

Chapter 7 Summary of End-of-Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modifications
1	1	
2	2	
3	3	
4	4	
5	5	
6	6	
7	7	Solution modified
8	8	Solution modified
9	9	
10	10	
11	11	
-	12	Problem deleted
12	13	
13	14	
14	15	
15		New problem
-	16	Problem deleted
16		New problem
17	17	
18	18	
19	19	
20	20	Solution modified
21	21	
22	22	
23	23	
24	24	Solution modified
25	25	Solution modified
26	26	
27	27	Solution modified
28	28	Solution modified
29	29	
30	30	
31	31	Solution modified
32	32	Solution modified
33	33	Solution modified
34	34	
35	35	
36	36	
37	37	Solution modified
38	38	
39	39	Problem updated

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40	40	
41	41	
42	42	
43	43	
44	44	
45	45	
46	46	Solution modified
47	47	Solution updated and modified
48	48	Solution updated and modified
49		New problem
50		New problem
51	49	Problem updated
52	50	
53	51	
54	52	Solution modified
-	53	Problem deleted
55		New problem
56	54	
57	55	
58	56	
59	57	
60	58	
61	59	
62	60	
63	61	
64	62	
65	63	Solution modified
66	64	Forms updated
67	65	Forms updated
68	66	Solution modified
69	67	Problem and solution modified
70	68	Solution modified
71	69	Solution modified
72	70	Solution modified
73	71	Solution modified
74	72	Problem modified

Solutions to Chapter 7 Problem Assignments

Check Your Understanding

1. *Asset Classification*

Solution: Assets are first classified as business, personal-use, or investment assets; then they are classified as capital assets, Section 1231 assets, and ordinary income assets to determine their tax treatment. Assets may also be classified as realty or personalty and tangible or intangible. Sales, exchanges, involuntary conversions, and abandonments all qualify as asset dispositions.

2. *Amount Realized*

Solution: The amount realized on a sale or exchange is the sum of the cash received, the fair market value of property received, and the liabilities assumed by the buyer reduced by the sum of the seller's selling expenses and the liabilities of the buyer assumed by the seller.

3. *Realized vs. Recognized Gain*

Solution: A realized gain is the excess of the amount realized on a sale or exchange over the adjusted basis of the property sold or exchanged. The recognized gain is the amount of this realized gain that will be treated as income and subject to tax on the seller's income tax return.

4. *Asset Classification*

Solution: The most common Section 1231 assets are depreciable realty and personalty used in a trade or business and nondepreciable trade or business realty that have been held for more than one year. Long-term capital gain property held for the production of income that is involuntarily converted is also Section 1231 property. To qualify, all of these assets must have been held for more than one year. Section 1231 assets include machinery and equipment, office furniture and fixtures, rental real estate, factory buildings and land held for future expansion of a business.

Capital assets include most investment properties and personal-use assets. They exclude inventory, real and depreciable property used in a trade or business, and accounts and notes receivable from the sale of inventory in the ordinary course of business. Capital assets include investment stocks and bonds and other investment property, personal residences, and personal property items such as furs, jewelry, autos, and clothing.

Ordinary assets include inventory, stock in trade, and accounts and notes receivable from inventory sales in the ordinary course of business. In addition, any asset that cannot be classified as a capital or Section 1231 asset must be an ordinary asset. Section 1231-type assets that fail to meet the more-than-one-year holding period are generally ordinary income assets.

5. *Recapture*

Solution: Taxpayers deduct depreciation expenses against ordinary income resulting in a tax savings equal to the depreciation expense times the ordinary income marginal tax

rate. Without recapture, all of the gain that is realized and recognized on the disposition of a depreciable asset would be Section 1231 gain and could receive favorable tax treatment as long-term capital gain. To ensure that all or part of the gain that results from the basis reduction for depreciation is taxed at ordinary income rates, depreciation recapture was instituted.

Section 1245 full recapture and Section 1250 partial recapture apply to depreciable property (including property on which Section 179 expensing was claimed) that has been disposed of at a gain (it does not apply to losses). Section 1245 property includes all depreciable personalty and Section 1250 applies to most depreciable realty.

6. *Section 1231 Look-Back*

Solution: The Section 1231 look-back procedure, which requires all or a portion of Section 1231 gain to be taxed as ordinary income, applies to the gain on Section 1231 assets to the extent the taxpayer deducted Section 1231 losses against ordinary income during the five preceding tax years (referred to as unrecaptured Section 1231 losses).

Taxpayers became adept at realizing Section 1231 losses in some years, deducting them from ordinary income and Section 1231 gains in other years, benefiting from taxation at capital gains rates. The look-back procedure was designed to prevent this "game."

7. *Section 291 Recapture*

Solution: Section 291, applicable only to corporations, requires corporations to recapture (tax as ordinary income) an additional amount of Section 1231 gain beyond the normal recapture amount required on property subject to the Section 1250 recapture rules. This "additional" recapture applies even if there is no otherwise required Section 1250 recapture on the realty sold. It simply converts part of the Section 1231 gain realized to ordinary income as Section 291 recapture. The amount of Section 291 recapture is 20% of the excess of Section 1245 recapture (as if Section 1245 recapture applied) over the Section 1250 recapture, if any. This corporate recapture rule eliminates some of the capital gains that would otherwise be available to offset capital losses as corporations can only offset capital losses with capital gains; the recapture amount is taxed as it if were ordinary income..

The term unrecaptured Section 1250 gains apply to individual taxpayers. This provision applies a maximum 25% tax rate to gains on the sale of realty that would be a Section 1250 gain if all prior depreciation were recaptured (similar to the rules for Section 1245 recapture). These capital gains would usually be taxed at a maximum 20% capital gains tax rate otherwise.

8. *Section 1231 Netting*

Solution: Net Section 1231 losses that are the result of the Section 1231 netting process are deductible from ordinary income of both corporations and individuals. When there is a net Section 1231 gain, the taxpayer must first recapture as ordinary income any unrecaptured Section 1231 losses from the previous five years. The remaining net Section 1231 gain enters the capital asset netting process and can offset capital

losses. If the taxpayer has no capital gains or losses, the net Section 1231 gain is included with the taxpayer's other income for taxation, based on the type of taxpayer. In the case of a corporate taxpayer, the net Section 1231 gains are included in and taxed as ordinary income. The net Section 1231 gains of individuals are taxed as long-term capital gains subject to a maximum 20% capital gains tax rate.

9. *Capital Assets*

Solution: A long-term capital asset is one that is held for more than one year. A short-term capital asset is one that does not meet the holding period for a long-term capital asset (that is, is held for one year or less).

Long-term capital gains and losses are first separated from short-term capital gains and losses. The long-term gains and losses are netted against each other and the short-term gains and losses are netted against each other separately. If the result is a short-term gain (loss) and a long-term loss (gain), these are then netted against each other with the resulting number taking the character of the largest element. The netting process continues subtracting losses from gains until there are only gains or only losses remaining. The net gain(s) or net loss(es) are then taxed according to the type of taxpayer.

10. *Capital Gains*

Solution: The net short-term capital gains of both individuals and corporations are included in income and taxed at ordinary income rates.

11. *Capital Losses*

Solution: An individual may deduct a maximum of \$3,000 of capital losses annually against ordinary income. Short-term capital losses are deducted before long-term losses up to the \$3,000 maximum. The remaining losses must be carried forward (and they retain their character as short-term or long-term) indefinitely until fully deducted. The losses that are carried forward enter the capital asset netting process in the carryover year and, thus, may also offset capital gains realized in that year. In future years in which the capital losses exceed capital gains, the excess losses continue to offset ordinary income at the rate of \$3,000 per year.

The net capital losses of corporations can only be carried back three years and then forward up to five years to offset capital gains in the carryover years. They are not permitted to deduct the net losses against ordinary income. The losses carried over are all assumed to be short-term capital losses and they enter the capital asset netting process in the carryover year. Any unused losses remaining at the end of the five-year carryforward period are lost.

12. *Section 1244 Stock*

Solution: Up to \$50,000 of the loss (\$100,000 if married filing jointly) on the sale of Section 1244 stock in any year may be treated as an ordinary loss rather than as a capital loss. Any loss in excess of this limit is capital loss. This provision only applies to individuals or partnerships that are the original owners of the stock.

13. *Qualified Small Business Stock*

Solution: A noncorporate taxpayer that realizes a gain on the sale of stock in a qualified small business may exclude a specified percentage of the gain from income based on the year of acquisition. These excluded amounts are 50% of the gain from taxation on stock acquired before February 18, 2009 and after December 31, 2013; 75% of the gain on stock acquired after February 17, 2009 and before September 28, 2010; and 100% on stock acquired after September 27, 2010 and before January 1, 2014.

14. *Personal Residences*

Solution: The personal residence must be the primary residence of the taxpayer; the taxpayer or the taxpayer's spouse must have owned the residence for at least two of the five previous tax years; and the taxpayer (and the taxpayer's spouse, if married) must have occupied the home for at least two of the last five years. If both spouses qualify, up to \$500,000 of gain is excluded. If only one spouse meets the use test, then the qualifying spouse can exclude up to \$250,000 gain.

Normally, this exclusion can be claimed only once every two years. If, however, the taxpayer(s) does not meet the ownership or use tests at the time of the sale and the sale of the residence is due to a change in health, employment, or other circumstance beyond the taxpayer's control, a portion of the gain may be excluded. Other circumstances include death of a spouse or co-owner, divorce, unemployment, disasters, and involuntary conversion of the residence.

The Housing Assistance Tax Act of 2008 now requires a reduction in the gain exclusion for any time after December 31, 2008, that a second home was owned but was not used as a principal residence, even if it meets the ownership and occupancy criteria for a personal residence at the time of sale.

15. *Capital Gains Tax Rates*

Solution: The general maximum tax rate for long-term capital gains for individuals is 15% except for higher income taxpayers who are subject to a 20% rate. The maximum tax rate for gains on antiques and collectibles is 28% and the maximum tax rate for unrecaptured Section 1250 gains is 25%. These tax rates may be modified if the individual's marginal tax rate on ordinary income is less than these rates. To the extent the taxpayer's taxable income (including capital gains) does not exceed the 15% tax bracket, the 25% and 28% assets are taxed at the 15% rate and the 15% assets are taxed at zero percent. Taxpayers may also be subject to the 3.8% Medicare surtax if modified adjusted gross income exceeds \$200,000 or more based on filing status. The rates applicable to the capital gains shown for a single individual are:

- a. 0%
- b. 15% + 3.8% Medicare surtax = 18.8%
- c. 20% + 3.8% Medicare surtax = 23.8%
- d. (a) 15%; (b) 28%; (c) 28% + 3.8% = 31.8%
- e. (a) 15%; (b) 25%; (c) 25% + 3.8% = 28.8%

16. *Capital Gains Tax Rates*

Solution:	<u>15%</u>	<u>25%</u>	<u>33%</u>	<u>39.6%</u>
a.	0%.	15%	18.8%	23.8%
b.	15%	28%	31.8%	31.8%
c.	15%	25%	28.8%	28.8%

Note that the rates for the 33% and 39.6% brackets include the 3.8% Medicare surtax.

Crunch the Numbers17. *Realized Gain or Loss*

Solution: a. $(\$40,000 + \$19,000 - \$2,000) - \$47,000 = \$10,000$ realized gain.
 b. $(\$40,000 + \$19,000 - \$2,000) - \$67,000 = \$10,000$ realized loss.

18. *Determination and Character of Gains and Losses*

Solution: a. $\$5,000 + \$15,000 + \$13,000 = \$33,000$ amount realized.
 b. $\$33,000 - \$34,000 = \$1,000$ loss.
 c. Long-term capital loss.
 d. If the property had been used in a business, it would be Section 1231 property and Allan would have a Section 1231 loss.

19. *Determination and Character of Gain*

Solution: a. $\$50,000 + \$100,000 + \$150,000 - \$15,000 - \$2,000 - \$234,000 = \$49,000$
 Section 1231 gain.
 b. As an investment, the gain would be long-term capital gain.

20. *Determination and Character of Gain*

Solution: a. $\$40,000 + \$180,000 - \$2,300 - \$7,000 = \$210,700$ amount realized.
 b. $\$210,700 - \$138,000 = \$72,700$ gain.
 c. Long-term capital gain. If she owned and used the house as her principal residence for at least two of the previous five years, she could qualify to exclude the gain.
 d. If used in a sole proprietorship, the gain on the building's sale would be Section 1231 gain. If she claimed any depreciation on the building, the portion of gain attributable to depreciation would be taxed as unrecaptured Section 1250 gain (subject to the 25% capital gains tax rate).

21. *Determination and Character of Gains and Losses*

Solution: a. DDF has $\$507,000$ ($\$575,000 - \$68,000$) Section 1231 gain on the land sale. It has a $\$635,000$ ($\$125,000 - \$760,000$) Section 1231 loss on the sale of the equipment.
 b. The $\$635,000$ loss is netted against the $\$507,000$ gain. The result is a $\$128,000$ net Section 1231 loss that is deducted against DDF Corporation's ordinary income.

22. *Determination and Character of Gain*

Solution: $\$27,000 - \$17,000 = \$10,000$ total gain. $\$7,000$ ($\$24,000 - \$17,000$) of the gain is taxed as ordinary income due to Section 1245 recapture; the remaining $\$3,000$ gain is Section 1231 gain.

23. *Determination and Character of Gains and Losses*

- Solution:** a. Machine 8: $\$12,000 - \$14,000 = \$2,000$ loss realized. Machine 6: $\$24,000 - \$19,000 = \$5,000$ gain realized.
- b. The machines are Section 1231 property. The loss on Machine 8 is a Section 1231 loss; the gain on Machine 6 is ordinary income due to Section 1245 recapture because the gain is less than the prior depreciation deductions ($\$45,000 - \$19,000 = \$26,000$ accumulated depreciation).
- c. The $\$2,000$ loss is deducted directly from ordinary income; the $\$5,000$ Section 1245 recapture is included directly in ordinary income.

24. *Determination and Character of Gains and Losses*

- Solution:** a. $\$680,000 - \$500,000 = \$180,000$ Section 1231 gain; $\$150,000$ ($\$650,000 - \$500,000$) of this gain would be unrecaptured Section 1250 gain subject to the 25% capital gains tax rate.
- b. $\$680,000 - \$500,000 = \$180,000$ Section 1231 gain; $\$150,000$ ($\$650,000 - \$500,000$) of this gain would be unrecaptured Section 1250 gain subject to the 25% capital gains tax rate.
- c. $\$30,000$ Section 291 recapture ($\$150,000 \times 20\%$); the remaining $\$150,000$ ($\$180,000 - \$30,000$) of gain is Section 1231 gain.

25. *Determination and Character of Gains and Losses*

- Solution:** a. $\$19,000 - \$16,000 = \$3,000$ long-term capital gain subject to the 20% maximum tax rate.
- b. $\$30,000 - \$31,000 = \$1,000$ short-term capital loss (on a collectible asset).

26. *Section 1231 Recapture*

- Solution:** a. Only $\$10,000$ of the $\$25,000$ of Section 1231 gain must be recaptured as ordinary income; Barbara deducted a $\$45,000$ Section 1231 loss in year 2, and $\$35,000$ ($\$20,000 + \$15,000$) was recaptured in years 3 and 4. The remaining $\$15,000$ ($\$25,000 - \$10,000$ recaptured) of the gain is simply Section 1231 gain.
- b. There is no unrecaptured loss remaining after year 5.

27. *Recapture*

- Solution:** a. $\$700,000 - (\$600,000 - \$80,000) = \$180,000$ total gain. Only $\$80,000$ of this gain is subject to Section 291 recapture, however, as that is the limit of Section 1245 recapture as if that provision applied. Thus, the Section 291 recapture = $20\% \times \$80,000 = \$16,000$. The corporation recognizes $\$16,000$ of ordinary income due to Section 291 and the remaining $\$164,000$ ($\$180,000 - \$16,000$) is Section 1231 gain.
- b. If Angel were a sole proprietorship, there would be no Section 291 recapture. The entire $\$180,000$ gain would be Section 1231 gain; however, the $\$80,000$ unrecaptured Section 1250 gain could be subject to the maximum 25% capital gains tax rate when included in the sole proprietor's tax return.
- c. If Angel Corporation has $\$43,000$ of Section 1231 losses in the prior year, $\$43,000$ of the $\$164,000$ Section 1231 gain would be recaptured (under the look-

back rules) and included in ordinary income (along with the \$16,000 Section 291 recapture). Only the remaining \$121,000 (\$180,000 - \$16,000 - \$43,000) is Section 1231 gain (treated as long-term capital gains).

28. *Section 1245/1250 Recapture*

- Solution:** a. Machine #1: $\$19,000 - (\$45,000 - \$35,000) = \$9,000$ Section 1245 recapture.
 Machine #2: $\$24,000 - (\$105,000 - \$90,000) = \$9,000$ Section 1245 recapture.
 Machine #3: $\$66,000 - (\$63,000 - \$12,000) = \$12,000$ Section 1245 recapture; \$3,000 Section 1231 gain.
 Building: $\$425,000 - (\$400,000 - \$45,000) = \$70,000$ total gain; \$9,000 (20% x \$45,000) is Section 1250 gain (by operation of Section 291); the remaining \$61,000 (\$70,000 - \$9,000) gain is Section 1231 gain.
- b. Performance Industries would have \$39,000 in ordinary income [\$30,000 Section 1245 recapture and \$9,000 Section 1250 gain (by operation of Section 291)] and \$64,000 in Section 1231 gains (treated as long-term capital gains), increasing net income by \$103,000.
- c. If Performance had \$6,000 of Section 1231 losses in year 3, it would be required to treat \$6,000 of its Section 1231 gain as ordinary income, reducing its Section 1231 gain to \$58,000 (\$64,000 - \$6,000) and subsequently reducing the amount treated as long-term capital gain to \$58,000.

29. *Capital Gains and Losses*

- Solution:** a. $\$10,000 - \$8,000 = \$2,000$ short-term capital gain (held only one year).
 b. $\$7,000 - \$8,000 = \$1,000$ long-term capital loss.
 c. $\$17,000 - \$15,000 = \$2,000$ long-term capital gain.

30. *Capital Asset Netting*

- Solution:** a. Ten year old machinery would be completely depreciated at the time of the tornado; as a result, all \$75,000 gain would be Section 1245 gain included directly in income and would not enter the Section 1231 netting process. All \$200,000 of the casualty loss on the building would be deductible as it would be the only item in Step 1 of the Section 1231 netting process. At Step 2 of the netting process, Brad would net the \$100,000 condemnation gain on the land with the \$150,000 Section 1231 loss and \$25,000 Section 1231 gain for a net Section 1231 loss of \$25,000. This \$25,000 loss would be deductible immediately and would not be included in the capital asset netting process.
- b. The result would be the same if Brad was a sole proprietorship except the gains and losses would be included on Brad's personal income tax return.

31. *Capital Asset Netting*

- Solution:** Investment land: \$44,000 (\$105,000 - \$61,000) long-term capital gain;
 Engagement ring: \$700 (\$1,800 - \$2,500) short-term capital loss that is a nondeductible personal loss; Stock: \$4,000 (\$14,000 - \$18,000) long-term capital loss; Auto: \$1,100 (\$12,000 - \$10,900) short-term capital gain. Netting the \$44,000 LTCG with the \$4,000 LTCL yields a net \$40,000 LTCG. Serena must include both the net \$40,000 LTCG and the \$1,100 STCG in her income. The

STCG is taxed at her marginal tax rate and the LTCG is taxed at a maximum rate of 20%. Although the auto was also a personal asset, she is not allowed to offset the nondeductible personal loss on the ring against the gain on the auto.

32. *Capital Asset Netting*

Solution: \$65,000. Netting the \$15,000 STCG with the \$24,000 LTCL results in a \$9,000 LTCL. Sharon can deduct only \$3,000 of this capital loss in the current year; thus, her adjusted gross income is \$65,000 (\$68,000 - \$3,000). She can carry the remaining \$6,000 LTCL forward and deduct it at a rate of \$3,000 per year unless she has additional gains in future years.

33. *Section 1231 Netting with Prior Section 1231 Loss*

Solution: a. Wilma has a \$25,000 casualty loss on the bearer bonds (an investment asset) that is the only item in Step 1 of the Section 1231 netting process; as a result it is deductible immediately as an investment casualty loss. In Step 2 of the netting process, Wilma will net the \$20,000 loss on the condemned land (an investment asset) with the \$60,000 Section 1231 gain and the \$15,000 Section 1231 loss from her sole proprietorship for a net Section 1231 gain of \$25,000. This \$25,000 net gain will enter the capital asset netting process and will be treated as if it is a long-term capital gain subject to a maximum 20% capital gains rate.

b. If Wilma had a Section 1231 loss two years ago, she would be required to recapture \$12,000 of her Section 1231 net gain from Step 2 of the netting process as ordinary income. Only the remaining \$13,000 (\$25,000 - \$12,000) of the Section 1231 gain would enter the capital asset netting process to be treated as a long-term capital gain subject to a maximum 20% capital gains rate.

34. *Capital Asset Netting and Loss Carryover*

Solution: In year 1, Chester has a \$3,100 net LTCL (\$3,500 - \$400) and a \$2,400 STCL. He first deducts the \$2,400 STCL and then deducts \$600 of the net LTCL (for a total deduction of \$3,000) from ordinary income. He has a \$2,500 LTCL (\$3,100 - \$600) carryover to year 2.

In year 2, he has a \$1,200 net STCL (\$500 gain - \$1,700 loss); he also has a net \$2,600 LTCL (\$900 gain - \$1,000 loss - \$2,500 loss carryover) for total capital losses of \$3,800 (\$1,200 + \$2,600), of which he can deduct \$3,000 in year 2 from ordinary income and carry \$800 of the LTCL over to year 3.

In year 3, he has a \$1,600 net STCG (\$2,000 gain - \$400 loss); he also has a \$1,000 LTCL (\$300 gain - \$500 loss - \$800 loss carryover) for a net short-term gain of \$600 (\$1,600 STCG - \$1,000 LTCL). He includes the \$600 STCG in ordinary income in year 3 and has no loss carryover to year 4.

35. *Capital Asset and Section 1231 Netting*

Solution: Taxable income is reduced by \$2,000.

Step 1. Net the \$10,000 Section 1231 gain with the \$6,000 Section 1231 loss; the result is a net Section 1231 gain of \$4,000.

Step 2. Net the \$4,000 Section 1231 gain with the long-term capital gains and losses; the result is a net \$1,000 long-term capital gain (\$4,000 + \$4,000 - \$7,000).

Step 3. The \$3,000 short-term capital gain is netted with the \$6,000 short-term capital loss; the result is a net \$3,000 short-term capital loss.

Step 4. The \$3,000 STCL and \$1,000 LTCG are netted; the result is a \$2,000 STCL. This loss is deducted from the taxpayer's other income, reducing taxable income by \$2,000.

36. *Multiple Property Transactions*

Solution: Juno's taxable income is \$224,000.

The \$8,000 of short-term capital gain and \$14,000 of long-term capital loss are given.

The machines and building are Section 1231 properties.

Machines: $\$30,000 - (\$80,000 - \$35,000) = \$15,000$ Section 1231 loss.

Building: $\$400,000 - (\$390,000 - \$108,000) = \$118,000$ total gain.

Because Juno is a corporation, Section 291 recapture must be determined:

$\$108,000 \times 20\% = \$21,600$ Section 291 recapture income. Total gain of \$118,000 - \$21,600 Section 291 recapture = \$96,400 Section 1231 gain. (Section 291 applies to only \$108,000 of the gain, the amount of prior depreciation deductions.) This Section 1231 gain is netted with the \$15,000 Section 1231 loss on the machines for a net Section 1231 gain of \$81,400 ($\$96,400 - \$15,000$) and is treated as a long-term capital gain.

Capital gains: The \$81,400 Section 1231 gain is netted with the \$14,000 long-term capital loss for a net \$67,400 LTCG.

Juno's taxable income: \$127,000 ordinary income + \$21,600 ordinary income due to Section 291 recapture + \$67,400 long-term capital gain + \$8,000 short-term capital gain = \$224,000.

37. *Qualified Small Business Stock*

Solution: \$5,500,000 long-term capital gain. Daniel acquired the stock before February 2009 and when he sells the stock for \$13,000,000, he has a gain of \$11,000,000. Gain eligible for the exclusion cannot exceed \$20,000,000 which is the greater of 10 times the stock basis ($10 \times \$2,000,000$) or \$10,000,000. Thus, he can exclude one-half of \$11,000,000, or \$5,500,000. He will have only a long-term capital gain of \$5,500,000 taxed at 28 percent.

\$10,000,000 long-term capital gain. If Daniel sells the stock for \$25,000,000, he has a gain of \$23,000,000, but the maximum that is eligible for the exclusion is \$20,000,000 (10 times stock basis) as this is greater than \$10,000,000. He can exclude one-half of the \$20,000,000 gain or \$10,000,000. The remaining \$13,000,000 will be taxed at 28 percent.

38. *Section 1244 Stock*

Solution: Vanessa has a total loss on the Section 1244 stock of \$104,000 ($\$3,000 - \$107,000$). She can treat \$50,000 of the loss as an ordinary loss, deductible from ordinary income. The remaining \$54,000 loss is a long-term capital loss. She can deduct \$3,000 this year as a capital loss giving her a total deduction of \$53,000 in the current year. The remaining \$51,000 of the long-term capital loss can only be

carried forward and deducted at a rate of \$3,000 per year after offsetting other net capital gains in future years.

39. *Section 1202 Stock*

Solution: a. In 2013, Taylor has a long-term capital gain of \$400,000 (\$500,000 - \$100,000) on start-up company A that must be fully recognized because she did not hold the stock for more than 5 years. On start-up company B, she has a \$220,000 (\$300,000 - \$80,000) long-term capital gain but is only required to recognize \$110,000 ($\$150,000 / \$300,000 \times \$220,000$) of the gain because she held the stock for more than six months and reinvested one-half of the proceeds in another qualifying Section 1202 stock.

b. If Taylor had purchased the stock in year 2006, she would have held the stock for more than five years when she sold the shares in years 2013. She could exclude \$200,000 of her \$400,000 gain and the remaining gain would have been taxed at 28% as Section 1202 stock.

40. *Section 1244 Stock*

Solution: a. George has a loss on the Section 1244 stock of \$115,000 (\$160,000 - \$45,000). As a single person, he can deduct only \$50,000 of this loss as an ordinary loss plus \$3,000 of the remaining loss as a capital loss from his other income. The remaining \$62,000 (\$115,000 - \$53,000) of the loss will have to be carried forward as a capital loss and deducted against future capital gains and/or deducted at a rate of \$3,000 per year if he has no capital gains.

b. If George is married and files a joint return, he can deduct \$100,000 of the loss as ordinary income on the Section 1244 stock. He can still deduct an additional \$3,000 as a capital loss. The remaining \$12,000 loss (\$115,000 - \$103,000) must be carried forward as a capital loss.

41. *Mixed-Use Asset*

Solution: \$410 Section 1231 loss plus \$290 nondeductible personal loss. This is a mixed-use asset and the business and personal portions must be separated.

Business-use portion: $2,250 / (2,250 + 250) = 90\%$ business use. Purchase price = $90\% \times \$4,000 = \$3,600$. Adjusted basis at sale = $\$3,600 - \$2,200$ depreciation = \$1,400. $(90\% \times \$1,100) - \$1,400 = \$410$ Section 1231 loss on sale of business portion.

Personal-use portion: 10% personal use: $(10\% \times \$1,100) - (10\% \times \$4,000) = \$290$ nondeductible personal loss on this portion of the computer.

42. *Sale of Personal Residence*

Solution: \$301,000 realized and \$0 recognized gain. Their realized gain = \$301,000 [$\$387,000 - (\$56,000 + \$30,000)$]. Under Section 121 they can exclude up to \$500,000 of gain from taxation; thus, they have no recognized gain as they both meet the ownership and use tests.

43. *Sale of Personal Residence*

Solution: Carlotta's realized and recognized gain is \$25,000 (\$235,000 - \$210,000). She is permitted to elect Section 121 only once every two years except in special circumstances that do not apply if she is only moving for her convenience.

If Carlotta moves into a nursing home because of her health and that is the reason she sells the home, she may exclude a portion of the gain based on the time lived in the second home. She would be able to exclude up to $10/24 \times \$250,000$ or \$104,167 of gain. Thus, she would not have to recognize any of her \$25,000 realized gain.

44. *Related Party Transaction*

Solution: Marilyn's basis in the shares sold = \$10,000 $[(200/500) \times \$25,000]$. She has a realized loss of \$3,000 (\$7,000 - \$10,000) but she can recognize none of it because the sale was to her brother. Her basis in her remaining 300 shares is \$15,000 (\$25,000 - \$10,000 sold).

Her brother's basis in the shares he purchased is the purchase price of \$7,000. When he sells the stock for \$12,000, he has a \$5,000 realized gain (\$12,000 - \$7,000). He only has to recognize \$2,000 of the gain, however, as he can offset his sister's unrecognized \$3,000 loss against his \$5,000 gain.

45. *Related Party Transaction*

Solution: William's realized loss on the sale is \$20,000 [\$80,000 - (\$100 × 1,000)]. William cannot recognize any of the loss because the sale was to his grandfather. The grandfather takes the \$80,000 cost as his basis in the stock purchased. When the grandfather sells the stock for a \$5,000 gain (\$85,000 - \$80,000 basis), he recognizes none of it. He offsets the \$5,000 gain with \$5,000 of William's unrecognized loss. The remaining \$15,000 loss on William's stock is simply lost and provides no one any tax benefit.

46. *Capital Asset Netting*

Solution: \$500 gain on stock is STCG (applicable rate = 25%); \$2,300 gain on land is LTCG (maximum applicable rate = 20%); \$1,900 loss on gold coins is LTCL (loss on an asset in the 28% applicable rate class); \$1,200 gain on toys is LTCG (applicable rate = 28%); \$1,300 loss on land is STCL (loss on asset in the ordinary 25% applicable rate class).

Net the LTCGs and LTCLs to see if the result is a gain or loss. $\$2,300 \text{ LTCG} - \$1,900 \text{ LTCL} + \$1,200 \text{ LTCG} = \$1,600 \text{ LTCG}$; thus, the gain/loss on the 28% class assets must be considered separately.

Netting \$1,900 loss on coins against \$1,200 gain on toys = \$700 net loss on 28% assets; this loss then offsets \$700 of the \$2,300 gain on land yielding a \$1,600 net LTCG (maximum 20% applicable CG rate). Netting the \$500 STCG on the stock against the \$1,300 STCL on the land = \$800 net STCL. This \$800 net STCL then offsets \$800 of the \$1,600 net LTCG for a final \$800 LTCG taxed at a maximum 20%.

47. *Income Tax Liability*

Solution: Clarice's taxable income is \$44,152 and her total tax liability for 2013 is \$6,357.

Clarice has a long-term capital gain of \$18,000 (\$34,000 - \$16,000) on the sale of her BBC stock and a \$25,000 (\$55,000 - \$30,000) long-term capital gain on the sale of the coin collection. She must pay self-employment tax on the \$12,000 of income from her sole proprietorship of \$1,696 ($\$12,000 \times 92.35\% \times 15.3\%$). She is allowed to deduct \$848 ($\$12,000 \times 92.35\% \times 7.65\%$) as a deduction for adjusted gross income. Clarice is also entitled to a standard deduction of \$6,100 and a personal exemption deduction of \$3,900. Her total taxable income is $\$12,000 + \$18,000 + \$25,000 - \$848 - \$6,100 - \$3,900 = \$44,152$ including her capital gains. The gain on the stock can be taxed at a maximum 20% rate and the gain on the coin collection at a maximum 28% rate; her taxable income, excluding these gains, however, falls into the 10% bracket; thus all or part of these gains will be taxed at less than their maximum rates (to the extent they do not exceed the 15% bracket), with the gain on the coin collection (a 28% asset) considered prior to the gain on the stock (a 20% asset).

Her taxable income before the capital gain is included is as follows:

$(\$12,000 - \$6,100 - \$3,900 - \$848) = \$1,152 \times 10\%$ regular tax rate = \$115

Tax on coin collection: $\$25,000 + \$1,152 = \$26,152$ taxable income with the gain on the coins only; as this is less than the \$36,250 end of the 15% bracket, part of the \$25,000 gain on the coins will be taxed at 10% and the remainder at 15% as follows:

$(\$8,925 - \$1,152) = \$7,773 \times 10\%$ tax rate = \$777

$(\$25,000 - \$7,773) = \$17,227 \times 15\%$ tax rate = \$2,584

Tax on stock: $\$36,250 - \$26,152 = \$10,098$ remaining in the 15% bracket; thus, part of the gain on the stock will be taxed at 0% and the remainder at 15% as follows:

$(\$10,098) \times 0\% = \0

$(\$18,000 - \$10,098) \times 15\% = \$1,185$

The total income tax is $\$115 + \$777 + \$2,584 + \$0 + \$1,185 = \$4,661$

Her total tax liability is $\$4,661 + \$1,696$ self-employment tax = \$6,357

48. *Income Tax Liability*

Solution: His taxable income is \$23,000 and his tax liability is \$3,003.75.

1. Al must include the \$13,000 Section 1245 recapture in ordinary income.
2. Net \$3,000 Sec. 1231 gain (d) with \$6,000 Section 1231 loss (f); the result is a net Section 1231 loss which is deductible from ordinary income.
3. Net \$26,000 Section 1202 gain (a) with \$24,000 long-term capital loss (c), \$8,000 long-term loss (e) and \$20,000 long-term gain (g); the result is a \$14,000 net long-term capital gain.
4. Net this \$14,000 long-term gain (3) with the \$5,000 short-term loss (b); the result is a \$9,000 long-term gain.
5. Because there is a net long-term gain and items included are subject to various tax rates (along with a short-term loss), further analysis is required.
6. 28% rate assets: net \$26,000 Section 1202 gain with \$8,000 loss on coin collection resulting in \$18,000 gain tentatively taxed at 28%.

7. Maximum 20% rate assets: Net \$24,000 LTCL with \$20,000 LTCG on stocks resulting in a \$4,000 loss.

8. Apply the \$4,000 loss (7) and the \$5,000 short-term capital loss against the \$18,000 net gain on the 28% assets resulting in a final taxed amount of \$9,000 of 28% assets.

9. Determine tax: Al's income before the capital gain:

\$14,000 salary + \$13,000 Section 1245 recapture (1) - \$3,000 Section 1231 loss

(2) - \$6,100 standard deduction - \$3,900 personal exemption = \$14,000.

Tax on \$14,000 = \$8,925 x .10 + (\$14,000 - \$8,925) x .15 = \$1,653.75

The \$9,000 capital gain (on a 28% capital asset) all falls within the 15% bracket so total taxable income is \$23,000 (\$14,000 + \$9,000 = \$23,000 which is less than the 15% bracket cut-off of \$36,250). Thus, this gain is taxed at the 15% rate and is \$9,000 x .15 = \$1,350.

Total tax = \$1,653.75 + \$1,350 = \$3,003.75.

49. Capital Gain Tax Rates

Solution: Net all the capital gains with the capital losses (all long term): \$10,200 - \$5,000 - 2,500 (all collectibles) + \$15,000 - \$11,300 (stock) + \$5,000 (Unrecaptured Sec. 1250 gain) = \$11,400 net capital gain. As there is a net gain, each of the asset types must be netted separately. Thus there is a \$2,700 gain (\$10,200 - \$5,000 - \$2,500) for collectibles taxed at a 28% rate; a \$3,700 gain (\$15,000 - \$11,300) on the stock taxed at the 15% rate (ordinary tax rate is 28%); and the \$5,000 unrecaptured Section 1250 gain taxed at the 25% rate.

50. Income Tax Liability

Solution: a. Tax liability = \$8,066. Total taxable income including all capital gains is \$59,000. Tax is first determined on the \$15,000 of ordinary income: \$8,925 x 10% + (\$15,000 - \$8,925) x 15% = \$1,803.75. The \$10,000 unrecaptured Section 1250 gain is taxed next at 15% since the taxable income thus far does not exceed \$36,250. \$10,000 taxed at 15% = \$1,500. The \$9,000 gain on the painting (collectible) is included next and is also taxed at 15% as the total now is \$34,000 - still below the \$36,250 threshold. \$9,000 taxed at 15% = \$1,350. The remaining \$25,000 gain is taxed as follows: (\$36,250 - \$34,000) x 0% + (\$25,000 - [\$36,250 - \$34,000]) x 15% = \$3,412.50. Total tax is \$1,803.75 + \$1,500 + \$1,350 + \$0 + \$3,412.50 = \$8,066.25

b. Tax liability = \$68,723. If ordinary taxable income is \$225,000; tax on this amount again would be determined first and would be \$44,603.25 + (\$225,000 - \$183,250) x .33 = \$58,380.75. The unrecaptured Section 1250 gain is taxed at 25% + 3.8% Medicare surtax: \$10,000 x 28.8% = \$2,880. The \$9,000 collectible gain is taxed at 28% + 3.8% Medicare surtax: \$9,000 x 31.8% = \$2,862. The \$25,000 gain on the stock is taxed at 15% + 3.8 Medicare tax: \$25,000 x 18.8% = \$4,700. Total tax is \$58,380.75 + \$2,880 + \$2,862 + \$4,700 = \$68,822.75

c. Tax liability = \$121,223. Ordinary taxable income is \$380,000; tax on this amount is determined first and would be \$44,603.25 + (\$380,000 - \$183,250) x .33 = \$109,530.75. The taxes on the \$10,000 unrecaptured Section 1250 gain and the \$9,000 collectible gain are the same as in (b). The \$25,000 stock gain is now

taxed at 20% + 3.8% Medicare surtax = 23.8% or \$5,950. The total tax is now \$109,530.75 + \$2,880 + \$2,862 + \$5,950 = \$121,222.75.

(Note: taxpayer's adjusted AGI must exceed \$400,000 when the standard deduction, personal exemption are added to taxable income along with the \$19,000 for the other capital gains, subjecting the \$25,000 stock gain to the 20% maximum capital gains tax rate.)

51. *Comprehensive Problem for Chapters 6 and 7*

Solution: a. Depreciation deductions for years 2010 through 2013:

<u>Asset</u>	<u>Life</u>	<u>Basis</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Computer	5 yrs.	\$ 900	\$ 180	\$ 288	\$ 173	\$ 52
Tools	5 yrs.	1,100	220	352	211	127
Machine A	7 yrs.	24,000	24,000			
Machine B	7 yrs.	40,000	5,716	9,796	6,996	4,996
Building	39 yrs.	125,000		3,076	3,205	3,205
Off. Furniture	7 yrs.	4,000		4,000		
Machine C	7 yrs.	48,000		48,000		
New Computer	5 yrs.	5,100				3,060
New Machine	7 yrs.	58,000				33,144
Total			\$30,116	\$65,512	\$10,585	\$44,584

Depreciation for all personalty is calculated using the half-year averaging convention. Machine A is the only asset on which Section 179 expensing was claimed. Bonus depreciation of 100% is claimed in 2011 and 50% in 2013 on asset acquisitions along with regular MACRS depreciation on the balance in 2013. A half-year's depreciation is taken in the year of disposition for the old computer.

b. \$6,000 Section 1245 ordinary income is realized and recognized on the disposal of Machine A. Machine A's basis was reduced to zero by Section 179 expensing. Therefore, the entire \$6,000 sales proceeds will be recaptured as ordinary income under Section 1245.

A \$600 long-term capital gain is realized and recognized on the bonds (\$10,400 - \$9,800 basis = \$600 long-term capital gain).

No gain or loss is recognized on the disposition of the computer. The computer's basis at disposition is \$207 (\$900 - \$693 depreciation) for loss and \$2,007 (\$2,700 cost - \$693 depreciation) for gain. Because it is sold for a price (\$300) between basis for gain and basis for loss, the basis is set equal to the selling price resulting in no realized or recognized gain or loss.

Think Outside the Text

These questions require answers that are beyond the material that is covered in this chapter.

52. *Personal Asset Converted to Business Use*

Solution: a. When personal property is converted to business use and then depreciated, dual depreciation schedules should be kept—one based on the asset's original cost, the

other on the fair market value, if lower because a different basis may be used to determine gain than for loss. Her adjusted basis for loss is \$9,000 (the \$12,000 fair market value at conversion less the \$3,000 depreciation). When the auto is sold for \$8,000, she has a \$1,000 Section 1231 loss (\$8,000 - \$9,000 basis).

b. Her adjusted basis for gain is \$13,000 (\$16,000 purchase price - \$3,000 depreciation). If the auto is sold for \$14,000, she would have \$1,000 gain (\$14,000 - \$13,000 basis). The gain would be taxed as ordinary income due to Section 1245 recapture.

53. *Gains and Losses on Stock Transactions*

Solution: a. If specific identification is not used, the first-in, first-out method is used to determine which shares are sold.

May 4, year 3 sale: $\$1,400 - [(150 \times \$5) + (50 \times \$6)] = \350 gain.

April 12, year 4 sale: $\$600 - (150 \times \$6) = \$300$ loss

b. $\$600 - (150 \times 6.50) = \375 loss.

54. *Capital Asset Netting*

Suggested Solution: The most likely reason that the netting process remains for corporations is that at some time in the future Congress could reinstate some form of preferential treatment for corporate capital gains. Preferential treatment for corporations' capital gains was dropped when corporate tax rates were reduced significantly; if these rates are increased in the future, preferential treatment for capital gains could easily be reintroduced. Another likely possibility is that these and many other provisions are just sitting unaddressed because Congress has chosen not to address these seemingly unnecessary provisions until a more complete revision of the tax laws is undertaken.

55. *Capital Gains*

Solution: Under the current tax provisions, *Gregory's gains on the Section 1202 stock and his art collections will be taxed at 28%: $(\$45,000 + \$102,000) \times 28\% = \$41,160$* . With the addition of these gains to his ordinary taxable income, his adjusted AGI will exceed \$400,000 and the \$55,000 gain on the stock will be subject to the 20% capital gains rate: $\$55,000 \times 20\% = \$11,000$. His AGI also far exceeds the threshold for adding the Medicare surtax so all gains will be subject to an additional tax of 3.8%: $(\$45,000 + \$102,000 + \$55,000) \times 3.8\% = \$7,676$. Total tax on the gains would be $\$41,160 + \$11,000 + \$7,676 = \$59,836$. If all gains were taxed at 20%, the total be $\$202,000 \times 20\% = \$40,400$. This would result in a reduction in taxes of \$11,760 ($\$147,000 \times 8\%$) due to the difference between the 28% and 20% rates and an additional reduction of \$7,676 if the Medicare surtax does not apply, for a total reduction of \$19,436 in taxes.

56. *Personal Residence Gain Exclusion*

Suggested Solution: Just as the interest rate deduction for mortgage interest encourages home ownership, the ability to invest in a personal residence and exclude gain on a future sale encourages persons to make this type of investment. In addition, most persons who do sell a home purchase another residence. Taxing gain on the sale of the first residence would reduce the taxpayer's ability to purchase a comparable

residence at the same price at which the old one was sold due to the tax payment. The old Section 1034 gain deferral required the taxpayer to purchase a more expensive residence to exclude any gain. This encouraged taxpayers to “move up.” Having to pay taxes defeats encouraging taxpayers to “move up.” The exemption also allows older persons who wish or need to move out of their home and into a more comfortable environment to do so without tax penalty. Many older persons’ primary investment is in their home and their equity is looked at as their retirement nest egg. Homes in general are purchased with after-tax income (although mortgage interest on most homes is deductible); thus, this allows the gain to be exempt from tax similar to allowing an exemption for retirement funds set aside with after-tax income (for example, the Roth IRA). Congress has now, however, reduced the amount of the gain that can escape taxation on a second home that is converted to the primary residence at a later date.

Identify the Issues

Identify the issues or problems suggested by the following situations. State each issue as a question.

57. *Worthless Stock*

Solution: What is Kwan Lu’s loss on the stock and how and when will he be able to deduct it?

58. *Character of Gain*

Solution: What will be Gallagher Farms amount and character of the gains realized on the sale of the dormitories and the land? How will these be taxed?

59. *Asset Sales*

Solution: How will Martco be taxed on the sales of the various hearing aids: those sold to customers, the first lots sold to retail outlets, and the second bulk sale to a distributor?

60. *Sale of Personal Residence*

Solution: What is the length of time Marco is considered to have occupied the smaller home? How will he treat the gain that he realizes on the sale of this home?

Develop Research Skills

Solutions to research problems are included in a separate file.

Search the Internet

64. *Capital Gains Rates*

Solution: Articles and citations will vary.

65. *Capital Gain Schedules*

Solution: The Schedule D that accompanies an individual’s Form 1040 for 2012 is only 2 pages long. Form 8949, however, must also be filed along with the Schedule D. This form is now where all the necessary information for all of the basic short- and long-term capital gains are reported rather than on the Schedule D. The totals for

the various gains and losses are then transferred to the Schedule D. The instructions for Schedule D are 13 pages long and contain a number of schedules related to determining tax rates and carryovers. Although included last year, the instructions for Form 8949 are no longer included but provided separately. Form 8949 is used to report the individual transactions that are then aggregated for reporting on the Schedule D. The Schedule D that accompanies a corporation's Form 1120 is 1 page long, but also requires the completion of Form 8949 for individual items. The instructions for this Schedule D are only 4 pages long. This is a perfect illustration that the capital gains for individuals are far more complex than they are for corporations.

66. *Form 4797*

Solution: A filled-in Form 4797 is included at the end of this file.

67. *Schedule D—Form 1040*

Solution: A filled-in Form 8949 and Schedule D are included at the end of this file. The net effect of these asset sales is to increase Gineen Tibeau's taxable income by \$250 taxed at a maximum tax rate of 28%. (\$8,000 gain on Dali drawing is first offset by the \$150 STCL on CDF and then by the net \$7,600 LTCL on ABC, GHI, and XYZ.)

68. *Sale of Personal Residence*

Solution: These instructions can be found in several places. The instructions for Schedule D for individuals and Form 8949 both contain basic instructions for completing these two forms for reporting the sale information, determining any recognized gain, and for filing instructions. Publication 523 provides much more detailed information on determining the tax results of selling a personal residence. If the taxpayer's entire realized gain on the sale of a personal residence is excluded from taxation, then the taxpayer does not report any information regarding the sale on his or her tax return. If the taxpayer has gain that is not excluded or elects not to exclude the gain, the gain is reported first on Form 8949 and then transferred to Schedule D.

Develop Planning Skills

69. *Selling Decision*

Solution: If Natalie elects to hold on to her Dritco stock, she will only be able to deduct \$3,000 of her \$5,000 capital loss. This will reduce her taxes by \$840 ($\$3,000 \times 28\%$). Currently, she has a \$12,000 unrealized gain on her Dritco stock, which is equal to a gain of \$12.00 per share. She has three potential courses of action: a. Sell all the stock now; b. Sell all the stock after June 15. c. Sell enough stock now to allow her to offset all \$3,000 of her loss and sell the remaining stock next year.

a. Sell all now: $\$27,000 - \$15,000 = \$12,000$ short-term capital gain; the tax on the net gain of \$7,000 net STCG ($\$12,000 \text{ STCG} - \$5,000 \text{ STCL}$) is \$1,960 ($\$7,000 \times 28\%$). Her net cash flow is \$25,040 ($\$27,000 - \$1,960$).

b. Sell all after June 15: $\$26,000 - \$15,000 = \$11,000$ long-term capital gain; tax on the net gain of \$6,000 ($\$11,000 \text{ LTCG} - \$5,000 \text{ STCL}$) is \$900 ($\$6,000 \times 15\%$). Her net cash flow is \$25,100 ($\$26,000 - \900).

c. Sell some stock now: Selling 167 shares now yields a gain of \$2,004 [$167 \times (\$27 - \$15)$]. She will have a net short-term capital loss of \$2,996 ($\$5,000 \text{ STCL} - \$2,004 \text{ STCG}$) that will reduce her taxes by \$839 ($\$2,996 \times .28$). If she sells the remaining shares next year, she will have a \$9,163 gain [$833 \times (\$26 - \$15)$] which will result in a tax of \$1,374 ($\$9,163 \times 15\%$). Her cash flow without considering the time value of the money would be $\$4,509 (167 \times \$27) + \$839 + \$21,658 (833 \times \$26) - \$1,374 = \$25,632$. If, however, we use a 6 percent discount factor for the sale and taxes in the next year, the net cash flow is reduced to $\$24,476 [\$4,509 + \$839 + .943 (\$21,658 - \$1,374)]$.

Considering the time value of money, Natalie's best decision would be to sell all of the stock sometime after June 15 to take advantage of the long-term capital gain rates. Alternatively, if her discount rate is much lower than 6 percent, the last alternative could be used, but any additional drop in the stock price could alter that.

70. *Timing of Sale*

Solution: Yes. If he sells the land now, he will have a long-term capital gain of \$40,000. This will offset all but \$2,000 of the short-term capital loss. He will be able to deduct this remaining loss and reduce other taxes by \$800 ($\$2,000 \times 40\%$). His total cash flow is \$60,800 ($\$60,000 + \800).

If he waits three more years, he will only be able to deduct \$3,000 of his short-term capital loss in the current and next two succeeding years. This will reduce his taxes in each of those years by \$1,200 ($\$3,000 \times 40\%$). In the 4th year, he will have a \$46,000 ($\$66,000 - \$20,000$) long-term capital gain on the sale. His remaining short-term capital loss of \$33,000 ($\$42,000 - \$9,000$) will offset all but \$13,000 of this gain. He will pay a federal capital gains tax of \$1,950 ($\$13,000 \times 15\%$)—assuming the 15% rate is applicable based on his other income) plus a state tax on this gain reducing his net proceeds to no more than \$64,050 ($\$66,000 - \$1,950$). The net present value of the proceeds over the current and the next three years is:

$\$1,200 \text{ (current tax savings)} + \$1,200 (.943) + \$1,200 (.89) + \$64,050 (.84) =$
 $\$1,200 + \$1,132 + \$1,068 + \$53,802 = \$57,202$ less the present value of any state tax.

George should sell to his brother this year as this improves the present value of his cash flow by a minimum of \$3,598 ($\$60,800 - \$57,202$).

(Note: This problem implicitly assumes that state and federal tax laws are similar. When federal laws change, state laws may differ and this could change the analysis.)

71. *Timing of Stock Sales*

Solution: If Wilma's marginal tax rate is relatively static, Wilma should sell all of her stock (or enough of the stock to realize a \$15,000 gain). The realized gain will offset all but \$2,000 (\$3,000) of the loss and allow her to deduct the remaining loss in the current year. She can then take the proceeds and repurchase some or all of this same stock to benefit from its expected appreciation. Although she may have some transaction costs, the present value of accelerating the tax benefit compared to

spreading the loss deduction over 6 years should exceed these costs. (There is no provision that prevents Wilma from selling gain stock and repurchasing it as there is for loss stock with the wash sale rules.)

72. *Avoiding Ordinary Income*

Solution: As a real estate dealer, Betty's sales of property would be sales of inventory and any gain taxed as ordinary income. She should give the piece of property to her son. She can avoid gift taxes by using her annual exclusion and part of her lifetime credit. The son can then either sell the property or he could borrow against the property. There would be the expense involved in the title transfers, but the tax savings to Betty would more than offset them. She could also gift partial (50%) interests in the property to her son over two years, avoiding gift taxes solely by using her annual exclusion for the interest gifted. If, however, the son needs the \$25,000 immediately, the first alternative would be a good option.

73. *Timing Asset Sales*

Solution: As a sole proprietorship, the sales of both personal and business property flow through to her personal tax return.

Gains/Losses on Business Assets:

<u>Asset</u>	<u>Amt. Gain (Loss)</u>	<u>Type</u>
Truck	\$ 3,000	Section 1245 ordinary income
Office Bldg.	140,000	\$125,000 unrecaptured Section 1250 gain and \$15,000 Section 1231 gain
Machine 1	(15,000)	Section 1231 loss
Machine 2	5,000	Section 1245 ordinary income

Monique should consider selling all of these business assets as the gains on them may be helpful in offsetting losses on sales of her personal investment assets. She has \$8,000 (\$3,000 + \$5,000) of Section 1245 ordinary income that will be taxed at her 39.6% marginal tax rate on sales of the truck and machine 2; her \$15,000 Section 1231 loss on Machine 1 offsets her \$15,000 Section 1231 gain on the building; she has a \$125,000 unrecaptured Section 1250 gain remaining on the building that is subject to the 25% tax rate (plus the 3.8% Medicare surtax), but which could potentially offset gains on other sales.

Potential Gains/Losses on Personal Assets:

<u>Asset</u>	<u>Amt. Gain (Loss)</u>	<u>Type</u>	<u>Proceeds of Sale</u>
Sculpture	\$140,000	LTCG @ 28% rate	\$400,000
Painting	(125,000)	LTCL @ 28% rate	400,000
100,000 sh. ACC	(250,000)	LTCL @ 15/20% rate	800,000
10,000 sh. BBL	50,000	STCG @ 39.6% rate	400,000

Monique needs \$800,000 from the sale of personal assets for her expansion. Her choices are (a) sell ACC stock only, (b) sell the sculpture and painting, (c) sell the sculpture and BBL stock, or (d) sell the painting and BBL stock.

(a) Sell ACC stock only: The \$250,000 loss on ACC stock offsets her \$125,000 unrecaptured Section 1250 gain on the building. She can only deduct \$3,000 of the remaining loss this year; the remaining \$122,000 loss is carried forward and is

deductible subject to the \$3,000 annual limit. She will pay no taxes on these sales.
 (b) Sell Sculpture and painting: Netting the \$140,000 LTCG on the sculpture against the \$125,000 LTCL on the painting and the \$125,000 unrecaptured Section 1250 gain leaves Monique with \$110,000 of unrecaptured Section 1250 gain to recognize that would be taxed at 25% plus the 3.8% Medicare surtax .

(c) Sell Sculpture and BBL stock: Monique will have \$315,000 (\$140,000 + \$50,000 + \$125,000) of total gain to recognize (\$50,000 at 39.6%, \$125,000 at 25%, and \$140,000 at 28%, all rates subject to the 3.8% Medicare surtax as well).

(d) Sell painting and BBL stock: Monique will have a net \$50,000 STCG taxed at 39.6% plus the 3.8% Medicare surtax. The \$125,000 LTCL offsets the \$125,000 unrecaptured Section 1250 gain).

Options (a) provides the best solution with (d) providing the next best alternative. The tax on the \$50,000 STCG would be \$21,700 (43.4% x \$50,000).

Option (a) has no current tax cost, but the value of the deductibility of the net loss could be greatly reduced unless Monique has the possibility of realizing additional capital gains in the near future. (If she sells her sculpture in addition to the ACC stock, she will have a LTCG of \$140,000 to offset the \$125,000 loss; the net \$15,000 gain would be taxed at 28% (plus Medicare surtax), but she will have freed up an additional \$400,000 to invest in the business.)

Option (d) does have a current tax cost, but it is the least costly of the three options providing the \$800,000.

74. *Sale of Personal Residence*

Solution: Joy can sell the Florida home at any time as she meets currently the two-out-of-five year requirement to qualify for the Section 121 exclusion, having moved December 1, 2010 and it is now 2013. She could move back up to the Maine home and restart this home as her primary residency but she will have to adjust any gain on its sale for the period of time she lived in the Florida home (as her primary residence) as during that time the Maine home would have been considered a vacation home. She would have to requalify for the 2 or 5 year residency on the Maine home and this may not be practical. She would have to wait to sell so that she could show that she lived there longer during the five-year period than she had in the Florida home. She effectively would have to move back and change her residency before having been a resident of Florida for 2½ years, to meet the residency requirement immediately and have a sale before the end of 2013 qualify. To avoid any problems with establishing the residency requirements, the sale of the Florida home is more practical if she needs to sell in 2013.

Form **4797**Department of the Treasury
Internal Revenue Service**Sales of Business Property**
(Also Involuntary Conversions and Recapture Amounts
Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.

▶ Information about Form 4797 and its separate instructions is at www.irs.gov/form4797.

OMB No. 1545-0184

2012Attachment
Sequence No. **27**

Name(s) shown on return

Identifying number

Taxpayer

- 1** Enter the gross proceeds from sales or exchanges reported to you for 2012 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)

1**Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
3	Gain, if any, from Form 4684, line 39						3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6	Gain, if any, from line 32, from other than casualty or theft.						6 6,000
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						7 6,000
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							
8	Nonrecaptured net section 1231 losses from prior years (see instructions)						8
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)						9

Part II Ordinary Gains and Losses (see instructions)

- 10** Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7						11 ()
12	Gain, if any, from line 7 or amount from line 8, if applicable						12
13	Gain, if any, from line 31						13 42,000
14	Net gain or (loss) from Form 4684, lines 31 and 38a						14
15	Ordinary gain from installment sales from Form 6252, line 25 or 36						15
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.						16
17	Combine lines 10 through 16						17
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:						
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions						18a
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14						18b 42,000

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 130861

Form **4797** (2012)

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255
 (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:		(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	Machine	4/24/yr2	12/20/yr6
B	Machine	3/05/yr1	12/20/yr6
C	Machine	6/18/04	12/20/yr6
D	Machine	11/10/yr5	12/20/yr6

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D	
20	Gross sales price (Note: See line 1 before completing.)	20	25,000	18,000	51,000	93,000
21	Cost or other basis plus expense of sale	21	45,000	75,000	63,000	87,000
22	Depreciation (or depletion) allowed or allowable.	22	25,000	67,000	21,000	18,000
23	Adjusted basis. Subtract line 22 from line 21.	23	20,000	8,000	42,000	69,000
24	Total gain. Subtract line 23 from line 20	24	5,000	10,000	9,000	24,000
25 If section 1245 property:						
a	Depreciation allowed or allowable from line 22	25a	25,000	67,000	21,000	18,000
b	Enter the smaller of line 24 or 25a	25b	5,000	10,000	9,000	18,000
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.						
a	Additional depreciation after 1975 (see instructions)	26a				
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b				
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d	Additional depreciation after 1969 and before 1976.	26d				
e	Enter the smaller of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f.	26g				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).						
a	Soil, water, and land clearing expenses	27a				
b	Line 27a multiplied by applicable percentage (see instructions)	27b				
c	Enter the smaller of line 24 or 27b	27c				
28 If section 1254 property:						
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a				
b	Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:						
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b	Enter the smaller of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	48,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	42,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	6,000

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less
 (see instructions)

	(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years.	33	
34 Recomputed depreciation (see instructions)	34	
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	

SCHEDULE D
(Form 1040)Department of the Treasury
Internal Revenue Service (99)**Capital Gains and Losses**

▶ Attach to Form 1040 or Form 1040NR.

▶ Information about Schedule D and its separate instructions is at www.irs.gov/form1040.

▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074

2012
Attachment
Sequence No. **12**

Name(s) shown on return

Gineen Tibeau

Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

Complete Form 8949 before completing line 1, 2, or 3.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price) from Form(s) 8949, Part I, line 2, column (d)	(e) Cost or other basis from Form(s) 8949, Part I, line 2, column (e)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I	4,950	5,100	0	(150)
2 Short-term totals from all Forms 8949 with box B checked in Part I				
3 Short-term totals from all Forms 8949 with box C checked in Part I				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824			4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions			6	()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back			7	(150)

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

Complete Form 8949 before completing line 8, 9, or 10.

This form may be easier to complete if you round off cents to whole dollars.

	(d) Proceeds (sales price) from Form(s) 8949, Part II, line 4, column (d)	(e) Cost or other basis from Form(s) 8949, Part II, line 4, column (e)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 4, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II	55,400	55,000		400
9 Long-term totals from all Forms 8949 with box B checked in Part II				
10 Long-term totals from all Forms 8949 with box C checked in Part II				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824			11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			12	
13 Capital gain distributions. See the instructions			13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions			14	()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back			15	400

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2012

Part III Summary

16 Combine lines 7 and 15 and enter the result	16	250
<ul style="list-style-type: none"> • If line 16 is a gain, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. • If line 16 is a loss, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. • If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22. 		
17 Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.		
18 Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet in the instructions . . . ►	18	250
19 Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet in the instructions ►	19	
20 Are lines 18 and 19 both zero or blank? <input type="checkbox"/> Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). Do not complete lines 21 and 22 below. <input checked="" type="checkbox"/> No. Complete the Schedule D Tax Worksheet in the instructions. Do not complete lines 21 and 22 below.		
21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of: <div style="display: flex; align-items: center;"> <div style="margin-right: 10px;"> <ul style="list-style-type: none"> • The loss on line 16 or • (\$3,000), or if married filing separately, (\$1,500) </div> <div style="font-size: 3em; margin-right: 10px;">}</div> <div> </div> </div>	21 ()
Note. When figuring which amount is smaller, treat both amounts as positive numbers.		
22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b? <input type="checkbox"/> Yes. Complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). <input type="checkbox"/> No. Complete the rest of Form 1040 or Form 1040NR.		

Form **8949**Department of the Treasury
Internal Revenue Service**Sales and Other Dispositions of Capital Assets**► Information about Form 8949 and its separate instructions is at www.irs.gov/form8949.

► File with your Schedule D to list your transactions for lines 1, 2, 3, 8, 9, and 10 of Schedule D.

OMB No. 1545-0074

2012
Attachment
Sequence No. **12A**

Name(s) shown on return

Gineen Tibeau

Social security number or taxpayer identification number

Most brokers issue their own substitute statement instead of using Form 1099-B. They also may provide basis information (usually your cost) to you on the statement even if it is not reported to the IRS. Before you check Box A, B, or C below, determine whether you received any statement(s) and, if so, the transactions for which basis was reported to the IRS. Brokers are required to report basis to the IRS for most stock you bought in 2011 or later.

Part I Short-Term. Transactions involving capital assets you held one year or less are short term. For long-term transactions, see page 2.

You must check Box A, B, or C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☒ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis **was** reported to the IRS
- ☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **was not** reported to the IRS
- ☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the Note below and see <i>Column (e)</i> in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
						(f) Code(s) from instructions	(g) Amount of adjustment	
	CDF Bonds	2012	2012	4,950	5,100			150
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 1 (if Box A above is checked), line 2 (if Box B above is checked), or line 3 (if Box C above is checked). ►				4,950	5,100			150

Note. If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Name(s) shown on return. (Name and SSN or taxpayer identification no. not required if shown on other side.)

Social security number or taxpayer identification number

Gineen Tibeau

Most brokers issue their own substitute statement instead of using Form 1099-B. They also may provide basis information (usually your cost) to you on the statement even if it is not reported to the IRS. Before you check Box A, B, or C below, determine whether you received any statement(s) and, if so, the transactions for which basis was reported to the IRS. Brokers are required to report basis to the IRS for most stock you bought in 2011 or later.

Part II Long-Term. Transactions involving capital assets you held more than one year are long term. For short-term transactions, see page 1.

You must check Box A, B, or C below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(A)** Long-term transactions reported on Form(s) 1099-B showing basis **was** reported to the IRS
- ☐ **(B)** Long-term transactions reported on Form(s) 1099-B showing basis **was not** reported to the IRS
- ☐ **(C)** Long-term transactions not reported to you on Form 1099-B

3	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the Note below and see <i>Column (e)</i> in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
						(f) Code(s) from instructions	(g) Amount of adjustment	
	100 share ABC Stock	2010	2012	6,000	4,000			2,000
	Original Daii Drawing	2010	2012	31,000	23,000			8,000
	200 shares GHI Stock	2010	2012	6,400	8,000			(1,600)
	5,000 shares of XYZ Stock	2010	2012	12,000	20,000			(8,000)
4 Totals.	Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 8 (if Box A above is checked), line 9 (if Box B above is checked), or line 10 (if Box C above is checked) ►			55,400	55,000			400

Note. If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.