

CHAPTER 9

ACQUISITIONS OF PROPERTY

2017 Edition	Topic	Status
Questions		
1	Effect of property's use on the cost recovery allowed	Unchanged
2	Difference between property use and its type	Unchanged
3	Explain the difference between tangible and intangible property	Unchanged
4	Personal property versus intangible property	Unchanged
5	Initial basis amount and gain recognition disposal	Unchanged
6	Initial basis versus adjusted basis	Unchanged
7	Taxpayer's alternatives for buying a corporate business	Unchanged
8	Problems when buying multiple assets for a single price	Unchanged
9	Tax implications of self-constructed assets	Unchanged
10	Cost capitalization versus expensing on self-constructed assets	Unchanged
11	Explain why gifts are not taxable income	Unchanged
12	Rationale for carryover basis on a gift	Unchanged
13	General rule for basis of gifts	Unchanged
14	Tax effect of making a gift of property when the basis is greater than fair market value	Unchanged
15	General rule in determining when the holding period of an asset begins	Unchanged
16	When is the general rule for the holding period of an asset not applicable	Unchanged
17	The primary valuation date for inherited property	Unchanged
18	The alternative evaluation date for inherited property	Unchanged
19	Deductibility of commissions on the purchase of securities	Unchanged
Problems		
20	Identify use and type of property - six scenarios	Unchanged
21	Identify use and type of property - six scenarios	Unchanged
22	Determining adjusted basis - two scenarios	Unchanged

2017 Edition	Topic	Status
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24-COMM	Effect of easement of basis of property	Unchanged
25	Basis adjustment to common stock with taxable and nontaxable dividends	Unchanged
26-COMM	Sale of an asset - allowed versus allowable depreciation	Unchanged
27	Sale of an asset - allowed versus allowable depreciation	Unchanged
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CHAPTER 9

ACQUISITIONS OF PROPERTY

DISCUSSION QUESTIONS

1. What effect does a property's use have on the cost recovery allowable on the property?

A property's use determines what, if any, deductions can be taken on the property. Current period expenditures related to a property that is used in a trade or business or for the production of income can be deducted. In addition, if the property has a finite life, its cost can be recovered over the period of use through either depreciation, depletion, or amortization deductions. The only recovery allowed on personal use property is at the property's disposition. Even then, if the disposition results in a loss, the capital recovery is allowed only to the extent of the amount realized on the disposition (i.e., a loss on the disposition of a personal use property is not deductible).

2. What is the difference between a property's use and its type?

Type of property refers to whether property is real, personal, or intangible. Any type of property can have any of the three uses of property - in a trade or business, for the production of income, or personal use. For example, a computer is always personal property. The computer can be used in a taxpayer's trade or business, a production of income activity of the taxpayer, or it could be used as a personal asset. Thus, the type of property never changes, but its use may change.

3. Explain the difference between tangible property and intangible property.

Tangible property has a physical existence; it has shape, form and substance. Intangible property only exists due to some economic right conferred by the property. Intangible property is usually represented by a document (e.g., a patent, copyright, or covenant not to compete). However, the value is not in the paper, but in the economic rights conferred in the document.

4. How is personal property different from personal use property?

Personal property is a type of property. It is any tangible property that is not real property. Personal use property is a use of property. It is any property that is used for personal purposes by the taxpayer. Therefore, personal use property can be personal property (e.g., the family car) or real property (e.g., the family residence).

5. Explain the role an asset's initial basis plays in determining the income to be recognized upon disposal of the asset.

The initial basis of the asset establishes the amount of capital recovery allowed on the asset. The basis may be recovered over time through depreciation, depletion, or amortization deductions. Any basis not recovered when the asset is disposed of is used to offset any amount realized from the disposition. Thus, the initial basis determines the maximum amount of capital recovery on the asset.

6. Explain the difference between a property's initial basis and its adjusted basis.

A property's initial basis is the amount paid to obtain the property and place it into operating condition (unless one of the special basis rules applies). It establishes the amount of capital recovery to be allowed on the property. As the property is used, additional expenditures that extend substantially beyond the end of the period of the expenditure (capital expenditures) are added to the basis for recovery. The recovery of capital, (i.e., depreciation) is subtracted from the basis to avoid a double recovery. The adjusted basis of a property is the initial basis with adjustments for capital expenditures (i.e., improvements) and recoveries of capital.

7. Larry is interested in acquiring a business owned by Jane. If Jane's business is organized as a corporation, what options are available to Larry in acquiring the business? Explain to Larry the difference in the options.

Larry can either purchase the assets of the business directly or acquire the stock of the company. The difference between the two is what Larry has a basis in. If he purchases the assets, Larry's basis is in the assets and is at the amount he paid for the assets. If he purchases the stock, his basis is in the stock at the amount he paid for the stock and the basis of the assets of the corporation remain unchanged.

8. What tax problems does a taxpayer encounter when purchasing more than one asset for a single price? Explain.

The main problem is allocating the purchase price between the assets purchased. Because the assets may have different tax characteristics (e.g., one depreciable, one not), each asset purchased must have a basis assigned to it. In addition, the assets may be disposed of at different times, necessitating the identification of the adjusted basis in the individual assets in order to calculate gain or loss on the disposition.

9. What are the tax implications of a taxpayer's self-construction of assets for use in the taxpayer's trade or business?

When a taxpayer self-constructs an asset for use in his or her trade or business, all direct and indirect costs of constructing the asset must be capitalized. Direct costs are those incurred to physically construct the asset - labor, materials, direct overhead. Indirect costs include an allocated portion of costs that support the construction - administrative costs, pension costs, interest on debt to construct the asset, and so on. These indirect costs are costs that are normally expensed in the period incurred. However, under the uniform capitalization rules, they are capitalized and deducted through depreciation on the asset.

10. List some costs that are normally expensed that must be capitalized when a taxpayer self-constructs an asset for use in a trade or business.

Costs that must be capitalized include:

- 1. General administrative costs.**
- 2. Depreciation on equipment.**
- 3. Interest on funds to finance construction.**
- 4. Pension costs of construction workers.**

11. Why are gifts of property not income to the person receiving the gift?

Gifts are not subject to income tax to avoid double taxation. The donor (person making the gift) is responsible for paying any required gift tax. Excluding gifts from income tax avoids having gifts subject to both taxes. Also, a gift is not an exchange because the donor does not receive anything in return.

12. A person who receives property as a gift makes no investment to receive the property. Why is a basis assignment to the gift property necessary even though the donee has no investment in the property?

Because gifts are subject to the gift tax, a basis must be assigned to the property in order that the gift is not subject to income tax when the property is disposed of by the donee. That is, if a basis is not assigned, the gift would effectively be taxed when it is disposed of by the donee.

13. What is the general rule for determining the basis of gift property?

The general rule is that the basis of the donee is equal to the basis of the donor. In addition, any gift tax paid on the net appreciation in the value of the property is added to the basis of the property.

14. Janine is planning to make a gift of 50 shares of Acran, Inc., stock to her nephew to help with his college tuition. The stock cost Janine \$5,000, and its current value is \$4,000. Explain to Janine why the gift might not be the best way to achieve her goal.

Janine should sell the stock. She will realize and recognize a \$1,000 capital loss (\$4,000 - \$5,000). Then Janine can give \$4,000 cash to her nephew.

A primary tax motive for making gifts of property is to pass appreciated property to a taxpayer in a lower marginal tax rate bracket. Because the gift is not subject to income tax, the donee receives the donor's basis. Thus, the appreciation in the value of the property can be realized by the taxpayer in the lower marginal tax rate, resulting in a tax savings.

Because of the split-basis rule for gifts, losses cannot be passed from the donor to the donee. Through this basis rule, the loss in value at the date of the gift could be totally lost when the property is disposed of later. Therefore, it would be better for the donor to realize the loss on the property and make a gift of the proceeds from the sale to avoid this happening.

15. What is the general rule for determining when the holding period of an asset begins?

The general rule is that any asset that has its basis made, in whole or in part, by reference to the basis of another asset or other entity includes the holding period of the other in its holding period. Thus, anytime an asset has a carryover basis, the holding period also carries over. Any property whose basis is made by reference to a market value has a holding period which begins on the date of the fair market value.

16. What type(s) of asset acquisitions do not follow the general rule for determining when the holding period of the asset begins?

Inherited property is always considered to be held long-term. Because the value of inherited property is always at fair market value, the general rule would be for the holding period to begin on the date of the fair market value. However, because Congress has specified that all inherited property is held long-term, the beneficiary may sell the property on the day they receive it and it will be considered long-term.

17. When is the primary valuation date for valuing inherited property? Does the executor of the estate have to do anything to use the primary valuation date?

The primary valuation date is the date of death. The executor of the estate will automatically use this date unless he or she elects to use the alternate valuation date. Thus, the executor need take no action to use the primary valuation date.

18. When is the alternate valuation date for valuing inherited property? When elected, are all assets valued on the alternate date? Explain.

The alternate valuation date is 6 months after the date of death. This date can only be used if the executor of the estate elects to value the assets at that date and the total value of all the estate's assets have decreased. The election can not be made on an asset by asset basis. If the alternate date is elected, any assets distributed before the alternate date must be valued on the date of distribution.

19. Are commissions paid to acquire securities a deductible expense? If not, are they ever deductible?

Commissions are part of the cost of acquiring securities and must be added to the basis of the securities. As part of the basis, they are not deducted (capital is not recovered) until the securities are sold.

PROBLEMS

20. For each of the following assets, determine whether it is personal property, real property, intangible property, or personal use property:

All tangible property is classified as either personal property or real property. Tangible property has a physical existence, while intangible property derives its value from some right that it creates for the owner of the property. Real property is land and any structures attached to land. Personal property is any tangible property that is not real property. Personal use property is tangible property that is used by a taxpayer solely for personal purposes. Thus, personal use property can be either personal or real property.

- a. Reagan gave her mother a new set of golf clubs for Christmas.

Golf clubs are personal property and personal use property.

- b. Roberta bought a whistle and uniform for use in her job as a referee.

The whistle and uniform are personal property. Because Roberta uses the whistle and uniform in her trade or business of being a referee, it is not personal use property.

- c. Rochelle purchased a building and furnishings to use as a pet shop.

The building is real property and the furnishings are personal property.

- d. Graham secured a copyright on the novel that he wrote.

A copyright grants the holder the exclusive rights to the creation embodied by the copyright. As such, it has no physical existence, but does provide a valuable right to the owner. Therefore, a copyright is intangible property.

- e. Farmer Brown installed an air-conditioning unit in the building that houses his chickens.

The air conditioning unit is real property if it is an integral part of the building (i.e., cannot be removed without damaging either the unit or the building). However, if the air conditioning unit is removable it is personal property.

- f. Alonzo traded his truck for cows for his dairy farm.

The cows and truck are both personal property used in a trade or business.

21. For each of the following assets, determine whether it is personal property, real property, intangible property, or personal use property:

All tangible property is classified as either personal property or real property. Tangible property has a physical existence, while intangible property draws its value from some right that it creates for the owner of the property. Real property is land and any structures attached to land. Personal property is any tangible property that is not real property. Personal use property is tangible property that is used by the taxpayer solely for personal purposes. Thus, personal use property can be either personal or real property.

- a. Woodrow spent \$5,380 on trees and shrubs for use in his landscaping business.

The trees and shrubs are inventory to Woodrow. Inventory is considered personal property. The cost of the trees and shrubs will be recovered when they are sold in the ordinary course of business (i.e., cost of goods sold).

- b. Woodrow spent \$12,100 on a new tennis court for the backyard of his personal residence.

The tennis court is considered real estate because it becomes a permanent part of the land. Because its use is not trade or business, or for the production of income it is personal-use realty.

- c. Woodrow purchased the trade name Green Gopher Landscaping for \$3,400 from the owner of a defunct business.

The trade name is an intangible asset used in Woodrow's trade or business.

- d. Woodrow purchased an acre of land with the idea of eventually using it to grow shrubs for resale.

The land is real estate. Currently, it is held for personal investment only. It is not used in Woodrow's business. When he begins growing shrubs on the property, the land converts to business use real property.

- e. Woodrow purchased an alarm system for the fences surrounding his landscaping business.

The alarm system is personal property used in a trade or business. Although it relates to the fences, it is not a permanent attachment to realty.

- f. Woodrow spent \$2,600 on lights for the backyard of his residence.

The lights are personal-use, personal property. They are not permanent attachments to the real estate.

22. Determine the adjusted basis of each of the following assets:

- a. Leineia purchased an automobile 2 years ago for \$30,000. She uses it 75% in her business and 25% for personal use. To date, she has deducted \$4,209 in allowable depreciation on the business use portion of the automobile.

Because the automobile is a mixed-use asset, the business basis and the personal use basis must be kept separately. The initial basis allocation is based on the percentage of business and personal use. The business portion of the automobile is depreciable and depreciation deductions will reduce its basis:

	100% Total	75% Business Use	25% Personal Use
Initial Basis	\$30,000	\$22,500	\$7,500
Less: Depreciation	(4,209)	(4,209)	-0-
Adjusted Basis	<u>\$25,791</u>	<u>\$18,291</u>	<u>\$7,500</u>

- b. Three years ago, Quon purchased an office building for \$330,000. The purchase price was properly allocated as \$250,000 to the building and \$80,000 to the land. Building remodeling cost \$8,000. He paid \$12,000 for the installation of a parking lot and sidewalks. Insurance premiums on the building are \$5,000 per year. Quon has deducted total allowable depreciation on the building of \$70,620 and \$1,000 on the land improvements for the three years.

The adjusted basis of the land and the building must be determined separately because the building is subject to depreciation while the land is not. The land improvements must be accounted for separately since the depreciable life for the improvements is shorter than the depreciable life of the building. The property taxes and the insurance premiums of \$5,000 are expensed in the current year. The adjusted basis of each is:

	Building	Land	Land Improvements
Original Cost	\$250,000	\$80,000	
Remodeling cost	8,000		
Parking lot and sidewalks			\$12,000
Depreciation	(70,620)		(1,000)
Adjusted basis	<u>\$187,380</u>	<u>\$80,000</u>	<u>\$11,000</u>

23. Determine the adjusted basis of each of the following assets:

- a. André purchased a parcel of land three years ago for \$17,000. In the current year, the adjoining property owner sues him, claiming that part of André's property belongs to him under the right of adverse possession. André incurs \$4,000 in legal fees successfully defending against the lawsuit. He pays annual property taxes of \$300 on the land and has paid \$3,700 in interest on the loan he took out to acquire the property.

The adjusted basis is equal to the \$17,000 initial basis plus the \$4,000 of legal fees to defend title to the property (an expenditure that benefits beyond the current period) for a total of \$21,000. The property taxes and interest are current period expenditures that are deducted in the period they are paid.

- b. René purchases 1,000 shares of Cramdem Company common stock for \$8 per share on October 13, 2015. In 2016, Cramdem pays a taxable cash dividend of 30 cents per share. René sells 300 shares on August 22, 2017, for \$3 per share. On December 2, 2017, Cramdem pays a nontaxable cash dividend of 10 cents per share.

The initial \$8,000 (1,000 x \$8) basis is reduced by the \$2,400 (300 x \$8) cost of the shares sold. The taxable dividend is included in René income and does not affect her basis. The nontaxable dividend is a return of investment and the basis in the 700 remaining shares must be reduced by the \$70 (700 x \$.10) cash dividend received, resulting in an adjusted basis of \$5,530:

Initial basis (1,000 x \$8)	\$ 8,000
Less: Cost of 300 shares sold (300 x \$8)	(2,400)
Basis of remaining 700 shares	\$ 5,600
Less: Nontaxable dividend (700 x \$.10)	(70)
Adjusted basis at December 2, 2017	<u>\$ 5,530</u>

- c. Rufus owns 12 acres of land he purchased as an investment for \$5,000. He spent an additional \$37,000 subdividing the land into residential parcels and having utility lines run to the property. After the subdividing and utility lines had been completed, he gifted two acres of the land to his sister as a wedding present.

The cost of subdividing the land is added to the initial cost of the 12 acres resulting in a basis of \$42,000. The basis of the 2 acres gifted to his sister, \$7,000 [(\$42,000 ÷ 12 = \$3,500) x 2] reduces the adjusted basis in the 10 remaining acres to \$35,000.

Original cost	\$ 5,000
Additional costs for subdividing	37,000
Basis before gift	\$42,000
Gift of two acres (\$42,000 ÷ 12 = \$3,500 x 2)	(7,000)
Adjusted basis of ten acres	<u>\$35,000</u>

24. Alberta owns 5 acres of land she purchased several years ago for \$6,500. A new housing development is being built on the north side of her property. The owner of the development needs part of Alberta's land to run utility and sewer lines to the new development. The owner offers Alberta \$13,000 for half of her land, but Alberta decides to wait to see if the land will appreciate further after the development is built. She agrees to grant the developers an easement to run the utility and sewer lines through her property for \$3,000. Write a letter to Alberta explaining the tax consequences of granting the easement.

An easement does not constitute a realization of income because the property has not changed its form or substance (i.e., Alberta still owns the land, she has only granted use of the land). Therefore, the \$3,000 is a nontaxable recovery of capital investment that reduces Alberta's basis in the land to \$3,500 (\$6,500 - \$3,000).

25. Luana pays \$40 per share for 100 shares of Manano Corporation common stock. At the end of the year, the market price of the stock is \$60 per share. During the year, she receives a cash dividend of \$4 per share. Manano reports that \$3 per share is taxable and \$1 per share is a nontaxable dividend. What are the tax effects of these events?

The \$3 per share is reported as gross income and does not affect the basis of the stock. The stock basis is reduced by the \$100 (\$1 x 100) nontaxable dividend that is excluded from gross income. The adjusted basis of the stock is now \$39 per share (\$40 - \$1). The original basis must be reduced because of the \$1 per share capital recovery.

26. Carl Corporation acquires a business use warehouse for \$200,000 on January 2, 2009. From 2009 through 2014, Carl Corporation properly deducts a total of \$30,000 in depreciation. Carl incurs a net operating loss and deducts no depreciation in 2015, even though \$12,500 could have been claimed. Kelsa Company has offered to buy the warehouse for \$185,000. The sale will be completed on January 1, 2016, if Carl accepts the offer. You are asked to review the proposed sale. Write a memorandum explaining the tax results of the proposed transaction.

The basis of depreciable property must be reduced by the greater of the actual depreciation taken on the property or the allowable depreciation. The failure to properly deduct depreciation will result in the allowable depreciation being higher than the actual depreciation. In this case, Carl Corporation must reduce the basis in the warehouse by the \$42,500 (\$30,000 + \$12,500) of allowable depreciation, and leaves an adjusted basis of \$157,500 at the date of the sale. Carl's gain on the sale is \$27,500:

Amount realized from the sale		\$185,000
Adjusted basis of warehouse:		
Original cost	\$200,000	
Less: Allowable depreciation	<u>(42,500)</u>	<u>(157,500)</u>
Gain on sale of warehouse		<u><u>\$ 27,500</u></u>

Carl Corporation should file an amended return for 2015 and deduct the \$12,500 of depreciation it failed to take in that year.

27. Hannibal owns a farm. He purchases a tractor in 2012 at a cost of \$25,000. Because 2012 is a bad year, he does not deduct any depreciation on the tractor in 2012. He sells the tractor in 2016 for \$16,000. He takes straight-line depreciation on the tractor of \$12,500 for the years 2013 to 2016. The total allowable straight-line depreciation for the tractor for 2012 to 2016 is \$15,000. What is Hannibal's gain or loss on the sale of the tractor? Explain.

The basis of depreciable property must be reduced by the greater of the actual depreciation taken on the property or the allowable depreciation. The failure to properly deduct depreciation will result in the allowable depreciation being higher than the actual depreciation. In this case, Hannibal must reduce his basis in the tractor by the \$15,000 of allowable depreciation (it is greater than the \$12,500 depreciation deducted on the tractor). This leaves an adjusted basis of \$10,000 at the date of the sale. Hannibal's gain on the sale of the tractor is \$6,000:

Amount realized from sale		\$ 16,000
Adjusted basis of tractor:		
Original cost	\$ 25,000	
Less: Allowable depreciation	<u>(15,000)</u>	<u>(10,000)</u>
Gain on sale of tractor		<u>\$ 6,000</u>

Instructor's Note: Because the 3-year statute of limitations has lapsed, Hannibal cannot amend his tax return and claim the depreciation expense for 2012.

28. Determine whether each of the following transactions would result in an increase in basis, a decrease in basis, or no effect on basis:

- a. Dolly pays \$3,000 for a survey to disprove her neighbor's claim that the boundaries dividing their properties are in error.

The amount Dolly pays for the survey is a cost of defending her rights in the property and is a capital expenditure and must be added to her basis in the property. The cost of the survey is considered a capital expenditure because the benefits of it extend substantially beyond the end of the current year.

- b. Dolly pays a \$500 street improvement assessment.

The assessment for the street improvement is not a deductible property tax because it is not based on the value of the property. The assessment increases Dolly's basis in the property.

- c. Dolly receives \$1,000 from the county for a portion of her property that was needed to widen the street.

The amount Dolly receives is considered an easement. The \$1,000 she receives is not taxable but is considered a recovery of capital. However, she must decrease her basis in the property by \$1,000. Instructors Note: If the amount Dolly receives exceeds her basis in the property (i.e., she fully recovers her capital), the amount in excess of her basis is considered income.

- d. Dolly's property tax bill totals \$1,200 for the year.

The property tax bill is deductible in the current year because it is based on the value of the property. It can be deducted either as an itemized deduction or as a deductible rental expense. The property tax has no effect on Dolly's basis in the property.

29. During the current year, Horace's personal residence is damaged by a tornado. The residence had an adjusted basis of \$80,000 before the tornado. The cost of repairing the damage is \$30,000. Horace's insurance company reimburses him \$22,000 for the repairs. Horace itemizes his deductions and has an adjusted gross income of \$57,000 for the year. What is his adjusted basis in the residence after the tornado?

The basis of Horace's residence will be increased by the cost of the repairs and decreased by the insurance recovery and his deductible loss (both are capital recoveries). Horace has a deductible loss of \$2,200:

Cost of repairs	\$ 30,000
Less: Insurance reimbursement	(22,000)
Statutory floor	(100)
Loss from tornado	\$ 7,900
Less: Annual limit (10% x \$57,000)	(5,700)
Deductible personal casualty loss	<u>\$ 2,200</u>

The adjusted basis in Horace's residence after the tornado is \$85,800:

Adjusted basis before the tornado	\$ 80,000
Add: Cost of repairs	30,000
Less: Capital recoveries	
Insurance reimbursement	(22,000)
Deductible loss	(2,200)
Adjusted basis after the tornado	<u>\$ 85,800</u>

Note that the \$5,800 increase in Horace's adjusted basis is equal to the unreimbursed portion of the loss that is not deductible due to the personal casualty loss limitations (\$100 + \$5,700 = \$5,800).

30. Amos and Thomas form the Show Corporation during the current year. Amos owns 40% of Show's stock, Thomas owns 20%, and Arthur owns the remaining 40%. Amos paid \$50,000 for his interest, and Thomas paid \$25,000. Amos and Thomas are responsible for Show's daily operations and serve as co-chief executive officers. During the current year, Show Corporation has an operating income of \$60,000 and pays out \$10,000 in dividends. What are Amos' and Thomas's adjusted bases in the Show Corporation stock if

- a. Show Corporation is organized as a corporation?

Show Corporation is a separate taxable entity. The \$60,000 operating income is taxed using the corporate tax rate schedule in Appendix A. The Show corporation's tax liability is \$10,000 [$\$7,500 + (\$60,000 - \$50,000 = \$10,000 \times 25\%)$].

Dividends are distributions of corporate earnings to shareholders and are taxable to the shareholders. Amos reports \$4,000 ($\$10,000 \times 40\%$) and Thomas reports \$2,000 ($\$10,000 \times 20\%$) of dividend income.

Neither the taxable income reported by Show nor the dividends paid affects a shareholder's basis. Amos's basis is \$50,000 (i.e., cost) and Thomas's is \$25,000.

- b. Show Corporation is organized as an S corporation?

Each shareholder must include their share of Show's income in their taxable income. This represents an additional capital investment in the entity because tax has already been paid on the income. The income increases each shareholder's basis in the entity. Dividend payments to shareholders are distributions of shareholder investment and are not subject to tax. As capital recoveries, the dividend payments reduce the basis each shareholder has in the stock. Amos and Thomas's basis at the end of the current year is:

	Amos	Thomas
Original investment - At cost	<u>\$ 50,000</u>	<u>\$ 25,000</u>
Add: Additional investment		
Share of income $\$60,000 \times 40\%$	24,000	
$\$60,000 \times 20\%$		12,000
Less: Recoveries of capital		
Dividends received	(4,000)	(2,000)
Adjusted basis - End of year	<u>\$ 70,000</u>	<u>\$ 35,000</u>

31. Return to the facts of problem 30. Assume that Show Corporation is organized as an S corporation. In its second year of operations, Show has an operating loss of \$40,000 and pays out \$20,000 in dividends. On December 31, Amos gives a 10% interest in Show (i.e., 1/4 of his interest) to his son, Buddy. What is Amos's adjusted basis in the Show stock? What is Buddy's adjusted basis in the Show stock?

As a conduit entity, the tax attributes of an S corporation flow through the corporation to the shareholders. Each shareholder will deduct their share of the NOL (subject to the at-risk and passive loss rules). Dividend payments to shareholders are distributions of shareholder investment and are not subject to tax. As capital recoveries, the dividend payments reduce the basis each shareholder has in the stock.

The gift of the 10% interest by Amos reduces his basis in the stock as of the date of the gift. Because the gift was made on December 31, Amos's adjusted basis to December 31 must be calculated to determine the basis of the gift:

Adjusted basis at beginning of year	\$ 70,000
Less: Recoveries of capital	
Share of loss (\$40,000 x 40%)	(16,000)
Dividends received (\$20,000 x 40%)	<u>(8,000)</u>
Adjusted basis at date of gift	\$ 46,000
Less: Gift to son (\$46,000 x 25%)	<u>(11,500)</u>
Adjusted basis - End of year	<u>\$ 34,500</u>

As a gift, Buddy's basis in the stock is subject to the rules for gifts. In general, Buddy's basis will be equal to Amos's basis at the date of the gift. However, if the fair market value of the stock is less than Amos's basis, then the split basis rule will apply and Buddy will have a basis for gain equal to Amos's basis and a basis for loss equal to the fair market value on the date of the gift.

32. Paula purchases a 40% interest in Dancer Enterprises for \$52,000 on January 2, of the current year. Dancer is organized as a partnership and has an income of \$50,000 in the current year. Dancer also distributes a total of \$15,000 to the partners in the current year. What are the tax effects to Paula of her investment in Dancer? What is her adjusted basis in the partnership at the end of the current year?

A partnership is a conduit entity - it does not pay tax on its income. Each partner is taxed on her or his share of the income. Paula must include \$20,000 ($\$50,000 \times 40\%$) in her income. Amounts distributed to partners are considered returns of capital investment and are not taxed.

Paula's \$52,000 initial basis must be adjusted to reflect the inclusion of income from the partnership. Because she is taxed on the \$20,000, it must be added to her basis to avoid having the income taxed again when Paula disposes of the investment in the partnership. The \$6,000 ($\$15,000 \times 40\%$) distribution Paula receives is not taxed. As a return of capital, her basis must be reduced by \$6,000. These adjustments result in a basis of \$66,000 at the end of the current year:

Initial basis	\$ 52,000
Add: Share of income ($\$50,000 \times 40\%$)	20,000
Deduct: Nontaxable distributions ($\$15,000 \times 40\%$)	(6,000)
Basis at end of year	<u>\$ 66,000</u>

33. Troy owns 600 of the 1,000 outstanding shares of Oiler Corporation. His adjusted basis in the Oiler stock at the beginning of the current year is \$88,000. Oiler Corporation is organized as an S corporation and reports the following results for the current year:

Operating income before special items	\$ 58,000
Charitable contributions	8,000
Nondeductible expenses	9,000
Cash dividends paid	22,000

- a. What is Troy's adjusted basis in the Oiler Corporation stock at the end of the current year?

An S corporation is a conduit entity - it does not pay tax on its income. The income and other tax attributes of the corporation flow through to the owners of the S corporation. Troy owns 60% of Oiler and must include \$34,800 ($\$58,000 \times 60\%$) in his gross income. He is also allowed a charitable contribution deduction of \$4,800 ($\$8,000 \times 60\%$). The \$13,200 ($\$22,000 \times 60\%$) of cash dividends he receives is a return of capital. The \$5,400 ($\$9,000 \times 60\%$) of nondeductible expenses allocated to Troy represents a loss of capital that reduces his investment. This results in a basis of \$99,400:

Basis at beginning of year	\$ 88,000
Add: Share of income	34,800
Deduct: Charitable contribution deduction	(4,800)
Nondeductible expenses	(5,400)
Cash dividends received	(13,200)
Adjusted basis at end of year	<u>\$ 99,400</u>

- b. What is the amount of Troy's gain or loss if he sells the 600 shares for \$100,000 to an unrelated person at the beginning of next year?

Troy's stock basis is \$99,400 at the date of the sale. Therefore, the capital recovery concept provides that Troy will realize a gain if the amount realized (sale price) is greater than the adjusted basis. For example, if the sale price is \$100,000, a gain of \$600 ($\$100,000 - \$99,400$) is realized.

If the sale price is less than the adjusted basis, Troy will not have recovered his capital (stock basis). Therefore, a loss is realized. For example, if the sale price is \$95,000, a loss of \$4,400 ($\$95,000 - \$99,400$) is realized.

34. Erin purchases 2 acres of land in 2016 by paying \$4,000 in cash at closing and borrowing \$40,000 to be repaid at \$8,000 per year for the next 5 years with interest on the unpaid balance at 10%. In addition, Erin agrees to let the seller store farm equipment on the land for 2 years (rental value of \$1,000 per year). In return, the seller agrees to pay the \$800 in points required to obtain the \$40,000 loan. Erin also pays legal and abstracting fees of \$700 on the purchase.
- a. In 2017, Erin pays \$250 in property tax on the land. In addition, the county paves the road that runs by the land and assesses each taxpayer \$1,300 for the paving. What is Erin's adjusted basis in the land at the end of 2017?

Erin's initial basis in the land is equal to the purchase price of the land. In this case, the \$44,000 (\$4,000 of cash and the \$40,000 of debt) must be adjusted for the payments made between Erin and the seller. The use of the land is equivalent to Erin paying the seller \$2,000 and is added to the purchase price. The payment of Erin's points by the buyer is equivalent to a cash payment back to Erin and reduces the purchase price. The attorney and abstracting fees are a cost of acquiring the land and are added to Erin's initial basis of \$45,900. The property taxes are deductible as itemized deductions. The paving assessment is not a tax and is added to the basis of the land. Erin's adjusted basis increases to \$47,200 (\$45,900 + \$1,300).

Cash paid	\$ 4,000
Amount borrowed (paid to seller)	40,000
Value of rental to seller (2 x \$1,000)	2,000
Points paid by seller on Erin's loan	(800)
Attorney and abstracting fees	700
Initial basis in land in 2016	<u>\$ 45,900</u>
Paving assessment	1,300
Adjusted basis in land in 2017	<u><u>\$ 47,200</u></u>

Note: The interest payments on the loan are not capitalized as part of the cost of acquiring the land. The interest paid each year must be deducted under the appropriate rule for deducting interest (e.g., if the land is an investment, the interest is investment interest).

- b. In 2017, Erin sells 1 acre of the land to her brother for \$18,000. What is her gain or loss on the sale of the land? What is her basis in the remaining acre of land?

The basis of the land sold to her brother is \$23,600 (\$47,200 x 1/2). This results in a loss on the sale of \$5,600 (\$18,000 - \$23,600) and leaves Erin with a basis in the land of \$23,600. Because this is a related party sale at a loss, Erin is not allowed to deduct any of the loss. However, her brother can use the loss to offset any gain on a subsequent sale to an unrelated party (Chapter 7).

35. Florian Corporation purchases a piece of land for investment purposes on April 1. Florian pays the seller \$2,000 cash and agrees to pay the seller \$3,000 per year for the next 5 years plus interest at 9% per year on the outstanding balance. As part of the purchase agreement, Florian agrees to pay all property taxes for the year, a total of \$360. In addition, Florian pays legal fees of \$500 connected with the purchase and gives the seller a car worth \$4,000 (Florian's basis is \$11,000). What is Florian Corporation's basis in the land?

The initial basis is equal to the cost of acquiring the land. In this case, Florian has paid \$2,000 cash and agreed to pay an additional \$15,000 ($\$3,000 \times 5$) over the next 5 years. The interest paid on the installment purchase is not capitalized as part of the cost of the land; it will be deducted each year according to the rules for deducting interest. The property taxes of \$90 [$\$360 \times (3 \div 12)$] are the seller's obligation and is part of the negotiated purchase price. The \$4,000 fair market value of the car that Florian gave to the seller is also part of the purchase price. The \$500 of legal fees are a cost of acquiring the land and are added to the initial basis. This gives Florian an initial basis of \$21,590:

Cash paid	\$ 2,000
Installment payments	15,000
Seller's property taxes paid	90
Fair market value of car	4,000
Legal fees	500
Initial basis	<u>\$ 21,590</u>

Instructor's Note: Florian Corporation realizes a loss of \$7,000 (\$4,000 - \$11,000) on the disposition of the car.

36. Alphonse purchases a store and a warehouse. The asking price includes \$150,000 for the store, \$50,000 for the warehouse, and \$90,000 for the land. Alphonse agrees to this price even though he does not want to buy the warehouse because it does not meet his needs. He sells the warehouse building for \$15,000 but has to pay \$10,000 to have the warehouse moved. What is Alphonse's basis in the land and store?

The basis in the store and land is the cost of the store, warehouse and land. The cost of having the warehouse moved is a cost of getting the land ready for use. The proceeds from the sale of the warehouse reduces the basis because the proceeds reduce the cost of having the warehouse moved. Alphonse has a basis in the store of \$150,000 and a basis in the land of \$135,000 ($\$50,000 + \$90,000 + \$10,000 - \$15,000$).

37. Barbara wanted to go into the long-distance trucking business. She bought a used tractor and trailer for \$102,000. However, the trailer wasn't suitable for Barbara's needs, so she sold it for \$24,000 and purchased the trailer she needed for \$30,000. What is Barbara's basis in the tractor? What is Barbara's basis in the trailer?

The proceeds from the sale of the trailer reduce the cost of the tractor, leaving an initial basis in the tractor of \$78,000 ($\$102,000 - \$24,000$).

Barbara has a basis in the new trailer of \$30,000, its cost.

38. On October 1, 2016, Mitzo Realty Partnership purchases a lot for future development for \$60,000 from the Elm Trust. The trust's adjusted basis in the lot is \$20,000. Real estate taxes attributable to the property are \$1,000. The city in which the lot is located operates on a calendar year, and taxes are due on April 1 of the following year. The sales agreement provides that Mitzo will pay the property tax bill in 2017.

- a. What is Mitzo's initial basis in the lot?

The initial basis of \$60,748 includes the explicit price paid (\$60,000) plus the amount of the seller's property taxes (\$748) paid by Mitzo. During 2016, Elm Trust owned the property until October 1. Therefore, 273 days (January 1 - September 30) of the property tax liability is Elm Trust's and 92 days (October 1 - December 31) of the property tax liability is Mitzo's. Although Mitzo paid the entire (\$1,000) property tax liability, \$748 ($\$1,000 \times 273 \div 365$) of it is Elm Trust's. Therefore, this amount is added to Mitzo's initial basis as an added cost of acquisition.

Purchase price	\$60,000
Plus: Seller's share of real estate taxes paid	748
Initial basis in the lot	<u>\$60,748</u>

The \$252 [$\$1,000 \times (92 \div 365)$] related to the part of the year that Mitzo owned the property is deductible as a property tax.

- b. What is Elm Trust's gain on the sale?

The amount realized (\$60,748) by Elm Trust on the sale includes the price of the property plus the amount of property taxes paid by the buyer. Elm Trust's adjusted basis in the lot is \$20,000. Therefore, Elm Trust's gain on the sale is \$40,748 ($\$60,748 - \$20,000$).

Amount realized from the sale	\$ 60,748
Less: Adjusted basis	(20,000)
Gain realized on the sale	<u>\$ 40,748</u>

- c. Assume that the sales agreement provides that Elm Trust will pay its portion of the real estate taxes. The sales price remains at \$60,000. On April 1, 2017, Mitzo Realty Partnership pays the \$1,000 property tax bill. What is Mitzo's initial basis in the lot? What is Elm Trust's gain on the sale?

The \$60,000 sales price is Mitzo's initial basis in the property. When Elm Trust pays its share of the property tax liability (to Mitzo), it has a deduction -- assuming it is a cash basis taxpayer. Although Mitzo pays the whole \$1,000, only \$252 is its liability. Mitzo then has a deductible property tax expense of \$252.

Elm Trust's gain on the sale is \$40,000.

Amount realized	\$ 60,000
Less: Adjusted basis	(20,000)
Realized gain	<u>\$ 40,000</u>

39. Fala is the sole shareholder of Campbell Inc. During the current year, Campbell sells Fala land that had a fair market value of \$40,000 for \$28,000. Campbell has paid \$30,000 for the land. What are the tax effects of the sale for Fala and Campbell? What is Fala's basis in the land?

Because Fala and Campbell are related parties, transactions between them are subject to special scrutiny. In this case, the sale of the land is a bargain purchase. Fala is deemed to have received a dividend from Campbell of \$12,000 (\$40,000 FMV - \$28,000 purchase price) that he must include in income. Campbell is deemed to have sold the property at fair market value (i.e., \$28,000 cash received + \$12,000 of dividend it did not have to pay in cash). This results in a gain on the sale of \$10,000 (\$40,000 - \$30,000) for Campbell.

Fala's basis in the land is \$40,000. Fala has paid \$28,000 in cash and has recognized income of \$12,000 from the bargain purchase. Therefore, the income from the bargain purchase is added to Fala's basis to insure that it will not be subject to tax a second time when the land is disposed.

40. Izzy is an employee of Kosmo's Kustom Kars, Inc. The company rebuilds classic automobiles for resale. Last year, Izzy bought a rebuilt 1956 Thunderbird for \$15,000 from the company. A car like Izzy's Thunderbird generally sells for \$28,000. On December 20 of the current year, Izzy receives an offer of \$25,000 for the car. What are the tax results if Izzy completes the sale?

Because Izzy is Kosmo's employee, the transaction between them is carefully scrutinized. In this case, the acquisition of the Thunderbird is a bargain purchase. Izzy is deemed to have received additional compensation from Kosmo of \$13,000 (\$28,000 - \$15,000). Therefore, Izzy must recognize the \$13,000 as gross income. Izzy's basis in the car is \$28,000. Izzy paid \$15,000 and recognized income of \$13,000 from the bargain purchase. The income from the bargain purchase is added to Izzy's basis to insure that it will not be subject to tax a second time when the car is sold. If the car is sold for \$25,000, Izzy realizes a loss of \$3,000 (\$25,000 - \$28,000). The loss is not deductible. The car is a personal-use asset. Izzy should not sell the car thinking he will be able to deduct a loss on the sale.

41. Nathaniel purchases a house by paying \$25,000 in cash and securing a home mortgage for \$75,000. He also incurs \$3,000 in legal fees, title search, and closing costs. He agrees to pay the property taxes for the entire year (\$6,000), even though his share would be \$1,000. A neighbor pays Nathaniel \$50 for a playhouse located in the backyard. As the neighbor is moving the playhouse from the property, he accidentally damages Nathaniel's fence. The neighbor is unaware of the damage. Not wanting to cause trouble in a new neighborhood, Nathaniel pays \$100 to have the fence repaired. Write a letter to Nathaniel explaining his basis in the house.

Nathaniel paid an initial sales price of \$100,000 for the house and the land. The \$3,000 in legal fees is added to the basis as a cost of acquiring the property. In addition, the \$5,000 (\$6,000 - \$1,000) of property taxes Nathaniel paid in excess of his share is considered part of the cost of acquiring the property. The cost of repairing the fence is considered a normal maintenance cost and is not added to his basis in the house. This gives Nathaniel an initial basis in the house of \$107,950.

Nathaniel's basis in the house is:

Initial purchase price (\$25,000 + \$75,000)	\$ 100,000
Add: Legal fees	3,000
Taxes paid on behalf of seller	5,000
Less: Payment received for playhouse	50
Initial basis in house	<u>\$ 107,950</u>

Instructor's Note: In acquiring the house Nathaniel paid \$100,000 for the house, land and other assets that remained in the home or the yard (e.g., refrigerator, stove, playhouse). Since he sold the playhouse upon moving into the home, it is logical and practical to view it as a recovery of his \$100,000 purchase price.

42. Hester Corporation purchases a building by giving stock with a fair market value of \$30,000 (original cost was \$21,000) and borrowing \$210,000. Hester pays closing costs of \$10,000 on the purchase. For property tax purposes, the land is assessed at \$10,000 and the building at \$40,000. Before buying the property, Hester hires an independent appraiser and receives appraisals of \$21,000 on the land and \$279,000 on the building. Compare initial bases of the properties using different allocation methods. What initial basis amounts should Hester use? Explain. Is there any other way to determine initial basis?

Hester's cost of the land and the building is \$250,000 (\$30,000 value of stock + \$210,000 borrowed funds + \$10,000 closing costs). Because the building is depreciable and the land is not, Hester must allocate the \$250,000 cost between the land and the building. A common method of making the allocation is the use of assessed property tax values. However, because they often reflect only relative values of the properties, an allocation based on the relative property tax values must be made:

	Property Tax Value	Relative Value %	Total Cost	Initial Basis
Land	\$ 10,000	$10/50 = 20\%$	\$ 250,000	\$ 50,000
Building	40,000	$40/50 = 80\%$	\$ 250,000	200,000
Total	<u>\$ 50,000</u>			<u>\$ 250,000</u>

While the use of assessed property values is an accepted allocation, the allocation may also be made based on the appraised values of the property or by agreement with the seller. Because Hester hired an appraiser to determine the values of the land and the building, he could use those values to determine the basis in the land and building.

	Appraised Value	Relative Value %	Total Cost	Initial Basis
Land	\$ 21,000	$21/300 = 7\%$	\$ 250,000	\$ 17,500
Building	279,000	$279/300 = 93\%$	\$ 250,000	232,500
Total	<u>\$ 300,000</u>			<u>\$ 250,000</u>

The apportionment based on the appraised values gives a larger initial basis to the depreciable asset (building). Therefore, Hester will receive a larger cost recovery deduction (depreciation) using this method. Alternatively, Hester and the seller could agree in the sales contract how much was being paid for the land and for the building. NOTE: In addition, to the basis allocation problem, Hester has also realized a gain of \$9,000 (\$30,000 - \$21,000) in exchanging the stock for the building.

43. Earl purchases all the assets and assumes the liabilities of Buddy's Market Shop. Details concerning the adjusted basis and fair market value of Buddy's assets and liabilities are as follows:

Asset	Adjusted Basis	Fair Market Value
Inventory	\$ 30,000	\$ 40,000
Equipment	22,000	70,000
Land	10,000	15,000
Building	118,000	155,000
Liabilities	(60,000)	(60,000)

- a. If Earl pays \$250,000 for Buddy's net assets, what is Earl's basis in the assets purchased?

The fair market value of the assets purchased minus the liabilities assumed is \$220,000. Because Earl paid \$250,000 for assets that have a net value of \$220,000, the remaining \$30,000 (\$250,000 - \$220,000) is goodwill. Buddy will value the assets (and the liabilities) at their market values at the date of purchase and have goodwill of \$30,000.

Inventory	\$ 40,000
Equipment	70,000
Land	15,000
Building	155,000
Goodwill	30,000
Liabilities	(60,000)
Total net asset value	<u>\$ 250,000</u>

- b. Assume that Buddy's Market Shop is a closely held corporation and that Earl pays \$250,000 for all the stock. What is Earl's basis, and what is the basis of the assets of the corporation?

In this case, Earl has not directly purchased the assets of the business. Rather, he has acquired the stock of the corporation for \$250,000. Therefore, Earl has a basis of \$250,000 in the corporate stock. Because only stock has changed hands, the assets remain on the books of Buddy's Market Shop at their adjusted basis.

44. ABC Company purchases all the assets of John's Saw Shop. Details on basis and fair market values of John's Saw Shop's assets are as follows:

Asset	Adjusted Basis	Fair Market Value
Inventory	\$ 10,000	\$ 27,000
Machinery & Equipment	2,000	12,000
Land	8,000	15,000
Building	20,000	6,000

- a. What is ABC's basis in the assets purchased if ABC pays \$40,000 for them?

The total fair market value of the assets purchased is \$60,000. The \$40,000 purchase price must be allocated based on the relative fair market values of the assets purchased:

	Fair Market Value	Relative Value %	Total Cost	Initial Basis
Inventory	\$ 27,000	27/60 = 45%	\$40,000	\$ 18,000
Machinery & Eqt.	12,000	12/60 = 20%	40,000	8,000
Land	15,000	15/60 = 25%	40,000	10,000
Building	6,000	6/60 = 10%	40,000	4,000
Total	\$ 60,000	60/60 = 100%		\$ 40,000

- b. What is ABC's basis in the assets purchased if ABC pays \$70,000 for them?

In this case, ABC has paid fair market value for the assets of John's Saw Shop. The additional \$10,000 (\$70,000 purchase price - \$60,000 fair market value) is considered to be goodwill. ABC will record the assets purchased at their individual fair market values and will have goodwill of \$10,000.

- c. What is ABC's basis if John's Saw Shop is a corporation and ABC purchases all John's stock for \$60,000?

In this case, ABC has not directly purchased the assets of John's Saw Shop. ABC will have a basis in the stock of John's Saw Shop equal to the \$60,000 purchase price. Because the assets have not been directly purchased, they will remain on the books of John's Saw Shop at their adjusted basis.

45. Kieu Corporation constructs a new warehouse. It pays \$100,000 for materials and \$70,000 to the general contractor. Architectural fees total \$18,000. The corporation pays \$13,000 in interest on its loan to finance construction. The land costs \$15,000, and the real estate taxes paid on the land during construction amount to \$1,000. What is Kieu's initial basis in the warehouse?

Kieu's initial cost basis in the warehouse is \$201,000 and \$15,000 in the land. Taxpayers who construct property for their own use must capitalize both the direct and indirect construction costs. Indirect costs are those that are normally expensed in the period incurred but indirectly support the construction project. Indirect costs include interest on funds to finance the construction, certain taxes, general administrative costs, depreciation on equipment, and pension costs for workers on the project. The real estate taxes paid on the land of \$1,000 are deductible as a current expense. The tax is not related to the building.

Direct materials cost	\$ 100,000
Direct contractor costs	70,000
Architectural fees	18,000
Interest on the construction loan	13,000
Initial basis of the warehouse building	<u>\$ 201,000</u>

46. Latham Corporation constructs a new factory building. The materials cost \$300,000. Other costs include direct labor of \$150,000, workers pension costs of \$5,000, architectural fees of \$15,000, and depreciation on equipment of \$25,000. The land was purchased for \$30,000. A loan of \$500,000 is needed to finance the construction, and interest of \$40,000 is paid during the year. What is Latham's basis in the building?

The initial cost basis in the factory is \$535,000 and \$30,000 in the land. Taxpayers who construct property for their own use must capitalize both the direct and indirect construction costs. The basis in self-constructed assets equals the total direct and indirect construction costs. Direct costs include materials, labor, supplies, architectural fees and other costs actually incurred to physically construct the asset. Indirect construction costs include interest on funds to finance the construction, taxes, general administrative costs, depreciation on equipment, pension costs for workers on the project, and other general costs that indirectly support the construction project.

Latham's \$535,000 basis in the building consists of the following direct and indirect construction costs:

Direct materials cost	\$300,000
Direct labor cost	150,000
Pension costs	5,000
Architectural fees	15,000
Depreciation on equipment	25,000
Interest on construction loan	40,000
Basis in building	<u>\$535,000</u>

47. Julia receives 1,000 shares of Cookery Corporation stock from her grandfather as a wedding present. The shares are selling for \$24 per share on the date of the gift. Grandfather paid \$8,000 for them 4 years earlier. He pays \$3,000 in gift tax on the transfer of the shares to Julia.

a. What is Julia's basis in the Cookery Corporation shares?

Because the Cookery Corporation stock is appreciated property ($1,000 \times \$24 = \$24,000$ fair market value $>$ \$8,000 basis), Julia's basis in the shares will be equal to her grandfather's basis plus the gift tax paid on the net appreciation in the value of the stock. This gives Julia a basis of \$10,000:

Grandfather's basis	\$ 8,000
Add: Gift tax on net appreciation:	
$\{ \$3,000 \times [(\$24,000 - \$8,000) \div \$24,000] \}$	2,000
Basis in Cookery Corporation stock	<u>\$10,000</u>

- b. Two months after her wedding, Julia wants to take a trip to Europe. To get the money for the trip, she sells 400 Cookery shares at \$17 per share and pays a \$500 commission on the sale. What is Julia's gain or loss on the sale of the 400 shares? What is her holding period for the shares?

Julia calculates her gain or loss on the sale of the stock as the difference between the amount realized from the sale and the adjusted basis of the shares sold. This results in a gain on the sale of \$2,300:

Amount realized from sale:	
Selling price (400 x \$17)	\$ 6,800
Less: Commissions on sale	(500)
Amount realized	<u>\$ 6,300</u>
Less: Adjusted basis:	
$(\$10,000 \div 1,000 = \$10.00 \times 400)$	(4,000)
Gain on Sale	<u>\$ 2,300</u>

Because Julia's basis in the Cookery Corporation is made, in part, by reference to the basis of her grandfather, Julia is deemed to have held the shares since her grandfather purchased them. Therefore, Julia's holding period is four years (grandfather's) and two months (Julia's). This results in the gain on the sale of the shares being classified as a long-term capital gain.

48. Calculate the basis for gain and basis for loss and the taxable gain or deductible loss for the following gifts which are received and sold in the current year:

	Donor's Adjusted Basis	FMV at Time of Gift	Gift Tax Paid	Selling Price
a.	\$100,000	\$400,000	\$40,000	\$350,000
b.	100,000	80,000	8,000	70,000
c.	100,000	30,000	6,000	40,000

The general rule for property received provides that the donee receives a carryover of the donor's basis. If the FMV of the gift is greater than the donor's basis, the gift tax paid by the donor on the net appreciation is added to the donee's basis. When the FMV is less than the donor's basis, the split basis rule applies. The split basis rule provides that the donee's basis for gain is the donor's basis (carryover basis) and the FMV at the date of the gift is the basis for loss.

a. Donor's basis	\$ 100,000
Gift tax on the net appreciation [(\$300,000 ÷ \$400,000) x \$40,000]	30,000
Donee's Basis for gain and loss	<u>\$ 130,000</u>

Amount Realized	\$ 350,000
Basis	(130,000)
Realized Gain	<u>\$ 220,000</u>

- b. The gift tax is not added to the basis of the property because the FMV at the date of the gift is less than the donor's basis. Basis for gain is \$100,00 and basis for computing loss is \$80,000.

Amount Realized	\$ 70,000
Basis	(80,000)
Realized Loss	<u>\$ (10,000)</u>

- c. The gift tax is not added to the basis of the property because the FMV at the date of the gift is less than the donor's basis. There is no realized gain or loss because the asset is sold for an amount that is between the gain basis (\$100,000) and the loss basis (\$30,000).

Amount Realized	\$ 40,000
Basis	(40,000)
Realized Gain	<u>\$ -0-</u>

49. For his birthday, Moose gives his son, Babe, a valuable basketball card. Moose paid \$100 for the card 12 years earlier. On Babe's birthday, the card is valued in a basketball card guidebook at \$90. What is Babe's basis in the card? Explain.

Because the fair market value of the baseball card (\$90) is less than Moose's basis in the card (\$100), Babe has a split-basis. His basis for calculating gain is his father's basis, \$100. His basis for loss is the fair market value on the date of the gift, \$90.

- a. Assume that Babe sells the card 2 months after his birthday for \$80. What is Babe's gain or loss on the sale of the card? What is the holding period?

The card is sold at a loss. Babe calculates his loss using the loss basis (i.e., FMV at the date of the gift). This results in a loss of \$10 (\$80 - \$90). Because Babe's basis is made by reference to the date of gift, Babe is deemed to have held the card for two months.

- b. Assume that Babe sells the card 2 months after his birthday for \$125. What is Babe's gain or loss on the sale of the card? What is the holding period?

The card is sold at a gain. Babe calculates his gain using the gain basis. This results in a gain of \$25 (\$125 - \$100). Because Babe's basis is made by reference to his father's basis, Babe is deemed to have held the card since his father purchased it. The holding period is 12 years and 2 months.

- c. Assume that Babe sells the card 2 months after his birthday for \$95. What is Babe's gain or loss on the sale of the card?

The sale of the card produces neither a gain nor a loss. A comparison of the \$100 gain basis with the \$95 selling price results in a loss. Similarly, a comparison of the \$90 loss basis with the \$95 selling price results in a gain. When the selling price is between the gain and loss basis, the selling price is deemed to be the basis, and no gain or loss results from the sale.

50. Stockton pays \$10,000 for 1,000 shares of Megacron, Inc., common stock on the day his niece Chama is born. Stockton's plan is to give the stock to Chama when she is ready to go to college. Eighteen years later, Chama is ready to leave for Eastern Private University. She needs the money for tuition. However, the market value of the stock is \$6,500. Stockton's marginal tax rate is 28%. Chama's marginal tax rate is 15%.
- a. What alternative course(s) of action does this situation offer?

Stockton could gift the shares of stock to Chama. Because the fair market value of the stock at the date of the gift is less than Stockton's basis in the stock, if he gifts the stock to Chama, she has a split basis in the stock. Her basis for calculating gain is her uncle's basis of \$10,000. Her basis for loss is the fair market value on the date of the gift, \$6,500. If she sells the stock shortly after receiving the gift, she probably will not report any gain on the sale. However, she could have a minimal loss if the stock price drops between the date she receives the stock as a gift and the date she sells it.

Alternatively, if Stockton sells the stock, he will realize a long-term capital loss of \$3,500 (\$6,500 - \$10,000). Assuming he has no other capital gains to offset the loss, he can deduct only \$3,000 of the loss in the year of the sale. The remaining \$500 (\$3,500 - \$3,000) is carried forward to the following year. The tax benefit received from the sale is only \$840 (28% x \$3,000) and \$140 (\$500 x 28%) the following year. This assumes that Stockton remains in the 28% marginal tax bracket. The receipt of the proceeds from the sale (less any selling expenses) by Chama is tax-free.

- b. Should Stockton sell the shares and give the proceeds to Chama? Explain.

Yes. The best alternative for Stockton is to sell the shares, recognize the loss, and give the proceeds of the sale to Chama. This will allow him to save \$980 in taxes over the subsequent two years. If he gifts the property he will not be able to recognize the \$3,500 (\$6,500 - \$10,000) loss on the stock.

51. Florence's daughter, Eunice, needs \$5,000 to start a business. Florence agrees to give her the money but will have to sell some securities to raise that much cash. Florence has 1,200 shares of Tom Corporation common stock, which is selling for \$5 per share. Florence purchased the shares six months ago for \$4 per share. Florence is in the 28% marginal tax rate bracket, and Eunice is in the 10% marginal tax rate bracket. Should Florence sell the shares and give the proceeds to her daughter? Write a memorandum to Florence explaining the tax results.

No. If Florence sells the shares, she will have a short-term capital gain of \$1,200 $[1,200 \times (\$5 - \$4)]$ and will pay a tax of \$336 $(\$1,200 \times 28\%)$. This will reduce the after-tax realization to \$5,664 $[(1,200 \times \$5) - \$336]$. A better strategy would be to gift the shares of stock to Eunice and have her sell the shares. Florence will not be taxed on the gift and Eunice will have a basis equal to Florence's basis. Because Eunice is in the 10% rate bracket, the short term capital gain is taxed at $10\% \times \$1,200$ or \$120. Thus, the strategy saves \$216 $(\$336 - \$120)$ in taxes.

52. Mikel's daughter, Liudmila, is planning to go to law school in the fall. Mikel has promised her that he will pay her tuition, fees, and book costs. Mikel has 1,000 shares of Konrad Corporation stock that he bought four years ago for \$50 per share plus commissions. He would like to use the stock to finance Liudmila's law school costs. The Konrad Corporation stock is selling for \$40 per share. If Mikel is in the 28% marginal tax rate bracket, should he sell the shares or gift them to Liudmila? Explain the differences in the tax consequences of each option.

If Mikel gifts the shares of stock to Liudmila, because the fair market value of the stock (currently \$40) at the date of the gift is less than Mikel's basis in the stock, she has a split basis in the stock. Her basis for calculating gain is her father's basis of \$50 per share. Her basis for loss is the fair market value on the date of the gift, \$40 per share. If she sells the stock shortly after receiving the gift, she probably will not report any gain on the sale. However, she could have a minimal loss if the stock price decreases between the date she receives the stock as a gift and the date she sells it.

Alternatively, if Mikel sells the stock, he will realize a long-term capital loss of \$10,000 $[(\$50 - \$40) \times 1,000]$. Assuming he has no other capital gains to offset the loss, he can deduct only \$3,000 of the loss in the year of the sale. The remaining \$7,000 $(\$10,000 - \$3,000)$ is carried forward to the following year. The tax benefit received from the sale in the current year is only \$840 $(28\% \times \$3,000)$. However, if she has other capital gains during the year she will receive additional tax savings since these gains can be offset by the remaining \$7,000 capital loss. The receipt of the proceeds of the sale (less any selling expenses) by Liudmila is tax-free.

The best alternative for Mikel is to sell the shares, recognize the loss, and give the proceeds of the sale to Liudmila.

53. Alex begins using his automobile for business purposes in his new job. The automobile cost \$25,000 and has a fair market value of \$9,000 on the date of conversion to business use.

a. What is Alex's initial basis in the automobile? Explain.

Under the split-basis rule, Alex has a dual basis in the automobile. The basis for computing gain is \$25,000. The basis for computing loss and depreciation is the fair market value, \$9,000. If Alex depreciates the automobile, both his gain and loss basis must be reduced by the amount of the depreciation deduction to determine his adjusted basis in the automobile. The adjusted basis is needed to determine the amount of gain or loss if Alex sells the automobile.

b. What is Alex's basis for computing depreciation on the automobile? Explain

Generally, the basis for depreciation is the lower of the FMV at the date of the conversion or the taxpayer's basis. By using this rule, if the FMV > basis, it prevents the taxpayer from taking a deduction for more than their investment in the asset. Conversely, when the FMV < basis, it prevents the taxpayer from receiving a deduction for any loss in value when the asset was held as a personal asset. Alex's basis in the automobile for depreciation purposes is \$9,000.

54. Refer to problem 53. Alex uses the automobile for 3 years and then sells it. During this period, he properly deducts a total of \$3,600 in depreciation. What is Alex's gain or loss on the automobile if he sells it for

Because the split-basis rule applies to the automobile, each basis must be reduced for the amount of depreciation taken on the automobile. This gives Alex an adjusted basis for computing gain of \$21,400 (\$25,000 - \$3,600) and an adjusted basis for computing loss of \$5,400 (\$9,000 - \$3,600).

- a. \$4,000?

A sale of the automobile for \$4,000 results in a loss. Therefore, the loss basis (\$5,400) is used and a loss of \$1,400 (\$4,000 - \$5,400) results from the sale.

- b. \$23,000?

A sale of the automobile for \$23,000 results in a gain. Therefore, the gain basis (\$21,400) is used and a gain of \$1,600 (\$23,000 - \$21,400) results from the sale.

- c. \$9,000?

The \$9,000 selling price falls between the basis for gain (\$21,400) and the basis for loss (\$5,400). Since neither basis can be used to compute the intended gain or loss, the basis is considered to be equal to the selling price and no gain or loss results from the sale (\$9,000 - \$9,000).

55. Yohanse's aunt Millie gives him a storage warehouse valued at \$250,000 to use in his delivery business. The warehouse has been vacant since Millie inherited it from her grandfather several years ago. At that time, the warehouse had a value of \$300,000 and a basis of \$50,000.

- a. What is Yohanse's initial basis in the warehouse? Explain.

Under the split-basis rule, Yohanse has both a gain and a loss basis in the warehouse. The basis for computing gain is Millie's basis, \$300,000. The basis for computing loss and depreciation is the FMV, \$250,000. If Yohanse depreciates the warehouse, both the gain and the loss basis must be reduced by the amount of the depreciation deduction in order to determine the amount of any gain or loss on the disposition of the warehouse.

- b. What is Yohanse's depreciable basis for the warehouse? Explain.

The depreciable basis for the warehouse is \$250,000 (FMV). Because the fair market value of the gift is less than the donor's basis, the split-basis rule applies. Millie's basis is \$300,000 because she acquired the warehouse through an inheritance. Inherited property receives a step-up in basis. Therefore, through application of the split-basis rule, Yohanse's depreciable basis is \$250,000. Instructor's Note: The solution assumes that the land is separately accounted for.

- c. Determine the holding period for Yohanse's warehouse.

Holding period of a gift is determined based on whether a carryover basis is used or fair market value at the date of the gift is used. A carryover basis uses a carryover holding period. If fair market value is used, the holding period begins as of the gift date.

56. Refer to problem 55. Yohanse used the warehouse for 4 years and sells it. During this period, he properly deducts a total of \$25,000 in depreciation. What is Yohanse's gain or loss on the warehouse if he sold it for

Because the split-basis rule for gifts applies to the warehouse, each basis must be reduced for the amount of depreciation taken on the warehouse. This gives Yohanse an adjusted basis for computing gain of \$275,000 (\$300,000 - \$25,000) and an adjusted basis for computing loss of \$225,000 (\$250,000 - \$25,000).

- a. \$285,000?

A sale for \$285,000 results in a gain. Therefore, the gain basis (\$275,000) is used and a gain of \$10,000 (\$285,000 - \$275,000) results from the sale.

- b. \$215,000?

A sale for \$215,000 results in a loss. Therefore, the loss basis (\$225,000) is used and a loss of \$10,000 (\$215,000 - \$225,000) results from the sale.

- c. \$245,000?

The \$245,000 selling price falls between the basis for gain and the basis for loss. Because neither basis can be used to compute the intended gain or loss, the basis is considered to be equal to the selling price and no gain or loss results from the sale.

57. Chanetra inherits land from her aunt, Tameka. Tameka's adjusted basis in the land was \$150,000 and the fair market value at the date of her death was \$200,000. Six months after Tameka's death, the land is appraised at \$225,000. Plans for a nearby shopping mall are announced, and the fair market value skyrockets to \$400,000 when the land is transferred to Chanetra 9 months after her aunt's death. The total value of all of Tameka's assets are \$850,000 at date of death and \$860,000 six months after death.

a. Can the executor elect the alternate valuation date? Explain.

Only the executor is permitted to make the alternate valuation date election. The alternate valuation date is 6 months after the date of death. This date may be used only if the total value of the estate is less than the total value of the estate at the date of death. In this case, because the total value of the estate 6 months after the date of death is greater than the total value of the estate on the date of death, the executor cannot choose the alternate valuation date.

b. What is Chanetra's basis?

Because the fair market value of the estate's assets has increased, the executor cannot elect to use the alternate valuation date. Chanetra's basis is \$200,000 -- the fair market value of the land at the date of her aunt's death.

58. Jesse's grandfather dies on April 13 of the current year. Jesse inherits the following property:

Property	Basis	FMV April 13	FMV Oct. 13
Land	\$ 5,000	\$ 20,000	\$ 13,000
Stock	14,000	10,000	12,000
Watch	50	500	500

- a. What is Jesse's basis in the inherited property?

Absent an election by the executor to use the alternate valuation date, the primary valuation date is used to value the assets of the estate. The primary valuation date is the date of death. Therefore, Jesse's basis will be equal to the fair market value of the assets on April 13, \$30,500. NOTE: Inherited property is always valued at fair market value. The basis of the decedent is never used to value the assets.

- b. What is Jesse's basis in the property if the executor of the estate elects the alternate valuation date?

The alternate valuation date is six months after the date of death. Only the executor of the estate can elect the alternate valuation date. In this case, Jesse's basis will be \$25,500, which is equal to the fair market value of the assets on October 13.

- c. Assume that the executor elects the alternate valuation date and distributes title to the land to Jesse on June 23 of the current year, when the fair market value of the land is \$17,000. What is Jesse's basis in her inherited property?

When the alternate valuation date has been elected and assets are distributed to heirs before the alternate valuation date, they are valued on the date of distribution. In this case, the land was distributed before October 13 and will be valued at \$17,000, the market value on June 23. The stock and the watch will be valued at their fair market values on October 13, which are \$12,000 and \$500 respectively.

- d. Assume that the executor elects the alternate valuation date and distributes the property to Jesse on December 2 of the current year, when the fair market values are \$15,000 for the land, \$11,500 for the stock, and \$500 for the watch. What is Jesse's basis in her inherited property?

The distributions of the property took place after the alternate valuation date. The last possible valuation date is the alternate valuation date. Therefore, Jesse's basis will be \$25,500, which is equal to the fair market value on October 13. The value of the properties at December 2 is irrelevant.

59. Taylor dies on February 19 of the current year. Among the assets in his estate are 500 shares of Dane Company preferred stock. Ten years earlier, Taylor paid \$14 per share for the stock. Market values per share for Dane preferred stock on various dates are as follows:

February 19	\$12
April 1	18
August 19	10
November 21	16

Taylor's will provides that his niece Sherry is to receive the Dane shares. What is Sherry's basis in the shares in each of the following circumstances?

- a. No elections are made by the executor, and the shares are given to Sherry on April 1.

Inherited property has a basis equal to the estate valuation. Absent an election by the executor of the estate, all assets are valued on the date of death. Thus, Sherry's basis will be the \$12 per share market value on February 19.

- b. The executor validly elects the alternate valuation date, and Sherry receives the shares on November 21.

The alternate valuation date is 6 months after the date of death. Sherry's basis will be the \$10 per share market value on August 19.

- c. The executor validly elects the alternate valuation date, and Sherry receives the shares on April 1.

The alternate valuation date is 6 months after the date of death. However, any assets distributed before the alternate date are valued on the date of distribution. Sherry's basis will be the \$18 per share market value on April 1.

60. Phong would like to begin planning her estate. She owns marketable securities that cost \$10,000 twelve years ago. The market value is \$40,000. She wonders whether she should sell her securities and distribute the proceeds to her son before she dies or just give the securities directly to him. Phong's marginal tax rate is 33%; her son's marginal tax rate is 15%. Write a letter to Phong explaining an optimal tax strategy for transferring assets to her son.

Selling the securities now will cause Phong to recognize and realize a gain of \$30,000. Although Phong's marginal tax rate is 33%, long-term capital gains are taxed at 15%. Her tax liability on the gain is \$4,500 (\$30,000 x 15%). *

Amount realized from the sale	\$40,000
Less: Adjusted basis of securities	(10,000)
Gain realized and recognized	\$30,000
Tax rate	x 15%
Tax liability	<u>\$ 4,500</u>

Giftng the securities will result in her son having the securities with a basis of \$10,000. Because the fair market value of the stock is greater than the basis as of the date of the gift, a carryover basis results. When her son sells the securities, his realized and recognized gain is the same as Phong's. However, the son's marginal tax rate is 15%. For taxpayers in the 15% marginal tax bracket, the long-term capital gain rate is 0%. So, his tax liability is zero. A net savings of \$4,500 results.

A third alternative is to hold the securities until Phong dies. Then her estate can transfer the securities to Phong's son. Inherited property takes the fair market value as of the date of death as its basis. Therefore, the son's basis in the securities would be approximately \$40,000. If he immediately sells the securities, no gain results. Assuming there is no estate tax to pay, this alternative is the most favorable from a tax point of view.

*** (This solution assumes that Phong would not be liable for the 3.8% surtax on unearned income.)**

61. Return to the facts in problem 60. Assume that the securities have a fair market value of \$2,000. What positive tax strategy exists in this situation? Explain.

Selling the securities produces a loss of \$8,000 (\$2,000 - \$10,000) for Phong. She can net that loss against any net capital gains. If no capital gains exist, she can deduct the \$3,000 loss in the year of sale. This will produce tax savings of \$990 (\$3,000 x 33%). The remaining \$5,000 (\$8,000 - \$3,000) loss is carried forward and can be used in future years.

If Phong makes a gift of the securities, her son will have a split basis in the securities. If her son sells the stock for more than her original cost (\$10,000), then her son's basis in the stock is \$10,000. If he sells the stock for less than the fair market value at the date of the gift (\$2,000) his basis in the stock is \$2,000. Finally, if her son sells the securities for a price that is between \$2,000 and \$10,000, he recognizes no gain or loss.

If the securities are transferred as part of an inheritance (upon Phong's death), his basis in the securities is the fair market value at the date of death or alternative valuation date. Selling the securities at fair market value produces no gain or loss. The first alternative is the most favorable from a tax point of view.

62. Demetri starts a public accounting practice during the current year. He converts 10% of his home into an office. Demetri purchased the property four years ago for \$100,000. The portion of the purchase price allocated to the house was \$80,000. The house (exclusive of the land) is worth \$120,000 when he begins operating his practice in his home. What is Demetri's basis in the home office?

Because the fair market value of the house (\$120,000) on the date the business use begins is greater than his adjusted basis (\$100,000), the general basis rule applies. Demetri must allocate the adjusted basis of his house (\$80,000) between the business use portion (i.e., home office) and the personal use portion. Because 10% of the home is used as his office, \$8,000 (\$80,000 x 10%) of the basis is business use and \$72,000 (\$80,000 - \$8,000) of the basis is personal use.

Instructor's Note: The same answer will be obtained if the total cost (\$100,000) of the property (i.e., land and house) is used as the starting point for allocating the business and personal use.

63. Alexis purchases a duplex by paying \$18,000 cash and assuming the seller's \$80,000 mortgage. She pays legal fees of \$3,000 and spends \$9,000 on painting and carpeting the 2 units before renting out 1 unit and moving into the other (i.e., 1 unit is her personal residence). Three years later, Alexis purchases a house and moves out of the duplex unit and rents it out. She had taken \$4,800 in depreciation on the rental unit and had her unit repainted at a cost of \$900 before renting it out. Because of a general decline in property values, the duplex is worth only \$60,000 when she moves out of it. What is her adjusted basis in the duplex?

Alexis initial basis in the two units is \$110,000 (\$98,000 + \$3,000 + \$9,000). The purchase price of \$98,000 (\$80,000 + \$18,000), plus the \$3,000 in legal fees, and the \$9,000 in painting and carpeting costs to get the units ready for occupancy. Because she lives in one of the units, the duplex is a mixed-use asset and each unit has an initial basis of \$55,000 (\$110,000 ÷ 2).

Alexis's conversion of her personal residence to business use is subject to the split-basis rules, because the fair market value (\$60,000 ÷ 2 = \$30,000) of the unit is less than its basis (\$55,000). The basis for gain is the basis of the unit prior to conversion, \$55,000. The basis for loss and for depreciation is the fair market value, \$30,000. In addition, her basis is increased by the \$900 painting cost to ready the unit for rental use. The gain and loss basis for the personal unit converted to rental use are \$55,900 and \$30,900:

	<u>Gain Basis</u>	<u>Loss Basis</u>
Fair market value (\$60,000 ÷ 2)		\$ 30,000
Adjusted basis at conversion	\$ 55,000	
Add: Cost of readying unit	900	900
Initial bases	<u>\$ 55,900</u>	<u>\$ 30,900</u>

The adjusted basis in the original rental unit is not affected by the conversion of the other unit. Its adjusted basis is \$50,200 (\$55,000 - \$4,800 depreciation).

64. Phoebe opens a bait delivery service during the current year. In starting up the business, she decides to use her personal truck as a delivery vehicle. She had paid \$16,000 for the truck, which was worth \$10,000 when she turned it into a delivery truck.
- a. What is her initial basis in the truck? What is her basis for depreciation on the truck? Explain.

Personal use property converted to business use is subject to a split-basis rule when the fair market value of the property is less than its basis at the time of conversion. The basis for computing gain is the adjusted basis of the property at the date of conversion. The basis for computing loss and depreciation is the fair market value of the property at the date of conversion. These valuation rules prevent the taxpayer from converting a personal use loss (i.e., the decline in market value before the property is converted) into a deductible business losses or deductible business expense (through depreciation). However, if the property does appreciate in value after the conversion, the taxpayer will not have to recognize any gain until their original basis is recovered (through the use of basis for computing gains). Phoebe's initial gain basis is \$16,000 and her initial loss basis is \$10,000. The \$10,000 loss basis is used to compute depreciation.

- b. After using the truck for 2 years, Phoebe sells it and uses the \$5,300 in proceeds as a down payment on a new delivery van. She had correctly deducted \$2,700 in straight-line depreciation on the truck during the 2 years of business use. Write a letter to Phoebe explaining the amount of gain or loss resulting from the sale and why that is the result.

The adjusted basis in the truck for purposes of calculating Phoebe's gain or loss are:

	Gain Basis	Loss Basis
Initial basis	\$ 16,000	\$ 10,000
Less: Depreciation	(2,700)	(2,700)
Adjusted basis	<u>\$ 13,300</u>	<u>\$ 7,300</u>

The \$5,300 selling price for the truck results in a loss. Phoebe calculates her loss using the \$7,300 loss basis. This results in a loss of \$2,000 (\$5,300 - \$7,300). Note that because of the split-basis rule, none of the \$6,000 (\$16,000 - \$10,000) personal use loss has been deducted either as depreciation or as a loss on the sale.

65. On January 5, 2016, Henry purchases 500 shares of Wichmann, Inc., common stock at a cost of \$24,700. On April 1, 2016, he purchases an additional 300 shares for \$19,500. On November 13, 2016, Wichmann, Inc., declares and distributes a 30% stock dividend. On December 23, 2016, Wichmann distributes a cash dividend of 50 cents per share. On February 19, 2017, Henry sells 800 shares of the Wichmann, Inc., stock for \$45 per share.
- a. How much income or loss does Henry recognize in 2016 and 2017 on his Wichmann, Inc. stock?

In 2016, Henry recognizes dividend income of \$520 and in 2017, he recognizes a capital gain of \$2,000.

Before the stock dividend, Henry owns 800 shares with a total basis of \$44,200. On November 13, he receives an additional 240 (800 x 30%) shares from the stock dividend.

<u>Date Acquired</u>	<u>Shares</u>	<u>Cost</u>
01/05/16	500	\$24,700
04/01/16	300	19,500
11/13/16	240	0

Because the 800 shares are purchased at different prices, Henry must allocate the basis of each purchase to the 240 shares he receives as a stock dividend. The 500 shares purchased on January 5 result in an additional 150 (500 x 30%) shares. Therefore, Henry has 650 shares with a basis of \$38 (\$24,700 ÷ 650). The 300 shares purchased on April 1 result in 90 (300 x 30%) additional shares. Therefore, Henry has 390 shares with a basis of \$50 (\$19,500 ÷ 390).

Henry recognizes \$520 (1,040 shares x \$.50) of ordinary dividend income in 2016 from the receipt of the cash dividend on December 23, 2016. This distribution does not affect Henry's stock basis. (It is assumed that Wichmann, Inc., has adequate E&P to support the dividend distribution).

The stock sale on February 19, results in a gain of \$2,000. Unless they are specifically identified by the taxpayer, the shares are assumed to be sold on a first-in, first-out basis. Using a strict date approach, the 800 shares sold are from the 500 shares purchased on January 5, 2016, and 300 shares purchased on April 1, 2016:

Amount realized (800 x \$45)		\$36,000
Less: Adjusted basis of shares sold		
Jan. 5 purchase (500 x \$38)	\$19,000	
Apr. 1 purchase (300 x \$50)	<u>15,000</u>	(34,000)
Gain realized on the sale		<u>\$ 2,000</u>

However, since the basis and holding period of the stock received through the stock dividend are determined by their acquisition date an acceptable alternative calculation using the FIFO method would be:

Amount realized (800 x \$45)		\$36,000
Less: Adjusted basis of shares sold		
Jan. 5 purchase and dividend shares (650 x \$38)	\$24,700	
Apr. 1 purchase (150 x \$50)	<u>7,500</u>	(32,200)
Gain realized on the sale		<u>\$ 3,800</u>

- b. Explain how can Henry improve the tax results of the 2017 sale.

Henry can reduce his gain by \$1,080 (\$2,000 - \$920) by specifically identifying the shares sold. If Henry identifies the 800 shares with the highest basis, he will realize the lowest gain (or highest loss) on the sale. So, Henry should identify the 390 shares with the \$50 basis and 410 (800 - 390) shares with \$38 basis.

Amount realized (800 x \$45)		\$36,000
Less: Adjusted basis of shares sold		
Apr. 1 (390 shares @ \$50)	\$19,500	
Jan. 5 (410 shares @ \$38)	<u>15,580</u>	(35,080)
Gain realized on the sale		<u>\$ 920</u>

66. On September 5 of last year, Edwina purchases 100 shares of Atlantis Corporation common stock for \$5,000. In December of the current year, she receives a nontaxable stock dividend of 10 shares of preferred stock from Atlantis. At the date of the dividend, the fair market value of the preferred stock was \$20 per share, and the fair market value of the common stock is \$30 per share. What is the basis of the preferred and common shares owned by Edwina?

A nontaxable stock dividend results in an allocation of the basis of the original shares between the original shares and the dividend shares. That is, the dividend shares could not have been obtained had the original shares not been purchased. When the dividend shares are of a different class of stock, the allocation is made based on the relative market value of the two classes of stock on the date of the dividend announcement. Edwina has received 10 shares of preferred stock. The relative market value allocation results in the following basis of the common and preferred shares:

<u># of Shares</u>	<u>Mkt. Value Per Share</u>	<u>Total Mkt. Value</u>	<u>% of Total</u>	<u>Cost of Common</u>	<u>Allocated Basis</u>
Common	100 x \$ 30	\$ 3,000	93.75%	\$ 5,000	\$ 4,687
Preferred	10 x \$ 20	200	6.25%	\$ 5,000	313
Total		<u>\$ 3,200</u>	<u>100.00%</u>		<u>\$ 5,000</u>

The basis of the common shares is \$4,687 (\$46.87 per share) and the basis of the preferred shares is \$313 (\$31.30 per share).

67. Clarece has the option of receiving 2 shares of common stock as a stock dividend on the 10 shares of Ramble Company common stock that she owns. She paid \$30 per share for her 10 shares. The common stock is now selling for \$20 per share. In lieu of receiving the 2 shares, Clarece may elect to receive \$40 in cash. Write a memo explaining the tax consequences of Clarece's options.

When a taxpayer has the option of taking cash in lieu of stock when a corporation issues a stock dividend, the dividend is taxable even if the stock is taken. The taxpayer must recognize as income the fair market value of the shares received in the dividend. Because Clarece receives 2 shares, she must recognize \$40 (2 x \$20) of dividend income. However, Clarece receives a basis in the stock equal to the income recognized. Therefore, her basis in these shares is \$40 (\$20 per share).

68. Eric owns 600 shares of Razor, Inc., stock for which he paid \$3,500 in 2012. On December 14, 2016, he sells the 600 shares for \$4 per share and pays a commission of \$200 on the sale. On January 3, 2017, Eric purchases 500 shares of Razor, Inc., for \$3 per share and pays a \$150 commission on the purchase. What is Eric's recognized gain or loss on the sale of the 600 shares? What is his basis in the 500 shares purchased in 2017?

Eric's 2016 realized loss of \$1,300 can be recognized only to the extent identical Razor, Inc., shares are not repurchased within 30 days of the sale (a wash sale). Eric sold 600 shares and repurchased 500 shares. Therefore, 5/6 of the loss realized, \$1,083 ($500 \div 600 \times \$1,300$), is deferred. Eric can recognize a loss of \$217 ($\$1,300 - \$1,083$) in 2016. The deferred loss of \$1,083 is added to the cost of the replacement shares. The new 500 shares will have a basis of \$2,683 ($\$1,500 + \$100 + \$1,083$).

Amount realized on 2016 sale	
(600 shares x \$4 = \$2,400 - \$200 commission)	\$ 2,200
Less: Adjusted basis	(3,500)
Loss realized on the sale	<u>\$ (1,300)</u>
Deferred loss (Wash sale on 500 of the 600 shares sold)	
(500 ÷ 600 x \$1,300)	1,083
Recognized loss	<u><u>\$ (217)</u></u>

Cost of 500 replacement shares	
(500 shares x \$3 = \$1,500 + \$150 commission)	\$ 1,650
Add: Deferred wash sale loss (\$1,300 - \$217)	1,083
Basis of 500 shares reacquired on January 3, 2017	<u><u>\$ 2,733</u></u>

69. On November 14, 2016, Noel sells 2,000 shares of Marker, Inc., stock for \$6,000. He had purchased the stock 2 years earlier for \$10,000. Because the price of the stock continued to drop, Noel purchases additional shares of Marker stock on December 10, 2016. What are the tax effects of the sale of the stock and the basis in the new shares if Noel

The shares sold on November 14 result in a loss of \$4,000 (\$6,000 - \$10,000). The repurchase of the shares on December 10 (within 30 days of the loss sale) constitutes a wash sale. Any loss on shares replaced is disallowed and added to the basis of the replacement shares.

- a. Repurchases 2,000 shares for \$5,000?

All 2,000 shares were replaced and the entire loss is disallowed. The \$4,000 loss is added to the basis of the replacement shares, resulting in a basis of \$9,000 (\$4,000 + \$5,000).

- b. Repurchases 800 shares for \$2,000?

Only the \$1,600 [$\$4,000 \times (800 \div 2,000)$] loss on the 800 shares replaced is disallowed. The remaining \$2,400 loss is a deductible capital loss. The basis of the 800 replacement shares is \$3,600 (\$2,000 + \$1,600).

- c. Repurchases 4,000 shares for \$9,000?

All 2,000 shares were replaced and the entire loss is disallowed. The \$4,000 loss is added to the basis of 2,000 of the replacement shares, resulting in a basis of \$8,500 (\$4,500 + \$4,000) on 2,000 of the shares. The 2,000 shares that were not part of the wash sale have a basis equal to their cost, \$4,500.

70. Lynn bought 100 shares of Filidelphia Corporation stock for \$10,000 three years ago. On December 24, she sells 50 shares for \$4,000. She plans to buy 100 more shares of Filidelphia stock for \$7,000 on January 17. Explain the tax treatment of these transactions. Include a discussion of the underlying concepts that govern the results. What could Lynn do to change the results?

Lynn's sale at a loss and potential repurchase of substantially identical shares within 30 days constitutes a wash sale. A wash sale loss is disallowed in the year of the sale and deferred. Substance over form governs this disallowance. Because Lynn plans to purchase (within 30 days) the same shares she sold at a loss, the tax law treats the transaction as if she has maintained a continuing interest in the stock. In essence, the law presumes that her financial position in these shares is unchanged and that her primary purpose for the sale is to minimize her tax liability. Strictly speaking the tax law views this as tax evasion, not tax avoidance. However, the disallowance is not permanent and the amount of deferred wash sale loss is added to the cost of the replacement shares. Lynn will not recognize a gain or loss until she disposes of the shares. The capital recovery concept governs gain or loss recognition (as long as no wash sale occurs).

If Lynn repurchases the shares within 30 days of the sale,

Amount realized from December 24 sale (50 shares)	\$ 4,000
Less: Adjusted basis of 50 shares sold ($50 \div 100 \times \\$10,000$)	(5,000)
Loss realized on the sale	<u>\$(1,000)</u>
Deferred loss due to wash sale	<u>1,000</u>
Loss recognized in the year of sale	<u>\$ - 0 -</u>

Cost of 50 shares repurchased ($50 \div 100 \times \\$7,000$)	\$ 3,500
Add: Deferred loss	1,000
Basis of 50 repurchased shares	<u>\$ 4,500</u>

Basis of new 50 shares purchased on January 17	<u>\$ 3,500</u>
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Basis of remaining 50 shares from original purchase	<u>\$ 5,000</u>
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If Lynn delays her repurchase until after the 30-day window expires, there is no wash sale. She can recognize the \$1,000 loss in the year of the sale and reap the benefits from that deduction. The 100 new shares she purchases will have a basis of \$7,000.

ISSUE IDENTIFICATION PROBLEMS

In each of the following problems, identify the tax issues posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

71. Leineia owns 1,000 shares of Serous Corporation common stock. She paid \$26 per share several years ago. On December 31 of the current year, Serous distributes a \$5 per share cash dividend. It reports that \$3 per share is taxable and \$2 is a nontaxable dividend.

The issue is the treatment of the nontaxable portion of the dividend. The \$3 per share tax portion is reported as gross income and does not affect the basis of the stock. Because the \$2 per share she receives is not taxable, Leineia must reduce the basis of the stock so that she does not recover the capital investment twice. The stock basis is reduced by the amount of nontaxable dividend excluded from gross income (\$2 x 1,000). Her adjusted basis is now \$24 per share because of the \$2 per share capital recovery.

72. During the current year, Horace's personal residence is damaged by a tornado. It had an adjusted basis of \$40,000 before the tornado. The cost of repairing the damage is \$11,000. Horace's insurance company reimburses him \$8,000 for the repairs. Horace itemizes his deductions and has an adjusted gross income of \$23,000 for the year.

The issue is to determine the deductible loss on the casualty and its effect on the basis of the residence. Horace has a deductible loss of \$600:

Cost of repairs	\$ 11,000
Less: Insurance reimbursement	(8,000)
Statutory floor	(100)
Loss from tornado	\$ 2,900
Less: Annual limit (10% x \$23,000)	(2,300)
Deductible personal casualty loss	<u>\$ 600</u>

The basis of Horace's residence will be increased by the cost of the repairs and decreased by the insurance recovery and his deductible loss (both are capital recoveries). The adjusted basis in Horace's residence after the tornado is \$42,400:

Adjusted basis before the tornado	\$ 40,000
Add: Cost of repairs	11,000
Less: Capital recoveries	
Insurance reimbursement	(8,000)
Deductible loss	(600)
Adjusted basis after the tornado	<u>\$ 42,400</u>

Note that the \$2,400 increase in Horace's adjusted basis is equal to the unreimbursed portion of the loss that was not deductible due to the personal casualty loss limitations (\$100 + \$2,300 = \$2,400).

73. Jolene owns a dry-cleaning business. During the current year, a rainstorm causes a roof leak that shorts out a dry-cleaning machine. The cost of repairing the machine is \$300, none of which is compensated by Jolene's insurance. The adjusted basis of the machine before it shorted was \$14,000.

The issue is to determine the loss suffered from the rainstorm and its effect on the basis of the dry-cleaning machine. Jolene has a casualty loss deduction of \$300 (the lesser of the decline in value as measured by the repairs or the adjusted basis of the property). The loss is fully deductible as a business casualty loss. Because Jolene has fully recovered the cost of the casualty through the casualty loss deduction, her investment in the machine has not changed and her adjusted basis remains at \$14,000.

74. Charles buys a car for \$15,000 that has a fair market value of \$10,000.

The primary issue is to determine why Charles was able to purchase the car for less than fair market value and what is his relationship with the seller. If Charles purchased the car from his employer, then he may have to recognize the \$5,000 as additional compensation (bargain purchase). The income recognized would be added to his basis in the car.

If the seller was a relative, the difference is a gift. If this transaction was part of a divorce settlement, there is no income to be recognized. If Charles merely got a good bargain in an arm's length transaction, there are no tax consequences.

75. Kendrick pays a construction company \$20,000 to remodel a house.

The issues relate to the purpose and nature of the costs and Kendrick's use of the house. If the work consists of repairs and maintenance work, the cost is deductible if Kendrick uses the house as rental property. But if the remodeling either substantially improves the capacity of the property or extends its useful life, then the cost would have to be capitalized. If Kendrick has only recently acquired the property or planned to convert it to rental property, then the cost must be added to basis.

However, if the home is used as Kendrick's personal residence, repair costs are not deductible. If the construction work is capital in nature, the costs be capitalized (added to the basis of the house).

76. The Lester Partnership wants to develop a shopping mall on a former farm. The farmer wanted \$260,000 for the land, \$80,000 for the farm buildings, and \$130,000 for the farmhouse. Although it wanted only the land, Lester agreed to the farmer's terms. It then paid Ace Wrecking Company \$20,000 to tear down the buildings. Lester was able to sell the scrap lumber from the buildings for \$12,000.

The issue is to determine the treatment of the \$20,000 cost of tearing down the buildings. The cost of the buildings is a cost of acquiring the land. The \$20,000 cost of tearing down the buildings is also a cost of getting the land ready for use. The \$12,000 from the sale of the scrap lumber is a reduction of the cost of tearing down the buildings. This results in a basis of \$478,000 (\$260,000 + \$80,000 + \$130,000 + \$20,000 - \$12,000).

77. Carter wants to retire from his florist business, and his long-time employee, Howard, would like to take over the business.

The issue is to determine the best way to structure the sale of the business. One question is whether the business is currently operated as a sole proprietorship, a partnership or corporation. If it is a corporation, then Howard can either buy the assets or stock from Carter. The book value and fair market value of the assets and the desires of Howard and Carter will impact this decision.

78. For his 18th birthday, Kevin gave his son, Gabe, 5 gold coins which he paid \$500 each for 2 years earlier. On Gabe's birthday, coins were selling for \$450. One month after his birthday, Gabe sells 2 of the coins for \$525 each and uses the money to buy a motorcycle.

The issue is to determine the gain or loss on the sale and whether the gain or loss is a short-term or a long-term capital gain or loss. Because the fair market value of the coins at the date of the gift is less than Kevin's basis in the coins, Gabe has a split-basis. His basis for calculating gain is his father's basis, \$500. His basis for loss is the fair market value on the date of the gift, \$450.

The coins were sold at a gain. Therefore, Gabe calculates his gain using the gain basis. This results in a gain of \$50 [(2 x \$525 = \$1,050) - (2 x \$500 = \$1,000)]. Because Gabe's basis is made by reference to his father's basis, Gabe is deemed to have held the coins since his father purchased them. Therefore, Gabe's holding period is two years (Kevin) and one month (Gabe). This makes the gain on sale a long-term capital gain.

79. Tommi inherits Dierhopf Corporation common stock from her uncle, Norvel. Norvel's adjusted basis in the stock is \$200,000, and the fair market value is \$380,000. Six months after Norvel's death, the stock's value is \$420,000. Nine months after his death, when the stock's value is \$350,000, Tommi receives the stock from her uncle's estate.

The issue is to determine the Tommi's basis in the stock. This will depend on the date the executor uses to value her Uncle's estate. If the primary valuation date is used by the executor, Tommi's basis will be the \$380,000 fair market value on the date of Norvel's death. If the executor elects the alternate valuation date, Tommi's basis will be the \$420,000 fair market value six months after Norvel's death. This is the latest date that the stock can be valued. Under no circumstances would Tommi's basis be the \$350,000 value nine months after Norvel's death.

80. On September 14 of last year, Wenona purchases 100 shares of Campbell Corporation common stock at a total cost of \$8,000. In December of the current year, Campbell pays a nontaxable stock dividend of 1 share of preferred stock for every 10 shares of common. On the date of the dividend announcement, Campbell's common stock is selling for \$14 per share and its preferred stock for \$20 per share.

The issue is the basis of the 10 preferred shares of stock. A nontaxable stock dividend results in an allocation of the basis of the original shares between the original shares and the dividend shares. That is, the dividend shares could not have been obtained had the original shares not been purchased. When the dividend shares are of a different class of stock, the allocation is made based on the relative market value of the two classes of stock on the date of the dividend announcement. Wenona has received 10 shares of preferred stock ($1,000 \div 10 = 100$). The relative market value allocation results in the following basis of the common and preferred shares:

	<u># of Shares</u>	<u>Mkt. Value Per Share</u>	<u>Total Mkt. Value</u>	<u>% of Total</u>	<u>Cost of Common</u>	<u>Basis</u>
Common	1,000	\$ 14	\$ 14,000	87.5%	\$ 8,000	\$ 7,000
Preferred	100	\$ 20	2,000	12.5%	\$ 8,000	1,000
Total			<u>\$ 16,000</u>	<u>100%</u>		<u>\$ 8,000</u>

The basis of the common shares is \$7,000 (\$7 per share) and the basis of the preferred shares is \$1,000 (\$10 per share).

81. Monica owns 1,400 shares of Northeast Utilities common stock. In August of this year, when its stock was selling for \$10 per share, Northeast announced a 20% stock dividend. In lieu of receiving the dividend shares, stockholders have the option of receiving \$2 per share in cash.

The issue is the treatment of the dividend and its effect on her basis in the shares of stock she owns or those that she receives if she takes the dividend in stock. If Monica takes the dividend in cash, she is taxed on the \$2,800 ($1,400 \times \2) she receives. Because she pays tax on the cash received, no adjustment to the basis of her stock is necessary.

When a taxpayer has the option of taking cash in lieu of stock in a stock dividend, the dividend is taxable even if the stock is taken. The taxpayer must recognize as income the fair market value of the shares received in the dividend. If Monica takes the dividend in shares of stock, she receives 280 ($1,400 \times 20\%$) new shares. She must recognize \$2,800 ($280 \times \10) of dividend income from the receipt of the stock. Because Monica includes the value of the stock in her gross income, she receives a basis in the stock equal to the income recognized. Therefore, her basis is \$2,800.

82. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Treasury Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Sec. 168(a)(1)] that answers the question. Note: If the answer can be found in both the code and regulations, you must provide both authorities.
- a. On March 1, Angela sells land that cost \$20,000 for \$32,000. To make the sale, Angela agrees to pay the property taxes on the land for the entire year. What code section and/or regulation provides the tax treatment of the payment of the property taxes on the sale of the property?

Sec. 1001(b)(1) requires the amount realized on the sale of the proper to not take into account real property taxes of the purchaser that are paid for by the seller of the property.

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS. **1001(b) AMOUNT REALIZED.** — *The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized —*

1001(b)(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

1001(b)(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

Reg. Sec. 1.1001-1(b) reiterates that requirement that the seller not include real property taxes of the purchaser that are paid by the seller of the property in the amount realized on the sale. This is clarified in Example 1 of Reg. Sec. 1.1001-1(b)(4).

§1.1001-1., Computation of gain or loss(b) Real estate taxes as amounts received

(1) Section 1001(b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164(d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001(b), any amount received as reimbursement for taxes which are treated under section 164(d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164(d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the seller. See also paragraph (b) of §1.1012-1.

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164(d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). Assume that the contract price on the sale of a parcel of real estate is \$50,000 and that real property taxes thereon in the amount of \$1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that \$750 of the taxes are treated under section 164(d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is \$50,000. Similarly, \$50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of \$50,000, the amount realized by the seller would be \$49,250, since the sales price would be deemed to include \$750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, \$49,250 would be the purchaser's cost.

- b. Miguel receives stock with a fair market value of \$30,000 from his grandfather as a wedding present. His grandfather's basis in the stock is \$5,000. A gift tax of \$2,000 is paid by the grandfather on the transfer. What code section and/or regulation provides the tax treatment of the gift taxes paid by the grandfather?

Sec. 1015 (d)(1) states that the basis of property acquired by gift on or after September 2, 1958 is increased by the amount of the gift tax paid on the gift.

SEC. 1015. BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST.

1015(d) Increased Basis for Gift Tax Paid. —

1015(d)(1) In general. —If —

1015(d)(1)(A) the property is acquired by gift on or after September 2, 1958, the basis shall be the basis determined under subsection (a), increased (but not above the fair market value of the property at the

time of the gift) by the amount of gift tax paid with respect to such gift, or

However, Sec. 1015(d)(6)(A) limits the amount of gift tax paid to the ratio of the net appreciation in the value of the gift to the amount of the gift.

1015(d)(6) Special rule for gifts made after December 31, 1976. —

1015(d)(6)(A) In general. —*In the case of any gift made after December 31, 1976, the increase in basis provided by this subsection with respect to any gift for the gift tax paid under chapter 12 shall be an amount (not in excess of the amount of tax so paid) which bears the same ratio to the amount of tax so paid as —*

1015(d)(6)(A)(i) the net appreciation in value of the gift, bears to

1015(d)(6)(A)(ii) the amount of the gift.

Sec. 1015(d)(6)(B) defines the net appreciation in the value of the gift as the excess of the fair market value of the gift over the donor's adjusted basis in the gift property immediately before the gift.

1015(d)(6)(B) Net appreciation. —*For purposes of paragraph (1), the net appreciation in value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift.*

Reg. Sec. 1.1015-5(c)(1) reiterates the addition of the gift tax paid on the net appreciation in the property to the basis of the gift property.

§1.1015-5, Increased basis for gift tax paid

(c) Special rule for increased basis for gift tax paid in the case of gifts made after December 31, 1976

(1) In general. —*With respect to gifts made after December 31, 1976 (other than gifts between spouses described in section 1015(e)), the increase in basis for gift tax paid is determined under section 1015(d)(6). Under section 1015(d)(6)(A), the increase in basis with respect to gift tax paid is limited to the amount (not in excess of the amount of gift tax paid) that bears the same ratio to the amount of gift tax paid as the net appreciation in value of the gift bears to the amount of the gift.*

(2) Amount of gift. —*In general, for purposes of section 1015(d)(6)(A)(ii), the amount of the gift is determined in conformance with the provisions of paragraph (b) of this section. Thus, the amount of the gift is the amount included with respect to the gift in determining (for purposes of section 2503(a)) the total amount of gifts made during the calendar year (or calendar quarter in the case of a gift made on or before December 31, 1981), reduced by the amount of any annual exclusion allowable with respect to the gift under section 2503(b), and any deductions allowed with respect to the gift under section 2522 (relating to the charitable deduction) and section 2523 (relating to the marital deduction). Where more than one gift of a present interest in*

property is made to the same donee during a calendar year, the annual exclusion shall apply to the earliest of such gifts in point of time.

(5) Examples. — *Application of the provisions of this paragraph (c) may be illustrated by the following examples:*

Example 1. (i) *Prior to 1995, X exhausts X's gift tax unified credit available under section 2505. In 1995, X makes a gift to X's child Y, of a parcel of real estate having a fair market value of \$100,000. X's adjusted basis in the real estate immediately before making the gift was \$70,000. Also in 1995, X makes a gift to X's child Z, of a painting having a fair market value of \$70,000. X timely files a gift tax return for 1995 and pays gift tax in the amount of \$55,500, computed as follows:*

Value of real estate transferred to Y	\$100,000
Less: Annual exclusion	10,000
Included amount of gift (C)	\$ 90,000
Value of painting transferred to Z	\$ 70,000
Less: annual exclusion	10,000
Included amount of gift	60,000
Total included gifts (D)	\$150,000
Total gift tax liability for 1995 gifts (B)	\$ 55,500

(ii) *The gift tax paid with respect to the real estate transferred to Y, is determined as follows:*

$$\frac{\$ 90,000(C)}{\$150,000(D)} \times \$55,500 = \$33,300$$

(iii) (A) *The amount by which Y's basis in the real property is increased is determined as follows:*

$$\frac{\$30,000 \text{ (net appreciation)}}{\$90,000 \text{ (amount of gift)}} \times \$33,300 = \$11,000$$

- c. Gloria exchanges her interest in the Amling Partnership for an interest in the Staten Partnership. What code section and/or regulation denies like-kind exchange treatment on Gloria's exchange?

Sec. 1031(a)(2)(D) states that exchanges of partnership interests are not eligible for the nonrecognition provisions for like kind property provided in **Sec. 1031(a)(1)**. This is reiterated in **Reg. Sec. 1.1031-1(a)(iv)**. In addition, the regulation provides that **Sec. 1031** does not apply to any exchange of any type of partnership interest.

SEC. 1031. EXCHANGE OF PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT.

1031(a) Nonrecognition of Gain or Loss From Exchanges Solely in Kind.

1031(a)(1) In general. —No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

1031(a)(2) Exception. —This subsection shall not apply to any exchange of —

1031(a)(2)(A) stock in trade or other property held primarily for sale,

1031(a)(2)(B) stocks, bonds, or notes,

1031(a)(2)(C) other securities or evidences of indebtedness or interest,

1031(a)(2)(D) interests in a partnership,

§1.1031(a)-1., Property held for productive use in trade or business or for investment

(a) In general

(1) Exchanges of property solely for property of a like kind. —Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of —

(i) Stock in trade or other property held primarily for sale;

(ii) Stocks, bonds, or notes;

(iii) Other securities or evidences of indebtedness or interest;

(iv) Interests in a partnership;

(v) Certificates of trust or beneficial interests; or

(vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of

the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1) (iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

- d. Melvin's apartment building is condemned by the City of Lacy. To compensate Melvin, the city gives him a comparable apartment building in another part of the city. Melvin had paid \$80,000 for the apartment building. The replacement building is worth \$125,000. What code section and/or regulation allows Melvin to defer recognition of the gain he realizes on his apartment building?

Sec. 1033(a)(1) provides no gain is recognized on property that is involuntarily converted due to a condemnation directly into property that is similar or related in service of use. Reg. Sec. 1033(a)-2(b) provides the same treatment and adds that the nonrecognition of gain is mandatory.

Sec. 1033, INVOLUNTARY CONVERSIONS

1033(a) General Rule. —If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted —

1033(a)(1) Conversion into similar property. —Into property similar or related in service or use to the property so converted, no gain shall be recognized.

§1.1033(a)-2., Involuntary conversion into similar property, into money or into dissimilar property

Involuntary conversion into similar property, into money or into dissimilar property

(a) In general. —The term “disposition of the converted property” means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) Conversion into similar property. —If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such nonrecognition of gain is mandatory.

83. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Treasury Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Sec. 168(a)(1)] that answers the question. Note: If the answer can be found in both the code and regulations, you must provide both authorities.

Jerry and Jane are married on March 18, 2016. They use Jane's house as their residence and sell Jerry's house on April 27, 2016 for \$420,000. Jerry had purchased the house in 2009 for \$120,000.

- a. What code section and/or regulation allows the exclusion of gain from the sale of a taxpayer's residence?

Sec. 121(a) allows the exclusion of gain from the sale or exchange of a property the taxpayer has owned and used as their principal residence for 2 of the 5 years preceding the date of the sale. The requirements for the exclusion are reiterated in Reg. Sec. 1.121-1(a).

SEC. 121. EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE.

121(a) EXCLUSION. —Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

§1.121-1., Exclusion of gain from sale or exchange of a principal residence

(a) In general. —Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

- b. What code section and/or regulation provides the general limit on the amount of gain that can be excluded?

Sec. 121(b)(1) limits the amount of gain excluded to \$250,000. Sec. 121(b)(2)(A) raises the limit for a married couple filing a joint return to \$500,000 provided that at least one spouse meets the ownership requirement and both spouses meet the use as a residence requirement. Sec. 121(b)(2)(A)(iii) also states that neither spouse can be ineligible for exclusion due to Sec. 121(b)(3). Since Jane has not met the 2-year use requirement, they are not eligible for the \$500,000 exclusion.

121(b) Limitations. —

121(b)(1) In general. —The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed \$250,000.

121(b)(2) Special rules for joint returns. —In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property —

121(b)(2)(A) \$500,000 limitation for certain joint returns. —Paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if —

121(b)(2)(A)(i) either spouse meets the ownership requirements of subsection (a) with respect to such property;

121(b)(2)(A)(ii) both spouses meet the use requirements of subsection (a) with respect to such property; and

121(b)(2)(A)(iii) neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

Reg. Sec. 1.121-2(a)(1) allows the exclusion of up to \$250,000 of gain on the sale of a principal residence. Reg. Sec. 1.121-2(a)(3)(i) increases the exclusion to \$500,000 for a married couple filing a joint return provided that one spouse meets the ownership requirement and both spouses meet the use requirement.

§1.121-2., Limitations**(a) Dollar limitations**

(1) In general. —A taxpayer may exclude from gross income up to \$250,000 of gain from the sale or exchange of the taxpayer's principal residence. A taxpayer is eligible for only one maximum exclusion per principal residence.

(3) Special rules for joint returns

(i) In general. —A husband and wife who make a joint return for the year of the sale or exchange of a principal residence may exclude up to \$500,000 of gain if —

A) Either spouse meets the 2-year ownership requirements of §1.121-1(a) and (c);

(B) Both spouses meet the 2-year use requirements of §1.121-1(a) and (c); and

C) Neither spouse excluded gain from a prior sale or exchange of property under section 121 within the last 2 years (as determined under paragraph (b) of this section).

Sec. 121(b)(3) disallows the exclusion if the taxpayer has claimed the exclusion during the 2-year period ending on the date of the sale.

121(b)(3) Application to only 1 sale or exchange every 2 years.

121(b)(3)(A) In general. — *Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.*

- c. What code section and/or regulation further limits the amount of gain that Jerry and Jane can exclude on their joint return?

If a spouse does not meet the ownership and use requirements of Sec. 121(b)(2)(A), Sec. 121(b)(2)(B) allows each spouse to claim the exclusion they would have been entitled to if they had not been married. Jerry can claim his \$250,000 exclusion even though Jane does not qualify for the exclusion on the sale of the property.

121(b)(2)(B) Other joint returns. — *If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.*

When a spouse fails to meet the requirements for the \$500,000 exclusion, Reg. Sec. 1.121-2(a)(3)(ii) allows each spouse to claim the exclusion they would have been entitled to had they not been married. Examples 4-6 of Reg. Sec. 1.121-2(a)(4) illustrate the application of the exclusion to married taxpayers.

(ii) Other joint returns. — *For taxpayers filing jointly, if either spouse fails to meet the requirements of paragraph (a)(3)(i) of this section, the maximum limitation amount to be claimed by the couple is the sum of each spouse's limitation amount determined on a separate basis as if they had not been married. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.*

The provisions of paragraph (a) are illustrated in examples 4-6 set forth below. The examples assume that §1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property.

Example 4. Married Taxpayers H and W sell their residence and file a joint return for the year of the sale. *W, but not H, satisfies the requirements of section 121. They are eligible to exclude up to \$250,000 of the gain from the sale of the residence because that is the sum of each spouse's dollar limitation amount determined on a separate basis as if they had not been married (\$0 for H, \$250,000 for W).*

Example 5. Married Taxpayers H and W have owned and used their principal residence since 1999. *On February 16, 2002, H dies. On September 24, 2002, W sells the residence and realizes a gain of \$350,000. Pursuant to section 6013(a)(3), W and H's*

executor make a joint return for 2002. All \$350,000 of the gain from the sale of the residence may be excluded.

Example 6. Assume the same facts as Example 5, except that W does not sell the residence until January 31, 2005. Because W's filing status for the taxable year of the sale is single, the special rules for joint returns under paragraph (a)(3) of this section do not apply and W may exclude only \$250,000 of the gain.

84. **TAX SIMULATION.** Blair and Britain divorce in the current year. Blair agrees to transfer her interest in their principal residence to Britain. They had purchased the home for \$80,000 four years before the divorce. At the time of the divorce, the house is worth \$120,000.

Required: Determine the income tax consequences of this transfer of property for Blair and Britain. Search a tax research database and find the relevant authority(ies) that forms the basis for your answer. Your answer should include the exact text of the authority(ies) and an explanation of the application of the authority to Britain and Blair's facts. If there is any uncertainty about the validity of your answer, indicate the cause for the uncertainty.

Sec. 1041(a) provides that:

No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)— (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce.

Thus, neither Britain nor Blair will recognize a gain or loss on the transfer.

Sec. 1041(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS. -- In the case of any transfer of property described in subsection (a) -- Sec. 1041(b)(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and 1041(b)(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

85. **INTERNET ASSIGNMENT** In the United States, gifts of property are subject to the gift tax. To avoid double taxation, the income tax excludes the receipt of a gift from taxable income. To ensure that a subsequent sale of gift property does not tax the gift, a basis is assigned to property received by gift. Other methods can be used to tax gifts of property. Use the Internet to find information on the taxation of gifts in another country. Compare the taxation of gifts in another country with the United States tax treatment. Which method do you think is better? Explain.

There are two good resources for international tax information. One is Ernst & Young's Global Executive at <http://www.ey.com>. This contains a series of country profiles that overview taxation in 150 countries. Another source may be found at <http://www.taxsites.com/>. These sources can be located by entering "international tax" as key words.

As an example of information which can be found, Israel does not currently impose taxes on inheritances or bona fide gifts that would normally be subject to capital gains tax or land appreciation tax. The recipient's tax cost basis and date of purchase are deemed to be the same as those for the transferor of the property.

INSTRUCTOR'S NOTE: Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

86. **INTERNET ASSIGNMENT** The basis of inherited property is generally the fair market value at the date of death. This enables the person who inherits the property to receive a “step-up” in basis. Use the Internet to find discussions related to this “stepped-up” basis.

An example of a web site that discusses the advantages can be found at <http://www.jklasser.com> "Tax Basis for Inherited Assets." This discussion was found at the J.K. Lasser home page by using a general search engine. The web pages of other tax preparation software probably contain similar information. In addition, similar material was found at: <http://www.fairmark.com/capgain/basis/decedent.htm> in an article entitled "Stock Received from a Decedent." Publication 551 may be accessed at www.irs.gov and contains a discussion on basis of inherited property.

A much more detailed article entitled "The Benefit of Tax Deferral and Stepped-up Bases in Taxable Investments" by William E. Fender, JD, CPA can be found in the CPA Journal Online at: <http://www.nysscpa.org/cpajournal/1997/1097/dept/PFP1097.htm>.

INSTRUCTOR'S NOTE: Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

87. **RESEARCH PROBLEM** Several years ago, Steve gave his nephew Rashan his coin collection valued at \$12,000 with a basis of \$3,000. Steve's intent was to ensure that Rashan has money for college. Rashan is now a senior in high school, and the coins are worth \$16,000. Rashan is considering selling some of the coins to put toward his first semester's tuition. His marginal tax rate is 15% and will remain at that rate throughout his college years because of part-time work. Steve asks Rashan to give the coins back to him and tells Rashan not to worry about it. Steve is elderly, and his will states that Rashan gets the coin collection. Rashan is confused. He can cover his tuition, fees, and other expenses for the first two years from savings and student loans. But he does not understand what Steve is trying to accomplish by asking for the coins. Research this situation and explain all the tax ramifications to Rashan.

Just as the original gift from Steve to Rashan did not change the basis of the coin collection, the gift of the coins from Rashan back to Steve does not change its basis. If the FMV of the coin collection at the date of gift is greater than the adjusted basis of the gifted property, the basis in the hands of the donee is the same as the donor's (i.e., carryover basis). However, if Rashan agrees to Steve's plan, then when he receives the coin collection back from Steve's estate, his basis in the coins will be the fair market value at the date of Steve's death or the alternative valuation date (i.e., stepped-up basis). If \$16,000 is the FMV at the date of death, then that amount becomes Rashan's basis. If Rashan sells the coin collection for that amount, no gain is recognized.

However, if Steve dies within one year of the gift, the basis of the reacquired property to Rashan is the adjusted basis of the property to Steve immediately before death or \$3,000. Sec. 1014(e)(1) denies the step-up in basis at death and defeats the purpose of Steve's plan. Therefore, Steve and Rashan must understand the risk involved in this plan. If Rashan does not agree to give back the coins, then his basis is \$3,000 and the sale of the coin collection produces a taxable gain of \$13,000 (\$16,000 - \$3,000).

88. **RESEARCH PROBLEM** Harry and Freddi, a married couple, purchased 100 shares of Opaque Mutual Fund in 2001 for \$2,800 as joint tenants with the right of survivorship. Freddi dies during the current year. Fair market value of the shares is \$5,000 on the date of death. Six months later, the value is \$5,100. Determine Harry's basis in the 100 shares?

Reg. § 1.1014-2(b)(2) states that property, which was held by the decedent another as joint tenants (with right of survivorship) and is included in the estate of a decedent is treated as property acquired from a decedent. The part of the property that is treated as property acquired from a decedent gets a stepped-up basis.

Therefore, Harvey's basis will depend on whether the executor of the estate elects the alternate valuation date. If the primary valuation date is used, Harry's basis in the stock is \$3,900 (\$1,400 + \$2,500). Harry adds the cost basis of his half-interest (\$1,400) to the fair market value of the half-interest he inherited from Freddi (\$2,500 = $1/2 \times \$5,000$). If the alternate valuation date is elected, Harvey's basis in the stock is \$3,950 [\$1,400 + \$2,550 (\$5,100 $\times 1/2$)].

INTEGRATIVE PROBLEM

89. Emelio and Charita are married taxpayers with 2 dependent children. Emelio starts a computer consulting business in 2016. Charita works as a real estate broker. During 2016, they have the following property transactions:
- a. Emelio purchases an office building on March 15, 2016, to use in his computer consulting business. The price of the property is \$120,000. He pays \$15,000 in cash and signs a 30-year, 10% mortgage for the remainder. For property tax purposes, the land is assessed at \$10,000 and the building at \$30,000. Emelio pays \$3,000 for a new roof for the building.
 - b. Emelio was employed by Computer Corporation as a consultant starting his own business. Computer Corporation lets Emelio purchase the computer equipment in his office for use in his business. He makes the purchase on April 3, 2016. The fair market value of the equipment is \$20,000, but Emelio pays \$16,000 to Computer Corporation. Computer Corporation's original basis in the equipment was \$36,000 and its adjusted basis at the time of the transfer to Emelio is \$8,000.
 - c. Emelio takes the color printer that the children have been using at home to use in the office in his consulting business. The original price of the printer was \$8,000, but it was worth \$4,000 when converted to business use on April 1, 2016.
 - d. On March 30, 2016, Emelio buys office furniture to use in his business for \$2,200.
 - e. In January, Charita purchases a new car to use in her real estate business. She pays \$19,500 for the car and \$1,500 to have a sunroof installed in it. During the year, she drives the car 6,800 miles for business and 3,200 for personal use.
 - f. Charita uses a room in their home exclusively and regularly as an office. The room is 12 feet by 12 feet. The total area in the home is 2,400 square feet. Charita purchased office furniture for \$800 when she started using the office in the home in June 2011. She and Emelio paid \$140,000 for the property in 2006, of which \$20,000 is allocated to the land.
 - g. Emelio and Charita own a rental house. Charita acquired the house from her former husband in 2007 as part of their divorce settlement. Charita and her former husband had paid \$50,000 for the house (which is her basis in the property) in 2000. Charita estimates that the property had increased in value to \$80,000 (\$70,000 for the house, \$10,000 for the land) when it was converted to rental property in October 2008.
 - h. Charita inherits 200 shares of stock in Desmond, Inc., from her uncle, who paid \$700 for it in 1984. At the date of the uncle's death, the stock is worth \$14,000. The executor of the estate elects to use the alternate valuation date, at which time the stock is worth \$13,300. Charita receives the stock 2 months later when it is worth \$14,500.

- i. Emelio and Charita own stock in Software Corporation. They purchased 1,000 shares for \$20 per share in July 2009. They paid \$400 in brokerage commissions. On July 21, 2016, Software Corporation distributed a 2-for-1 stock split. The fair market value at the time of the split was \$100 per share.
- j. On July 21, 2011 Emelio's father gives him 100 shares of stock in Flex Corporation. His father paid \$35 per share in June 2003. The fair market value at the date of the gift was \$45 per share.

Based on the information provided, determine the initial basis of each of Emelio and Charita's assets. If more than one basis is possible, list the alternatives and explain when each basis would apply.

Emelio ' s Business Assets:

Land and Building - Purchase Price = \$120,000

$$\text{Land} = (\$10,000 \div \$40,000) \times \$120,000 = \$30,000$$

$$\text{Building} = (\$30,000 \div \$40,000) \times \$120,000 = \$90,000 + \$3,000 = \$93,000$$

Computer Equipment - Emelio acquired the computer equipment in a bargain purchase. Therefore, he must recognize as income the difference between the fair market value of the computer (\$20,000) and the \$16,000 he paid for the computer. Emelio's basis in the computer is \$20,000. The \$4,000 he recognizes as income from the bargain purchase is added to the \$16,000, he paid for the computer.

$$\text{Basis in Computer: } \$16,000 \text{ cost} + \$4,000 \text{ bargain purchase} = \$20,000$$

Printer - Personal property converted to business use. The basis is the lesser of the adjusted basis (\$8,000) or the fair market value (\$4,000) at the date of conversion (this is also the depreciable basis).

$$\begin{aligned} \text{Split-basis rule: Gain basis} &= \$8,000 \\ \text{Loss and depreciation basis} &= \$4,000 \end{aligned}$$

Office Furniture Purchased - The basis in the furniture is \$2,200 - its cost.

Charita ' s Business Assets:

$$\text{Charita ' s Automobile} - \$19,500 \text{ purchase price} + \$1,500 \text{ sunroof} = \$21,000$$

The automobile is a mixed-use asset. The basis must be allocated between business and personal use:

$$\text{Business Use} = (6,800 \div 10,000 \text{ miles}) \times \$21,000 = \$14,280$$

$$\text{Personal Use} = (3,200 \div 10,000 \text{ miles}) \times \$21,000 = \$6,720$$

Home Office - Charita can deduct the costs associated with the home office. A portion of the basis of the home must be allocated to the home office space. At the date the home office use began, the basis of the house is \$120,000 (\$20,000 is allocated to the land). Based on square footage, the basis of the home office would be \$7,200:

$$[(12 \times 12 = 144) \div 2,400] \times \$120,000 = \$7,200$$

Investment Assets:

Rental House - The basis of property received in a divorce is equal to the adjusted basis of the property. Therefore, Charita's basis as a personal residence is the \$50,000 adjusted basis. At the date of conversion to business use, the basis is the lesser of the adjusted basis or the fair market value of the property. The rental house basis is Charita's \$50,000 adjusted basis. The basis of the land and the building must be determined separately:

$$\begin{array}{lcl} \text{Land} & = & (\$10,000 \div \$80,000) \times \$50,000 = \$6,250 \\ \text{Building} & = & (\$70,000 \div \$80,000) \times \$50,000 = \$43,750 \end{array}$$

Inherited Stock - Inherited property is valued at fair market value. Because the executor elected the alternate valuation date, the property is valued at six months after the date of death. This gives the stock a basis of \$13,300.

Stock in Software Corporation - The basis is equal to the purchase price plus the other costs of acquiring the stock. The basis is \$20,400.

Purchase Price (1,000 x \$20)	\$20,000
Brokerage Commission	400
Total Basis	<u>\$20,400</u>

The stock split increases the number of shares to 2,000 and reduces the cost per share from \$20.40 per share (\$20,400 ÷ 1,000) to \$10.20 (\$20,400 ÷ 2,000) per share. Note that the total investment in the stock is unchanged.

Stock from father - The fair market value of the gifted property is greater than the donor's basis. Thus, Emelio's basis is his father's basis or \$35 per share x 100 shares = \$3,500.

DISCUSSION CASES

90. Monica is planning to start her own accounting, tax, and financial planning business. Her uncle Gus has given her file cabinets, a desk, computer equipment, and bookcases that were in his den until he sold his house. Gus recently moved to a lakefront cottage and no longer needs the furniture and equipment. Gus's adjusted basis for all the items is \$3,500, and the fair market value is \$2,000. Monica will convert 20% of her personal residence into her office and will use it exclusively for her business. Monica's residence has a fair market value of \$150,000 and an adjusted basis of \$80,000 (10% is allocated to the land). What are the tax ramifications of the gifts and the conversion? What will be the depreciable basis of the property? Explain your answers in terms of the underlying concepts that govern the result.

The property Monica receives as a gift is tax-free. In addition, Monica's conversion of 20% of her personal residence into business use is tax free.

The depreciable basis of the furniture and equipment is the fair market value (\$2,000) of the property at the date of the gift. The split basis rule for gifts applies in this case. Because the donor's adjusted basis (\$3,500) is greater than fair market value (\$2,000), the fair market value is used to compute a loss and depreciation. This rule prevents the loss from the personal use of an asset from being deducted as depreciation expense.

Because the FMV of the personal use property is more than its adjusted basis on the date business use begins, the adjusted basis of her home is used to compute the depreciation deduction for her home office. Monica must allocate \$8,000 ($\$80,000 \times 10\%$) of the adjusted basis of the house to the land. The conversion of 20% of Monica's personal residence to business use results in a depreciable basis for her home office of \$14,400 [$20\% \times (\$80,000 - \$8,000)$].

91. Terry purchased stock in Yippee Corporation for \$10,000 in May 1981. He bought stock in Zapper Corporation for \$20,000 in June 1984. The Yippee Corporation stock is currently worth \$90,000, and the Zapper Corporation stock is worth \$15,000. Terry is in very poor health, and he comes to you for tax advice. What advice would you give him regarding his stock holdings? Is there any additional information you would like to ask him for before giving him tax advice?

Terry should be advised that property that is transferred by his estate will be valued at fair market value to his heirs. Thus, appreciated property receives a “step up” in basis and the appreciation is never taxed. However, the loss on property that has declined in value is never deducted. Therefore, if Terry wants to sell any stock, he should be advised to sell the Zapper Corporation stock and realize the \$5,000 (\$20,000 - \$15,000) loss. Assuming Terry has no other capital gains or losses for the year, he can only deduct \$3,000 of the loss and the remaining \$2,000 (\$5,000 - \$3,000) is carried forward to the following year.

Other information is needed regarding Terry’s financial position. If he needs cash, he may need to sell a portion of the Yippee Corporation stock or other appreciated property and use the loss from the Zapper Corporation stock sale to offset the gain. If he wants to donate stock to charity, he should give away the Yippee Corporation stock and avoid paying taxes on the gain. Another option is to sell the Zapper Corporation stock and give the proceeds to the charity. You would like to know more about his estate, including the value and type of the other assets. Then you could calculate his potential estate tax liability. If his estate will have an estate tax liability, then he could lessen this liability by transferring appreciated assets before death. Additional information about his health, his plans for his heirs and their needs, and his future cash needs would be helpful in giving him income tax and estate tax advice.

TAX PLANNING CASES

92. Luther, 72, is a lifelong bachelor who has been very successful in his business and investment endeavors. He realizes that he should begin to do some tax planning for his death. Although he intends to leave the bulk of his \$200,000,000 estate to the Northern State Technical University School of Accounting, he does have a few nieces and nephews for whom he would like to provide (although not too lavishly). Listed here is a selection of assets he is thinking of giving to his nephews and nieces:

Asset	Fair Market Value	Basis	Suspended Loss
Keating S&L stock	\$ 10,000	\$ 200,000	
Impressionist painting	\$ 5,000,000	-0-	
Land Held as an investment	\$ 2,000,000	\$ 1,500,000	
Limited partnership interest	\$ 100,000	\$ 400,000	\$ 1,300,000
Rental property	\$ 4,000,000	\$ 1,000,000	\$ 2,500,000
General Motors stock	\$ 2,000,000	\$ 1,000,000	

1. Consider each of the following questions from Luther's point of view (what is best from the standpoint of his tax situation). Explain.
 - a. Which of these properties would be best to give away to his favorite nephew? Why?

The best gift property is property that has appreciated in value. By making a gift of such property, Luther would avoid paying any tax on the appreciation in value. However, appreciated property held at death also escapes income tax because it is valued at fair market value. Thus, the best property to gift is appreciated property which has the smallest unrealized gain. In this case, the land held as an investment has only a \$500,000 unrealized gain and would be the best property to gift to his nephew.

- b. Which of these properties would be the worst to give away? Why?

Because of the split-basis rule for gifts, the worst type of property to gift is property that has an unrealized loss on it. Because of the potential use of the fair market value as the basis upon disposition, there is a strong possibility that a gift of such property would result in no deduction for the loss. The Keating stock and the Limited Partnership interest are properties that have unrealized losses on them. The unrealized loss on the rental property is the largest of the two, so it would be the one single property that should not be gifted (although neither is a good candidate).

Another consideration with the limited partnership interest is if Luther dies, he receives no benefit for the suspended loss (see part d for more detail). A final point to consider is that the suspended loss on the rental property is added to the donee's basis (see passive losses in Chapter 7), making it more likely that a loss would be realized on any future disposition.

- c. Which property(ies) should Luther definitely retain? Why?

Because appreciated property held at death escapes income taxation, it should not be disposed of prior to death. The impressionist painting has a 5 million unrealized gain and should definitely not be gifted or sold. The rental property should also be held because the suspended loss would be added to the Nephew's basis and could not be realized until the nephew sold the property (see passive losses in Chapter 7). Therefore, if Luther desires or needs to get rid of any property prior to his death, he should consider either the land or the General Motors stock as candidates for disposition. As stated in part a, the land is the best property to gift if Luther does not intend to dispose of any of the appreciated property.

- d. Which property(ies) should Luther consider selling? Why?

Luther should consider selling the loss properties. Because of the valuation for estate tax purpose at fair market value, any loss on such properties which are held at death will be lost forever. Luther should realize the losses on the Keating stock and the limited partnership interest before he dies. This is particularly important for the limited partnership interest as he will lose both the \$300,000 unrealized loss and the \$1,300,000 suspended loss if the property is held at death.

2. Luther comes to your accounting firm for advice. Write a memorandum explaining your recommendations for optimizing Luther's tax situation in regard to the assets listed.

The memo should contain the points discussed in parts a through d.

93. Your client, Dale, is the president and sole stockholder of a steel fabrication company. He has been planning to buy a new piece of equipment for \$500,000. He is upset to learn that the \$500,000 cost would have to be depreciated over seven years. He comes to you with an idea from his son, Dale Jr., who is taking an introductory accounting course at the local college. Dale Jr. tells his father that self-constructed assets are accounted for differently from purchased assets and that the company could be better off if it constructed the needed new equipment. Dale figures his regular employees could indeed build the new equipment using the company's idle capacity. For several years, the company has operated at 80% of capacity, and that level of production is used as the denominator level for allocation of overhead. Overhead is currently charged to production at a rate of 150% of direct labor cost, but Dale Jr. says the new equipment will not have to bear any overhead costs because the company has idle capacity and all overhead costs are already being absorbed by regular production. Dale expects to incur the following incremental costs if his regular employees construct the new equipment:

Direct labor	\$300,000
Direct materials	120,000
Other direct costs	30,000
Interest on construction loan	50,000
Total cost	<u>\$500,000</u>

Although the cost will be the same regardless of whether Dale makes or buys the equipment, he feels he would be better off under the construction alternative because the interest is deductible in the year incurred. As a result, the depreciable cost would be only \$450,000. Do you agree or disagree with Dale's analysis? Write a memorandum to Dale explaining your recommendations for optimizing his tax situation

Dales' analysis is incorrect because he is not including the indirect costs of construction in the basis. The basis in self-constructed assets equals the total direct and indirect construction costs. Direct costs include materials, labor, supplies, architectural fees and other costs actually incurred to physically construct the asset. Indirect construction costs include interest on funds to finance the construction, taxes, general administrative costs, depreciation on equipment, pension costs for workers on the project, and other general costs that indirectly support the construction project.

The cost of constructing the equipment would include the following:

Direct labor	\$300,000
Direct materials	120,000
Other direct costs	30,000
Interest on construction loan	50,000
Indirect costs (overhead @ 150% of direct labor)	450,000
Basis in self-constructed asset	<u>\$950,000</u>

All of the above expenses must be capitalized and may not be deducted in the current year.

ETHICS DISCUSSION CASE

94. Assume you are a CPA. A new client, Mark, a local chiropractor, has brought you the financial information for his business at the close of the past year. Previously, Mark prepared his own tax returns and had them reviewed by Blacke & Co. You find the information to be organized and fairly straightforward. Mark does bring one recent transaction to your attention. He sold an x-ray machine for \$10,000 near the end of the past year. The machine cost \$25,000 three years earlier. Mark did not deduct depreciation expense in the year of acquisition. His business incurred an operating loss that year. Therefore, Mark "saved" some of his basis and did not report a loss as big as he could have. For the following year and for this year, Mark recorded depreciation of \$5,000 annually. He tells you that he would like to "reclaim" the depreciation he did not deduct in the year of acquisition. He insists there will not be a problem because he could have taken the depreciation 3 years ago. Also, by applying it to the adjusted basis for the sales transaction, he will not report a loss. So the recognized loss will not be used to offset other income. Advise Mark on the propriety of this transaction. You may wish to consult the Statements on Standards for Tax Services (which can be found at www.cengagebrain.com). Write a letter to Mark explaining his situation.

SSTS No. 6 suggests that practitioners inform clients promptly of any errors and recommend the proper measures to correct them. However, a practitioner is not obligated to inform the IRS of these errors. In the present scenario, the error occurs because Mark (and the reviewer) failed to deduct depreciation on the x-ray machine. The tax law requires that the basis of business assets must be reduced (capital recoveries) by the amount of depreciation allowed or allowable. Therefore, the adjusted basis of the x-ray machine must be reduced by the amount of depreciation allowed in the year of acquisition. Because Mark did not deduct depreciation in the year of acquisition, he cannot decide to "catch-up" by deducting that amount in the year of sale. Assuming the 3-year statute of limitations has not lapsed, the practitioner should recommend that Mark amend his tax return and claim the depreciation expense for the year the x-ray machine was acquired.

Chapter 9

Check Figures

20. a. Personal use property & personal property b. Personal property
 c. Real property and personal property d. Intangible property
 e. Real property f. Personal property
21. a. Personal property b. Personal-use real property
 c. Intangible property d. Real property
 e. Personal property f. Personal-use personal property
22. a. Business basis = \$18,291; personal-use basis = \$7,500
 b. Building = \$187,380; Land = \$80,000; Land Improvements = \$11,000
23. a. \$21,000 b. \$5,530
 c. \$35,000
24. \$3,500
25. Adjusted basis = \$39 per share
26. Gain = \$27,500
27. \$6,000 Gain
28. a. Increase basis b. Increase basis
 c. Decrease basis d. No effect
29. Adjusted basis - \$85,800
30. a. Amos' basis = \$50,000; Thomas' basis = \$25,000
 b. Amos' basis = \$70,000; Thomas' basis = \$35,000
31. Amos' basis = \$34,500
32. \$66,000
33. a. \$99,400
 b. Gain if sales price is greater than adjusted basis
 Loss if sales price is less than adjusted basis.
34. a. Initial basis \$45,900; 2015 - \$47,200 b. \$23,600
35. \$21,590
36. \$285,000
37. Tractor's basis = \$78,000; Trailer's basis = \$30,000

38. a. \$60,748
c. \$60,000 basis; \$40,000 gain
39. \$40,000; Income of \$12,000
40. Nondeductible loss of \$3,000 on sale
41. \$107,950
42. Land = \$50,000; Building = \$200,000 or Land = \$17,500; Building = \$232,500
43. a. Use fair market values and have goodwill of \$30,000
b. Basis in stock - \$250,000
44. a. Inventory = \$18,000; Machinery = \$8,000; Land = \$10,000; Building = \$4,000
b. Goodwill \$10,000
c. Basis in stock - \$60,000
45. \$201,000
45. \$535,000
47. a. \$10,000
b. \$2,300 Gain
48. a. \$220,000 realized gain
c. No gain or loss realized
b. \$10,000 realized loss
49. a. \$10 loss
c. No gain or loss
b. \$25 gain
50. a. Sell or gift the shares
b. Stockton should sell the shares
51. Giving the shares to Eunice will save \$216.
52. Sell the shares
53. a. Gain basis = \$25,000;
Loss basis = \$9,000
b. \$9,000
54. a. \$1,400 loss
c. No gain or loss
b. \$1,600 gain
55. a. Gain basis - \$300,000; loss basis - \$250,000
c. Carryover basis, carryover holding period
FMV uses gift date
b. Depreciable basis - \$250,000
56. a. \$10,000 gain
c. No gain or loss
b. \$10,000 loss

57. a. Cannot use the alternative valuation date b. Primary valuation date basis = \$200,000;
58. a. \$30,500 b. \$25,500
c. Land = \$17,000; Stock = \$12,000 d. \$25,500
Watch = \$500
59. a. \$12 per share b. \$10 per share
c. \$18 per share
60. Assuming no estate tax, hold the securities until Phong dies.
61. Sell the securities.
62. \$80,000 (\$72,000 personal use; \$8,000 business use)
63. Gain basis \$55,900; loss basis \$30,900
64. a. \$16,000 gain basis; \$10,000 loss basis b. \$2,000 loss
65. a. 2014: dividend income of \$520; 2015: capital gain of \$2,000
b. \$920 gain
66. Common: \$4,687; Preferred: \$313
67. \$40 of dividend income
68. Basis of reacquired stock - \$2,733; Recognized loss - \$217
69. a. Loss is disallowed. b. \$2,400 capital loss; \$1,600 disallowed loss
c. Loss is disallowed.
70. Delay repurchase for 30-days and recognize \$1,000 loss.