

Chapter 6

Property Acquisitions and Cost Recovery Deductions

Solutions to Develop Research Skills

Note to Instructor: No research aids or “hints” are provided in the textbook for problems in this chapter. Before the solution to each problem, however, suggested research aids are provided. This allows you to choose whether or not to provide any hints to your students for a particular problem. For problems that can be solved using free Internet sources, you must provide students with the citations in these hints and refer students to Figure 2.2 of Chapter 2 in the text for the URLs to enable them to solve these problems using free Internet sources. Some of the problems require access to *Checkpoint®* or a similar service. The research process for solving a sample problem is illustrated in Appendix A through screen captures for *Checkpoint®*.

54. *Basis for Inherited Property (can be solved using free Internet sources)*

Robert owns some investment land that has a basis of \$1,000 and a fair market value of \$22,000. He expects that it will continue to appreciate in value. Robert’s uncle, Mike has a terminal illness and is expected to survive no more than six months. Robert would like to increase the basis of the land and has devised a scheme in which he gifts the land to Mike. When Mike dies, Robert will inherit the land. Mike has agreed to participate in the plan; however, Robert wants you to confirm what his basis will be when he inherits the land from Mike.

Hint: Section 1014(e)

Issue: Will Robert receive a stepped-up basis when he inherits the land from Mike?

Conclusion: No, unless Mike lives longer than one year after receiving the gift, Robert will not be able to receive a stepped-up basis for the land. Robert’s basis in the inherited land will be \$1,000. If Mike lives longer than one year, Robert will inherit the land with a new basis equal to the fair market value at the date of Mike’s death.

Discussion of Reasoning and Authorities: In general, when someone inherits property, the new basis for such property is the fair market value at the date of death (or alternate valuation date, if elected). However, under Section 1014(e), if the appreciated property was acquired by the decedent by gift during the 1-year period before death and the person (or the spouse) who gave the property to the decedent inherits it, then the recipient’s basis will not be the fair market value at the date of death. Rather, the recipient’s basis of the appreciated property will be the decedent’s adjusted basis in the property immediately before death. Therefore, Mike’s basis in the investment land would be \$1,000 when received as a gift from Robert. Upon Mike’s death, Robert would inherit the property with a \$1,000 basis. If, however, Mike survived for more than one year after receiving the land, then Robert’s basis in the inherited land would be the fair market value at the date of Mike’s death (or alternate valuation date, if elected).

55. *Depreciating an Antique Musical Instrument (can be solved using free Internet sources)*

Jessica, a professional violinist with the Lincoln Symphony Orchestra, purchased a 100-year-old antique violin at a cost of \$180,000. She thinks that it is a good investment because she knows that it will continue to appreciate in value as a treasured work of art. She plays this violin in concerts and wants to know if she can depreciate it as a business-use asset.

Hint: *Liddle, Brian v. Comm.*, 76 AFTR 2d 95-6255, 65 F3d 329, 95-2 USTC ¶50,488 affg. 103 TC 285, nonacq. AOD 1996-1009, 7/15/96.

2 Taxation for Decision Makers Research Solutions

Issue: Can Jessica depreciate the violin as a business-use asset?

Conclusion: Yes, Jessica should be permitted to claim depreciation for the violin.

Discussion of Reasoning and Authorities: Section 167 provides that a reasonable allowance may be claimed for depreciation if the asset is used in a trade or business and the taxpayer can establish the cost, the salvage value and the useful life of the property. One of the cases decided while this was the controlling Code section was *Browning v. Comm.* (65 AFTR 2d 90-385, affg. TC Memo 1988-293). The Court relied on Section 167 to disallow a depreciation deduction for an antique violin stating that taxpayer could not establish that the salvage value of the violin was less than the original cost because the violin would appreciate in value, so no deduction would be allowed.

However in 1981, Congress adopted the Accelerated Cost Recovery System (ACRS) and codified it in Section 168. This effectively modified the requirements of Section 167 by no longer requiring the taxpayer to establish the useful life (because class lives were established by ACRS) and ignoring salvage value. Thus, the logic behind the ruling in *Browning* no longer applied. In two subsequent cases, the taxpayers were allowed to claim depreciation deductions.

In *Liddle, Brian v. Comm.* (76 AFTR 2d 95-6255, 65 F3d 329, 95-2 USTC ¶50,488, affg. 103 TC 285), the Appellate Court had to determine whether a valuable 17th century bass violin could be depreciated when used as a tool of trade by a professional musician even though the instrument actually increased in value while the musician owned it. The critical question was whether or not the violin was “property of a character subject to the allowance for depreciation” under Section 168. The Court ruled that the violin was, in fact, depreciable since it was subject to daily wear and tear as required by Section 168. The Court pointed out that musicians, unlike rare-instrument collectors, did use the instruments in their profession.

In a similar decision, the Second Circuit allowed Richard Simon (76 AFTR 2d 95-6911, 95 USTC ¶50,552, affg. 103 TC 247) to depreciate 19th century violin bows used in his profession. In both of these cases, the IRS nonacquiesced (AOD 1996-009, 7/15/96) indicating that the instruments appreciated in value despite use. The IRS said that it would continue to contest the treatment of antique musical instruments without a determinable useful life in circuits other than the Second and Third Circuits. Therefore, the taxpayer should be advised that unless she is in the Second or Third Circuit, she may have to litigate to prevail on her position.

56. *Amortization of a Covenant-Not-to-Compete (can be solved using free Internet sources)*

Juan owns 40 percent and Mario owns 60 percent of Crispy Donuts, Inc. (CDI). Juan wants to buy out Mario's interest in CDI, so he arranges a stock sale agreement under which CDI will redeem (purchase) all of Mario's shares for \$900,000. This will then make Juan the sole shareholder of CDI. Juan wants to ensure that Mario does not open a competing donut business nearby so he also has a covenant-not-to-compete drawn up at the same time as the stock sale agreement. Under the terms of the covenant-not-to-compete, Mario cannot open another donut business within a 10-mile radius for a period of five years. During this 60-month period, CDI will pay Mario \$9,000 per month in return for his agreement not to compete. CDI wants to know over what time period it should amortize the covenant-not-to-compete.

Hint: Section 197.

Issue: Over what time period should CDI amortize the covenant-not-to-compete?

Conclusion: CDI should amortize the covenant-not-to-compete over 15 years.

Discussion of Reasoning and Authorities: As a general rule, Section 197(a) states that a taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis of such intangible ratably over the 15-year period beginning with the month in which such

intangible was acquired. A covenant-not-to-compete is considered a “section 197 intangible” pursuant to Section 197(d)(1)(E). Even though the covenant only covers a five-year time period, it still must be amortized over 15 years. The amount of CDI’s yearly amortization is \$36,000 $[(\$9,000 \times 60 \text{ months}) / 15 \text{ years}]$.