberglaw.com/ms/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTRUSDg_amNzZWFyY2g9SVJDJTI1MjAxMjMxIl1d--819d5d9467f58b87700089d6a6f608834e1d4a5e/document/1?citation=26%20USC%201221(a)&amp;summary=yes#jcite), or
		- 1231(b)(1)(D)  — a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section [1221(a)](https://www.bloomberglaw.com/ms/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSTRUSDg_amNzZWFyY2g9SVJDJTI1MjAxMjMxIl1d--819d5d9467f58b87700089d6a6f608834e1d4a5e/document/1?citation=26%20USC%201221(a)&amp;summary=yes#jcite).

e. Options:

* Only taxed at time of exercise or sale of option.
* § 1234(a) Option holder Treatment 🡪 G/L on exercise or sale of option is capital if the property subject to the option would be capital asset in T’s hands. Otherwise, ordinary.
* § 1234(a)(2) 🡪 Deemed sale on day the option expires/lapses.
	+ § 1234A 🡪 G/L from lapse of an option is treated as capital gain or loss.
	+ Remember 1211 🡪 Loss will offset gain but if no gain, loss allowed limited to $3K.
* Key point: the higher the option price relative to the FMV, the closer it looks like a sale because the seller no longer faces a risk of loss and has cash in pocket.
	+ In these cases, it is clear that selling to option is like selling the underlying asset.
* The writer of the option does not recognize g/l until the option is exercised or lapsed – RR 78-182.
	+ Then the AR on the option is included in the AR paid pursuant to the option.

f. Hedging Transaction:

* Purchasing one item as insurance or assurance for something that may happen in the future (can be a commodity, debt instrument, etc.).
* If it is a *hedging transaction*, it is treated as ordinary income - § 1221(a)(7) + § 1221(b)(2).
	+ A hedging transaction is excluded from capital asset status under § 1221(a)(7).
	+ Definition:
		- Any transaction entered into by T in the normal course of T/B primarily:
			* To manage risk of price changes with respect to ordinary property held by T;
			* To manage risk of interest rate or price changes – e.g., borrowings or obligations incurred by T; or
			* To manage any other IRS-approved risks.
		- Must identify the transaction as a hedging transaction on the day of transaction and identify the hedged property within 35 days. Reg. § 1.1221-2(g)(1):
			* Identification is binding as to gain treatment (= ordinary) but not loss treatment (get capital loss).
		- Property is ordinary property to T only if a sale or exchange of the property by T could not produce capital gain under any circumstances.
			* Ex: Buying insurance against price changes of 1231 property is not a hedging transaction.
			* Ex: Buying futures in ash lumbar to offset price increases in pine lumbar used in inventory, is a hedging transaction.
			* If it can be a capital asset, then it is not ordinary property.
			* G/L on short sale or option that is part of a hedging transaction is ordinary G/L.
			* Hedging against interest rate risk by using short sale of bond – it is a complex relationship between interest rate for the company as a borrower and the value of the derivative assets (the bond).
				+ Not clear if Unit Iv, #5 will be hedging transaction or not – prohibits purchase or sale of debt instrument, but unclear if the Code or Regs intends to stop the described transaction.

g. Short Sales:

* What is a short sale:
	+ Seller borrows property (e.g., stock). He then sells it for cash. When the property’s value goes down, he buys it back at the lower price and then makes good on his note by returning the property to the lender.
		- The Question is whether that property is a capital asset and then long-term or short-term gain/loss.
		- The goal for the short sale is to liquidate the stock for cash right before the value drops.
* A short sale may meet the definition of a hedging transaction. If so, it will be an ordinary asset.
	+ Reg.§ 1.1221-2(a)2): G/L on short sale or option that is part of a hedging transaction is ordinary income or loss.
* § 1233: G/L on a short sale is capital to the extent the property used to close the short sale is a capital asset in the hands of t.
	+ Ex: if a dealer in securities makes a short sale of stock, it is ordinary G/L if the stock hled primary for sale to customers in the ordinary course of his T/B. If the stock is capital, then the gain/loss is capital.
	+ Remember to look at the holding period.
	+ Timing: delivery of property to the lender closes the short sale. Holding period ends on that date – Reg. § 1233-1(a).
* § 1233(b): if G/L from the short sale is a capital asset and on the date of the short sale, *substantially identical property* has been held by T *for not more than 1 year, the gain is short-term gain*.
	+ Shorting Against the Box:
	+ T actually owns the securities she’s going to sell short.
		- Ex. T borrows stock from dealer. Dealer purchases stock from the market and delivers to T. Then, T transfers her own original shares to the dealer to cover her loan.
	+ § 1259: constructive sale of appreciated financial position.
		- If there is a constructive sale of an appreciated financial position, T recognizes gain as if such position were sold for its FMV on the date of such sale.
			* *Appreciated Position*: sale of stock, debt, or partnership interest results in gain. Does not include a hedge. Applies to short sales only. § 1259(b)(2)(B).
			* *Constructive Sale*: short sale of substantially identical property.
		- The result is that T recognizes gain as if the position were sold at its FMV on the date of the constructive sale.

h. Substitutes for Ordinary Income:

* Look for a scenario where T is selling a right to income or an interest in property he still owns – did he sell his entire right (CG) or only a portion (OI)?
	+ § 1241: Cancellation of Lease or Distributor’s Agreement: Amounts received by lessee for cancellation of a lease or by a distributor of goods for cancellation of an agreement (if the distributor has a substantial capital investment in the distributorship) are considered amounts received in exchange for such lease or agreement (AR for § 1001).
		- Amounts received as a substitute for lease payments (including a cancellation payment) are ordinary income. The payment means the lease ended, and T could not sue to enforce the terms (*Hort*).
		- This is different than just purchasing a lease from a seller.
	+ *Metropolitan Building*: Because it was not the liquidation of a right to future income but rather one of a disposition of income-producing property itself, it was a capital gain.
	+ *Lattera*: the key distincition: the right to earn income through an asset vs. the right to earned income from an asset. In *Lattera*, the earned income, not the right to earned income was sold – ordinary income.
	+ *Maginnis*: T made no capital investemtn in return for the lottery ticket and the sale didn’t reflect an accretion in value over cost to the underlying asset. It was ordinary income.
	+ Who is taxed on the income interest:
		- If donor has given everything he owns (the tree), the donee is taxed.
	+ What is the character:
		- If you sell the whole interest (the tree), it is capital gain.
		- If you sell only a portion of your interest (the fruit from the tree), it is ordinary income.
	+ Family Resemblance Test from *Lattera* (Gray areas):
		- 1) classify the property into capital asset or ordinary asset;
		- 2) determine whether the property bears a family resemblance to one of the capital or ordinary categories.
			* Horizontal carve-out: if a person owning the interest disposes only part of the interest, then this is fruit from the tree and will be ordinary income. Stop here – Ordinary income.
			* Vertical Carve-Out: if T disposed of entire interest, keep going.
		- 3) look at the character of the asset:
			* Unearned income interest = capital gain treatment
			* Assets that have already earned income = ordinary income
				+ *Lattera*: the right to future payments were O/I because they had already been won.
				+ A/R in sale of partnership (right to receive payment has already been earned).

**V. Loss Limitations:**

a. In General:

* § 62(a)(3): deductions allowed include losses from the sale/exchange of property as allowed by  §161 *et seq*.
* § 165(a): ordinary losses generally allowed as a deduction, but §267(a)(1) limits – no deduction on sale/exchange between related parties.
	+ For Individuals (§ 165(c)):
		- Losses incurred in a trade or business;
		- Losses incurred in any transaction entered into for profit; and
		- Losses of property not connected with T/B or profit if loss came from a casualty loss – fire, storm, theft, etc.
	+ Losses on Sales/exchanges between related parties:
		- § 267(b) describes the prohibited relationships – members of family; controlled corporations, etc.
			* § 1041 governs transfers between spouses – treated as gift.
		- § 267(d):
			* When there is a disallowed loss and a subsequent disposition:
				+ Only recognize gain on the subsequent disposition to the extent the realized gain exceeds the previously disallowed loss.
* Realization requirement:
	+ The taxpayer gets the benefit of the realization when there is built-in gain because he doesn’t recognize the gain on the appreciation until there is a disposition.
	+ The taxpayer is burdened by the realization requirement on built-in losses because taxpayers want to recognize losses sooner rather than later.
* Reg. § 1.165-4(a): a mere decline in value, even if substantial, is not sufficient to establish a loss deduction.
* This is not a realization event.
* Capital Asset Losses:
* § 1211 & § 1212 – limited to offset other capital gains & up to $3,000 to offset ordinary income. The rest carried forward.

b. Worthless Securities Rule:

* § 165(g)(1): worthless security rules: allows for a loss if the security becomes worthless during the year as a capital asset.
	+ (g)(2): Security:
		- Share of stock in a corporation;
		- a right to subscribe for, or to receive, a share of stock in a corporation; or
		- a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.
	+ Reg. § 1.165-4(a): There must be no recognizable value.
	+ Treated as if it was sold on the last day of the taxable year – Reg. § 1.165-5(c).
		- Don’t have to wait for an actual sale/exchange.

c. Sales of Debt & Bad Debt:

* Sale of Debt:
	+ If the transaction (the lending) was a profit motivated transaction, § 165(c)(2) would allow a loss.
		- The character would depend on if T was in the business of lending or was a dealer:
			* If not, capital; if so, ordinary. §1221.
	+ There would be no tax consequences to the borrower – nothing has changed on his end.
	+ Purchase of Debt of related persons:
		- § 108(e)(4)(A): it is treated as if the borrower purchased the note back himself. Borrower recognized COD Income.
			* The acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section [**267(b)**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSUJBSDg_amNzZWFyY2g9SVJDJTI1MjAxMDglMjUyOGUlMjUyOSUyNTI4NCUyNTI5Il1d--f49abd18b5214e164f404cc4a205f11f939ecb66/document/1?citation=26%20USC%20267(b)&amp;summary=yes#jcite) or [**707(b)(1)**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE9GSUJBSDg_amNzZWFyY2g9SVJDJTI1MjAxMDglMjUyOGUlMjUyOSUyNTI4NCUyNTI5Il1d--f49abd18b5214e164f404cc4a205f11f939ecb66/document/1?citation=26%20USC%20707(b)(1)&amp;summary=yes#jcite) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor.
			* Uses § 267(b) relationships, but In-laws are considered family for this purpose - § 108(e)(4)(B).
		- The lender/seller of the debt would not have a different tax consequence.
* Satisfaction of Debt for Less than FV:
	+ Would recognize a loss if sold for less than FV.
* Worthless Debts:
	+ § 166(a): loss deduction for debt that becomes worthless (or when debtor is unable to pay).
		- Reg. § 1.166-1: does not apply to nonbusiness debts.
		- Must be a bona fide debt arising from debtor/creditor relationship based on enforceable obligation to pay a fixed amount;
		- Can be debt due to A/R from accrual method taxpayer;
		- Worthless = legal action to enforce payment would not result in satisfaction of the obligation (e.g., bankruptcy is indication debtor is unable to pay).
	+ Bad Nonbusiness Debts:
		- If debt is worthless, the loss is short-term capital loss during the tax it became worthless - § 166(d).
			* §166(d)(1)(B): Where any nonbusiness debt becomes worthless, it will be considered a loss for an asset held for not more than 1 year
			* § 166(d)(2): Nonbusiness debt defined: debt other than:
				+ a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
				+ a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

d. Related Party Transactions:

* § 267(a): provides that no loss deduction is allowed if the sale/exchange is between these persons:
	+ Family members (brothers, sisters, spouses, ancestors, & lineal descendants) (*but* not in-laws)
		- § 267(g): § 1041 applies to transfers between spouses.
			* § 1041(a): no g/l recognized on transfers between spouses, whether in trust or outright, or to former spouses incident to a divorce. Treated as if it was a gift. Transferee takes transferor’s basis.
	+ An individual and a corporation in which he owns more than 50% of the outstanding stock;
	+ 2 corporations in the same controlled group;
	+ A grantor and a fiduciary of a trust;
	+ A fiduciary of a trust and a beneficiary of such trust;
	+ A fiduciary of a trust and a fiduciary of another trust if the trusts have the same grantor;
	+ A fiduciary of a trust and a beneficiary of another trust if the same person is the grantor of both trusts;
	+ A fiduciary of a trust and a corporation in which *more than* 50% of the outstanding stock is owned (directly or indirectly) by or for the trust or by a or for a person who is a grantor of the trust;
	+ A person and a tax-exempt organization controlled by that person or his family members;
	+ A corporation and a partnership if the same person owns *more than* 50% in each;
	+ An S Corp and an S Corp if the same person owns 50% in each;
	+ An S corp. and a C Corp if the same person owns *more than* 50% of each;
	+ An executor of an estate and a beneficiary of such estate (other than to satisfy a bequest).
* § 267(c): Constructive Ownership Rules:
	+ Stock owned directly or indirectly by or for a corporation, partnership, or trust is considered as owned proportionally by or for its SH, partners, or beneficiaries.
	+ An individual is considered to own the stock owned directly or indirectly by his family.
	+ An individual owning corporate stock is considered to own stock by or for his partner.
	+ **No double attribution - § 267(c)(5)**.
* Amount of Gain where loss previously disallowed:
	+ If the loss was disallowed on the transaction between related parties and the related party subsequently disposes of the property for a gain:
		- The gain is recognized *only to the extent the gain exceeds the loss that was previously disallowed*.

e. Wash Sales:

* § 1091(a): when there is a loss claimed to have been sustained form any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain/loss was recognized by law), or has entered into a control or option so to acquire, substantially identical stock/securities, then no deduction shall be allowed under § 165.
	+ No loss if:
		- 1) sale/exchange that would trigger loss;
		- 2) T buys or enters into a contract/option to buy substantially identical stock/securities within 30-day period before or after the sale.
			* Don’t count day of sale. 30 days before 🡨 Sale 🡪 30 days after.
* § 1091(d): the basis in the new shares is the basis of the original stock/securities *plus* the difference between the original AR and the AR of the substantially identical stock/securities.
	+ OG AB + (1st sale AR – 2nd sale AR) = New AB
* These rules do not apply to the seller of the substantially identical stock.
	+ RR 56-602: excludes the seller of the substantially identical stock.
* Look out for a transaction where T sells to the market and a related person purchases substantially identical stock/securities within the 30-day period.
	+ The mere fact that B bought the shares on the exchange rather than directly from the sister is not dispositive. So, § 267(a) would disallow loss. (directly or indirectly sells). This would be an indirect sale.

f. At-Risk & Passive Loss Limitations:

Look for a scenario where T is trying to claim a loss deduction for a business or investment. Only applies to losses. Look amounts which T has “skin in the game.”

* **§ 465: Deductions Limited to Amounts at Risk**: Analyze the transaction under § 465 1st then § 469.
	+ Who is subject: § 465(a)(1): individuals, trusts, estates, and certain closely held corporations.
	+ What activities are covered: § 465(c)(:
		- Holding, producing, or distributing motion pictures;
		- Farming;
		- Leasing any § 1245 property;
		- Exploring for or exploiting oil and gas resources;
		- Exploring for geothermal deposits; or
		- *Catchall*: any activity engaged in by T in the carrying on a T/B for the production of income - §465(c)(3).
	+ Effect of § 465:
		- Loss deduction is limited only to the extent that the taxpayer is at risk. If the loss is more than that, the loss is suspended until the next year the taxpayer is at risk.
		- Even if § 465 doesn’t apply, go to § 469 before taking the loss deduction.
	+ § 465 Analysis – applies to each activity:
		- Step 1) determine the total stating loss:
			* Income – Business Expenses = total starting loss
				+ Expenses: interest, depr., tax, repairs, carry forward loss.
				+ § 163(a): deduction allowed for interest paid or accrued on debt within tax year.
		- Step 2) Keep tract of statutory amount at risk.
			* (b)(1): Amount at risk includes:
				+ Amounts of money T contributed to the activity;
				+ Amount borrowed for the activity & is personally liable or pledged security other property used in the activity (other than nonrecourse debt) – § 465(b)(2);
				+ Qualified Nonrecourse financing is included: § 465(b)(6):

i.e., borrowing from a bank

* + - * What other expenses are at risk: (maintenance, repairs, mortgage interest payments, property taxes, etc.
				+ Look at cash that left T’s hand and cash that came in (rental income) – and the net amount will be the increase to at risk – look to Reg. § 7.465-2. This section really points at the concept of cash tracking.
	+ § 465 At-Risk Limitations are applied before the § 469 passive activity loss limitations – Reg. § 1.469-2T(d)(6)(i).
	+ Carry-Over:
		- § 465(a)(2): allows a carry over of disallowed losses.
* **§ 469 – Passive Activity Loss:**
	+ § 469(a): passive activity losses not allowed.
		- Passive activity defined:
			* § 469(c):
				+ Involves conduct of a T/B;
				+ In which T does not materially participate.
			* Rental activity is per se passive, unless it fits into certain exceptions.
				+ Reg. 1.469‑1T(e)(3) provides an exception.

Motel rentals: if rentals are for less that 7 days, it is not per se passive. Look to material participation.

* + - * Does not include portfolio income activity – 469(e)(1)(A).
		- Passive Activity Loss:
			* § 469(d)(1): Passive activity loss = aggregate passive losses from all activities over aggregate passive activity income.
				+ § 1.469-2T(b)(1): passive activity loss = aggregate passive activity losses over aggregate passive activity income.
			* Exclusions from PAL status:
				+ Reg. § 1.469-2T(d)(2): Excludes certain expenses from PAL status:

state and local taxes are not counted as passive activity deductions.

* + - * + Reg. § 1.469-2T(d)(6): remove the previously disallowed § 465 at risk limitations.

Reg. § 1.469-2T(d)(6)(iii): the 465 disallowed losses should be spread ratably across the losses that are allowed under § 469:

Amt. of 465 disallowed loss/total losses X each 469 allowed loss item.

This prevents a portion of each expense from being deducted.

This would prevent a portion of the otherwise allowable SALT deduction from being taken.

If 465 doesn’t apply, the allowed losses would be able to be taken in full.

* + - Who is covered:
			* Individuals, estates, trusts, personal services corporations, and small corporations.
		- Effect of § 469:
			* Any loss due to passive activity is suspended and carried forward to the next year in which there are passive activity gains to offset.
			* Former Passive Activities – § 469(f):
				+ This is any activity that is not currently a passive activity but was a passive activity in a prior year.
				+ If there are carried over PAL from this activity, it will be used to offset gains from this activity.
			* Look at the § 465 allowed losses, were they the result of a passive activity?
				+ If so, then PAL is suspended.
			* If the loss is not a passive activity, they the loss will be ordinary.
		- Material Participation:
			* There is material participation if:
				+ T participated *more than* 500 hours in the activity;
				+ T’s participation is all of the participation in the activity (including non-owners);
				+ T participates *more than* 100 hours *and* no one participates more;
				+ T’s participation is a “significant participation activity” and T aggregate participation is *more than* 500 hours in all SPAs;

SPA: spends *more than* 100 hours & is not otherwise materially participating in the activity;

Result: T participates *more than* 100 hours in the activity and his aggregate

Reg. § 1.469-2T(f):

If there is one or more SPAs;

And there is an aggregate net income from all SPAs;

The result is a ratable portion of the gross income from each activity is treated as not from a passive activity.

Ex: 3 SPAs: (15), 20, 40 = Net 45; Gross 60

 Activity 2: 20 X 45/60 = 15 not passive

 Activity 3: 40 X 45/60 = 30 not passive

* + - * + T materially participated in the activity in 5 out of the last 10 years;
				+ The activity is a personal service activity and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year

E.g., retired law partner with retained interest in the firm.

* + - * + Facts & circumstances
			* Credit for spouse’s participation: § 469(h)(5) In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.
				+ This does not extend to other family members – e.g., a son.
		- Netting of PALs and PIGs
			* § 469(d): allows the PAL from one activity to offset a PIG from another activity.
* **Dispositions of Activities with built-in PAL or 465 Loss:**
	+ 1) AR – AB.= G/L.
		- Reg. § 1.469-2T(c)(2): the disposition is treated as income from that activity.
	+ 2) If there is a gain, offset the gain by any previously disallowed §§ 465 or 469 loss.
	+ 3) If there is a loss
		- Aggregate loss from the selling activity: loss from sale + previously disallowed losses = allowed loss.
			* § 469(g): losses from such activity over income/gain from other passive activities is allowed to offset OI.
			* A loss from disposition is a deduction from such activity – § 1.469-2T(d)(5)(i)(A).
		- Characterize based on how asset was held – capital/ordinary.
			* If capital, subject to capital loss limitations.

**VI. Non-Recognition: Like-Kind Exchanges**

a. General Overview:

* § 1001 has the language “except as otherwise provided”
	+ § 1001-1(a): except as otherwise provided . . .
		- This is a low bar to meet because 1031 works to exclude certain transactions.
			* Don’t want to make it hard to have a realization event and then make the other sections superfluous.
	+ § 1001(c) except as otherwise provided entire gain/loss shall be recognized.
	+ A 1031 Like-Kind exchange is one instance where the Code provides otherwise.
* § 1031(a)(1): No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.
* Personal property is not eligible for 1031 anymore.

b. 1031 General Rule:

* No g/l is recognized if:
	+ Real property held in a T/B or investment purpose is exchanged for:
		- Real property of like-kind;
		- That is held for T/B or investment purpose.
			* *Click v. Comm.; Reesink* are similar to this.
				+ If you immediately use the property for personal use, that is evidence of your intent to not hold the property for investment purposes.
			* Reesink converted the property to a personal residence but only after unsuccessful rental efforts.
	+ Both the properties held before and after must be held for T/B or investment purpose.
	+ T may have like-kind exchange with another party that does not meet 1031. If so, T gets 1031 treatment, and other party gets 1001 treatment.
		- I.e., it doesn’t matter how the party on the other end of the transaction held the property or plans to hold the property for T’s qualification under 1031.

c. Like-Kind Requirements – Reg. § 1.1031-1:

* Reg. § 1.1031(a)-1(b) defines like kind to be of the nature or character not grade or quality. The fact that real estate is improved or unimproved is not material.
* Personal property does not qualify.
* Real property outside of the US is not like-kind property to real property located in the US - § 1031(h).

d. Related Party Transactions:

* § 1031(f): If a taxpayer exchanges property with a related taxpayer, there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection).
	+ If there is a disposition by the related party of the exchanged property or by the taxpayer of the exchanged property within 2 years of the exchange, there shall be no nonrecognition of g/l.
		- Tp will recognize the realized g/l on the original transfer.
			* Losses are disallowed.
		- To determine relationship, look at § 267 – § 1031(f)(3).
		- At the time of the 2nd disposition, T recognizes the g/l that 1031 originally deferred (from the original exchange).
			* § 267 will kick in and prevent a loss recognition here though.
			* § 267(d) will also limit the gain on the second disposition to the extent it exceeds a previously disallowed loss.

e. Basis in 1031 Like-Kind Exchange:

* § 1031(d): the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange.
	+ OG Basis
	+ Reduced by money received
	+ Increased by gain recognized/reduced by amount of loss
	+ New Basis in exchanged property
* If you have to unwind transaction because of 1031(f) Related Party issue, then basis = cost basis or FMV of the property received.
* Basis with Mortgages Exchanged
	+ Old Basis
	+ (mortgage shed)
	+ Mortgage assumed
	+ Cash rec’d
	+ Gain Recognized
	+ (Loss Recognized)
	+ New Basis

f. 1031 is Mandatory, Not Elective:

* RR 61-119: you look at the substance of the transaction rather than the form. If the two steps are mutually dependent, the IRS will recharacterize this as a like-kind exchange (step transaction).
	+ BUT, T can bust 1031 and recognize loss that way
		- *Bell Lines*: T sold to third party for cash instead of exchanging with buyer. Buyer had arranged for the third party to purchase the property without T knowing it. Court said presence of third party without the T’s knowledge that the third party would engage in a transaction with the buyer did not invoke step transaction. T’s losses respected.
	+ RR 61-119: clear that 1031 is not elective and you cannot set up two transaction to get around the nonrecognition provision.

g. Like-Kind & Other Property Exchanged:

* **Amount Realized = FMV of Property Received + Boot (1031(d))**
	+ Liabilities (mortgages) treated as boot under 1031(d).
		- § 1031(b): there is no gain recognition when the mortgage shed is the same as the mortgage assumed – no boot received.
	+ If two liabilities are exchanged
		- Boot = (liability shed – liability assuming) + Boot he paid
			* Can offset shedding more liabilities by paying cash to avoid recognizing gain.
		- If liability shed is less than liability assumed, treat as cash and add to basis.
	+ **G/L When there is Exchange of Liabilities (Reg. 1.1031(d)-2)**
		- **Step 1) Gain/Loss Realized**

FMV of property received

+ Mortgage Shed

- Adjusted Basis

- Cash Paid

- Mortgage Assumed

Gain realized

* + - **Step 2) Boot from Mortgage Shed**

Mortgage Shed Mortgage Assumed

- Mortgage Assumed or - Mortgage Shed

Boot received Boot given

* + - **Step 3) New Basis**

OG Basis

(Mortgage Shed)

Mortgage Assumed

Cash rec’d

Gain Recognized

(Loss Recognized)

New Basis

* *Recognize boot gain only to extent of amount of gain realized.* (1031(b))
* On the giving end of boot tax consequences:
	+ § 1.1031(d)-1(e) provides that if property and stock are exchanged for property, the taxpayer is treated as though he received an amount equal to the stock’s FMV and will recognize the gain/loss on that portion of the exchange.
	+ Need to bifurcate the transaction between like kind & other property.
		- Sale of other property:
			* Recognize g/l based on deemed sale for FMV.
		- Exchange of like kind property
			* Portion of AR attributed to this exchange – AB of property = g/l realized.
	+ Basis:
		- AB other property
		- AB LK property
		- + G recog/ - L recog.
		- New Basis in exchanged property
* On the Receiving end of boot tax consequences:
	+ § 1031(b) does not disqualify an exchange because boot was received. Recognize the lesser of the boot received or the gain realized.
	+ Character of Gain:
		- Determined by how the asset was held – likely capital b/c of T/B or investment use requirement.
			* Watch out for 1250 recapture.
	+ Basis:
		- § 1031(d) states that the basis will be allocated on the basis of FMV on the date of the exchange.
			* “for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.”
		- Allocate basis first to other property (boot) then to like-kind property.
		- Calc.
			* OG Basis
			* - Money rec’d
			* + G recog. / -L reocg.
			* New basis to allocate between properties.
* 1.1031(d)-2: amt. of any liabilities of a taxpayer assumed or taken subject to by the other party is treated as money received.
	+ Cash boot received is not offset by liabilities assumed, but it can be offset by giving cash.

h. Non-Simultaneous Exchanges (1031(a)(3)):

* Property not LK if:
	+ Property received is not identified within 45 days after transferring property; OR
	+ Actual receipt of property does not occur before 180 days after the transfer or after the due date of T’s tax return
* Identifying property
	+ T may identify up to 3 properties to be used in the LK exchange (1.1031(k)-1(c)(4))
	+ T can identify as many properties as he wants as long as aggregate value is not more than 200% of gross value of relinquished property
	+ T can identify as many properties as he wants as long as T ends up with 95% of those properties.
* Security for property in like-kind exchange
	+ Can be mortgage interest, stand-by letter of credit, qualified escrow accounts
	+ CANNOT be cash. So in getting a security for anything other than for cash, make sure there’s no way for T to have access to the funds except for nonperformance of the exchange.)
	+ Can also get a qualified intermediary!

i. Multi-Party 1031 Exchanges:

* RR 77-297: provides an example of how to accomplish a multi party 1031 exchange.
	+ 1) X purchases Y apartment for cash;
	+ 2) X and T exchange properties;
	+ 3) T gets 1031 nonrecognition treatment;
	+ 4) X would recognize any gain/loss made on the sale, but like in the Rev Rule, it is likely there would be no gain because the cost basis would be the same as the amount received.
		- You need to hold the property exchanged for productive use in T/B or investment – it doesn’t look X would be doing either of those things.
		- So because the property X exchanged was not for investment or T/B, no 1031.
* Qualified Intermediary:
	+ Reg. § 1.1031(b)-2 Safe Harbour for QIs:
		- The safe harbor makes sure that the QI is not considered an agent of the party that wants 1031 treatment.
		- Qualified Intermediary Requirements – Reg. § 1.1031(k)-1(g)(4)(iii):
			* Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and
			* Enters into a written agreement with the taxpayer (the “exchange agreement”) and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.
* Safe Harbor for Parking Property in EATs:
	+ Rev. Proc. 2000-37: safe harbor for parking; *Rutherford v. Comm.* (heffer case) allow this transaction:
		- You can get the replacement property first.
		- QEAA (Qualified Exchange Accom. Agmt.
			* 3rd party EAT
			* Replacement property is parked with EAT
			* Relinquished property must be identified within 45 days of parking replacement property;
			* EAT can only hold replacement property for 180 days.
				+ IRS does not allow you to prolong 1031s through EATs.

j. Exchanging of a Fee for a Leaseback:

* *Century Electric*: applies -1(c) straight forwardly: you cannot recognize the loss. This is the earlier case.
* *Jordan Marsh*: distinguishes against *Century Electric*: the mere fact a fee and leasehold are exchanged is not enough. Must look at whether the exchange was for FMV. If the sale was for FMV then the transaction is outside of 1031. The lease looks like it is part of a separate transaction.
	+ Whether the cash consideration paid is equal to the FMV of the value and whether the lease rents are below market would determine whether it is a like-kind exchange and thus whether gain/loss is recognized.
	+ If not required to pay state/local real estate taxes, would look more like an exchange.

**VII. Deferred Payment Sales:**

a. General Overview:

* § 453 only applies to gains. Any losses will be recognized in year of the sale.
* *Installment Sale*: A disposition of property in which one or more payments are to be received after the year of disposition. § 453(b).
	+ This allows the tp to spread his profit out over a period of time rather than recognizing in the same year as the sale.
	+ § 453(c): income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.
		- Formula: Pmt. X (GP/TKP)
* Gross Profit:
	+ § 15a.453-1(b)(2)(iii): defines gross profit.
		- means the selling price less the adjusted basis as defined in section [**1011**](https://www.bloomberglaw.com/product/tax/bc/W1siRG9jdW1lbnQiLCIvcHJvZHVjdC90YXgvZG9jdW1lbnQvWE5PUUFMSDg_amNzZWFyY2g9MjYlMjUyMGNmciUyNTIwMTVhJTI1MjA0NTMtMSUyNTI4YiUyNTI5JTI1MjgyJTI1MjkiXV0--909146ddbb23328ad0ff6d0a431894b91f8d6e07/document/1?citation=26%20USC%201011&amp;summary=yes#jcite) and the regulations thereunder.
* Payment:
	+ The payment by a note is not a payment by itself – an evidence of indebtedness is not a payment – even if guaranteed by a 3rd party (see below).
	+ 15a.453-1(b)(3) defines payments:
		- Payments are not:
			* 3rd party guarantees don’t count as a payment;
				+ A stand-by letter of credit is treated as a 3rd party guarantee;
		- Payments include amounts actually or constructively received in the taxable year under an installment obligation.
			* An evidence of indebtedness that is secured by cash or a cash equivalent is a payment;
				+ such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment.
			* Payment may be received in cash or other property, including foreign currency, marketable securities, and evidences or indebtedness which are payable on demand or readily tradable.
			* If another person (not the tp) owes the debt to the buyer, and the tp receives that obligation, it will be a payment.
			* Marketable securities are payments.
* Exceptions to the Installment Method:
	+ Sales that are dealer dispositions (§ 453(b)(2)(A);
	+ Sales of inventory (§ 453(b)(2)(B);
	+ Sales of Stock traded on an established securities market (§ 453(k);
	+ Sale of Depreciable Property between related persons (§ 453(g)):
		- Sales of depreciable property between related persons is not eligible for § 453(a) treatment. Gain is recognized in the year of disposition.
		- Requirements:
			* 1) must have a sale of depreciable property;
			* 2) Need a related person:
				+ § 453(g) points to § 1239, which points us to § 267.

A person and a corporation if that person owns more than 50% of the stock of that corporation

A person and a partnership if that person owns more than 50% of the capital or profits interest in that partnership

“Related Persons” under 267(b)(3), (10), (11), or (12). Applicable 267 “related persons”:

267(b)(3) 🡪 two corporations in the same controlled group

267(b)(10) 🡪 a corporation and a partnership if the same person owns more than 50% of the stock and more than 50% of the partnership interests

267(b)(11) 🡪 an S corp and another S corp if the same people own more than 50% of the stock of each corp

267(b)(12) 🡪 An S corp and a C corp if the same people own more than 50% in each corp’s stock

1239(c)(2) 🡪 Ownership includes constructive ownership under 267(c) (not (c)(3))

Stock owned directly or indirectly by or for a corp, partnership, estate or trust = owned proportionally by or for its shareholders, partners, or beneficiaries (c)(1)

Individual considered to own stock his family owns directly or indirectly (brothers, sisters, spouse, ancestors, lineal descendants) (267(c)(2), (c)(4)).

No more than one level of constructive ownership applies. (267(c)(5))

* + If the taxpayer elects to not use the installment method (§ 453(d)).
		- The taxpayer must elect out of 453 treatment if the disposition otherwise qualifies.
* § 453(c) Mechanics:
	+ **Step 1:** Determine Gain
		- AR – AB
			* AR = cash down payment + FMV of any not received.
	+ **Step 2:** Determine the Gross Profit Ratio:
		- Formula: GP / TKP - § 15a.453-1(b)
		- *Gross Profit*: Selling price less “qualified indebtedness” up to the amount of basis.
			* If contingent selling price, use the stated maximum selling price as the TKP.
			* *Qualified Indebtedness*:
				+ Includes mortgage or other debt encumbering the property and unsecured debt incurred by the purchaser incident to the purchaser’s acquisition.

Essentially, to the extent you have old and cold debt, you get the benefit of using your basis first to absorb what would be income that would otherwise be from debt relief.

* + - * + Includes tp’s debt relief (e.g., selling property to creditor for cancellation of debt, a novation) Reg. § 15a.453-1(b)(3).
				+ Does not include:

§ 15A-453-1(b)(2)(iv) states that qualified indebtedness is not an obligation created and incurred in contemplation of the disposition of the property, if that results in the tp accelerating the recovery of basis in an installment sale

Tp’s obligation incurred incident to the sale at hand (ex.: legal fees related to the sale) or an obligation functionally related (ex. Medical bills).

* + - * + If it is not QID, no reduction of TKP.

Assumption of the liability will be treated as a payment in the first year.

* + - * Only subtract QID up to the amount of AB.
				+ If there is still remaining QID, the excess is treated as a payment in the year of disposition.
	+ **Step 3:** Multiply GPR X Payment Received to get gain for the year.
		- For year 1: this would be the down payment plus any excess QID or other payment X GPR.
		- For subsequent years, it would be the payment X GPR.
		- The character of gain reported is based on the asset sold.
			* Capital or ordinary/ long-term or short-term/ 1245 or 1250 recapture.
* Recaptured Amounts:
	+ 453(i): any recapture amount is taken into account in year in disposition rather than later during the installment method.
		- § 1250 recapture: 1.453-12(a) tells us that the § 1250 recapture amounts can be reported on the installment method.
			* Until the § 1250 recapture is fulfilled, the entire gain from the year is taxed as 1250 recapture.
* Second Dispositions by Related Persons – § 453(3):
	+ Requirements:
		- 1) Seller must sell property to a related person on an installment plan; and
		- 2) Before Seller receives ***all*** payments on the installment plan, the related person sells (or exchanges) the property.
	+ Results:
		- The AR on the second disposition by the related person is treated as being received by the Seller on the original disposition in the year of the second disposition.
			* The AR is limited by the excess:
				+ The lesser of:

The AR in the second disposition; or

The TKP for the original disposition

* + - * + Over the sum of:

The aggregate amounts of payments from the original sale received by the Seller before the close of the year of the second disposition; plus

The aggregate amounts of payments from the original sale received by the Seller in the prior years.

* + - Later payments – § 453(3)(5):
			* Payments received by the Seller in subsequent years on the original disposition shall not be a payment with respect to the original disposition until the aggregate of the later payments exceed the amount treated as received in the year of the second disposition.
* Disposition of Installment Obligations:
	+ § 453B(a):
		- If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the AR or (2) the FMV of the obligation at time of disposition.
	+ § 453B(a): to the extent that AR exceeds basis in the obligation, then treated as gain.
		- Basis of Obligation:
			* the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full
				+ **Formula: FV – (FV \* GPR) = Basis**
		- § 453B(a) includes satisfaction for other than FV of the obligation.
			* Satisfaction of debt has to be for other than face value for 453B to kick in.
		- A gift is treated as a disposition – RR 79-371
* Rules for Large Installment Sales:
	+ Interest is charged on the installment sales deferred gain on certain large transactions.
		- We are concerned that the tp will get too much of a tax benefit for large sales & obligations – make sure they pay interest on that deferred tax liability. In a sense undoes the benefit.
	+ Transactions Affected:
		- 1) The sales price must exceed $150,000; and
		- 2) The FV of the obligation at the close of the taxable year exceeds $5MM.
	+ Calculations:
		- **Applicable % X Deferred tax liability (DTL) X Underpayment Rate**
			* DTL: the amount of gain with respect to an obligation which has not been recognized as of the close of such taxable year multiplied by the maximum rate of tax in effect under § 1 or § 11, whichever is appropriate.
				+ If capital gain, use maximum capital gain rate (20%).
			* Applicable %: the portion of the aggregate face amount of such obligations outstanding as of the close of such taxable year in excess of $5MM, divided by the aggregate face amount of such obligations outstanding as of the close of such taxable year.
				+ (TKP - $5MM)/Amt. outstanding at close of taxable year.
			* Underpayment Rate: given in § 6621(a)(2).

**VIII. Leasing:**

a. General Overview:

* When there is a sale and leaseback, you want to look at the substances of the transaction to determine who the true owner of the property is.
	+ If there is a true sale, the owner will have:
		- Depreciation deductions;
		- Deductions for interest expense on financing;
		- Lessee entitled to rent deductions for rent;
		- Lessee not entitled to interest deductions (not an obligor on the debt);
		- Lessee not entitled to depreciation deductions.
* Seminal Cases: *Alstores*; *Frank Lyon* & *Hilton*.

b. Real Property:

* Who is the true owner:
	+ *Alstores* Analysis: respect the form of the transaction if other factors are ambiguous. For owner, look to:
		- Who bears the risk of loss;
		- Who pays the normal maintenance expenses;
		- Who gets the benefits and who has the burdens of ownership.
	+ *Frank Lyons* Analysis:
		- Non-tax (regulatory) reasons for entering into the transaction as designed;
		- Evidence of a genuine multi-party transaction;
		- Evidence of a down payment;
		- Competitive bidding;
		- No revenue loss;
		- Lessor retains significant and genuine attributes of lessor status.
	+ *Hilton* Analysis:
		- * Use *Frank Lyon* factors;
				+ This case came out the other way from *Frank Lyons*.
			* Personal liability is a neutral factor;
			* Balloon payment at the end of lease is a neutral factor.