

# CHAPTER 11

## PROPERTY DISPOSITIONS

2017 Edition	Topic	Status
<b>Questions</b>		
1	Deferral versus disallowance	Unchanged
2	Assumption of seller's debt and amount realized	Unchanged
3	Deductibility of brokerage commissions	Unchanged
4	Amount realized determined using FMV of property received	Unchanged
5	Distinction between long-term capital gain (loss) and short-term capital gain (loss)	Unchanged
7	Tax advantage(s) of long-term capital gains	Unchanged
8	Purpose of the netting of capital gain(s) and capital loss(es)	Unchanged
6	Explain the deductibility of net capital loss rules on corporations	Unchanged
9	Exclusion of realized capital gain on small business stock	Unchanged
10	Year-end tax-planning strategy with net capital gains	Unchanged
11	Basis of securities sold when portfolio contains stocks purchased at different prices	Unchanged
12	Loss recognition on a worthless security	Unchanged
13	Definition of Section 1231 property	Unchanged
14	Tax advantage of selling 1231 property at a gain	Unchanged
15	Differences between capital assets and Section 1231 property	Unchanged
16	Explain the lookback rule for Section 1231 netting	Unchanged
17	Purpose of the depreciation recapture rules	Unchanged
18	Differences between Section 1245 and 1250 recapture rules	Unchanged
19	Determining when a building is considered Section 1250 property	Unchanged
20	Sales of depreciable property not afforded capital gain treatment	Unchanged
21	Tax treatment of unrecaptured 1250 gain	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
<b>Problems</b>		
22	Determining the amount realized - four scenarios	Unchanged
23	Determining the amount realized - four scenarios	Unchanged
<b>24-COMM</b>	Determining amount realized - complex problem	Unchanged
25	Determining recognized gain (loss) and realized gain (loss) - four scenarios	Unchanged
26	Determining the amount realized - four scenarios	Unchanged
<b>27-COMM</b>	Effect of sales commissions and legal fees on realized gain and basis of asset	Unchanged
28	Exchange of properties encumbered by debt	Unchanged
29	Identification of stock basis, FIFO method	Unchanged
30	Identification of stock basis, FIFO method - relates to #29	Unchanged
31	Identification of stock basis, FIFO method - relates to #29	Unchanged
32	Identification of stock basis, specific identification - relates to #29	Unchanged
33	Classifying various assets as either ordinary, capital, Section 1231, or personal use	Unchanged
34	Classifying assets as either ordinary, capital, Section 1231 or personal use	Unchanged
35	Stock basis and wash sale rules	Unchanged
36	Identification of stock basis, wash sale rules, and gain (loss) on stock sales	Unchanged
37	Realized capital gains (losses) and holding period - four scenarios	Unchanged
38	Realized capital gains (losses) and holding period - four scenarios	Unchanged
39	Capital gain (loss) netting – net capital loss	Unchanged
40	Capital gain (loss) netting - corporation	Unchanged
41	Capital gain (loss) netting - individual (relates to #40)	Unchanged
42	Capital gain (loss) netting	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
43	Capital gain (loss) netting	Unchanged
44	Capital gain (loss) netting with collectible gain	Unchanged
45	Capital gain (loss) netting with collectible gain and capital loss carryover	Unchanged
46	Capital gain (loss) netting with collectible gain	Unchanged
47	Capital gain (loss) netting with collectible gain, unrecaptured 1250 gain, and capital loss carryover	Unchanged
48	Qualified small business stock	Unchanged
49	Qualified small business stock (relates to #48)	Unchanged
50	Qualified small business stock – 75% Exclusion	Unchanged
51	Qualified small business stock – 100% Exclusion	Unchanged
<b>52-COMM</b>	Qualified small business stock	Unchanged
53	Sale of small business stock at a gain by partnership	Unchanged
54	Sale of small business stock at a gain by an individual	Unchanged
<b>55-COMM</b>	Year-end planning with a net capital gain position	Unchanged
56	Year-end planning with a net capital loss position	Unchanged
57	Worthless securities	Unchanged
58	Section 1231 netting	Unchanged
59	Section 1231 netting - refers to problem #58	Unchanged
60	Section 1231 netting - recapture	Unchanged
61	Business casualty and Section 1231 netting	Unchanged
62	Section 1231 netting – lookback rule	Unchanged
63	Section 1245 recapture relates to Chapter 10, #48	Modified
64	Sale of equipment Section 1231 gain and Section 1245 recapture	Unchanged
65	Mixed-use auto - realized gain and loss on sale	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
66	Gain on the sale of Section 1250 real estate	Unchanged
67	Compare 1250 recapture between 1985 and 1989 acquired property	Unchanged
68	Gain on the sale of Section 1250 realty - relates to Chapter 10, #54	Unchanged
69	Gain on the sale of Section 1250 realty with additional capital gains and losses (Continuation of #67)	Unchanged
70	Gain on the sale of Section 1250 realty with additional capital gains and losses	Unchanged
71-IID	Amount realized - mortgage assumption	Unchanged
72-IID	Amount realized - loan assumption	Unchanged
73-IID	Gain on sale of inherited property	Unchanged
74-IID	Character of gain on sale of gift property	Unchanged
75-IID	Income recognition on treasure troves	Unchanged
76-IID	Income recognition - FIFO rule for stock	Unchanged
77-IID	Character of loss on worthless securities	Unchanged
78-IID	Character of loss on sale of equipment	Unchanged
79-IID	Treatment of Section 1231 gain	Unchanged
80-IID	Character of gain on sale of building	Unchanged
81-IID	Character of gain on sale of construction crane	Unchanged
82-IID	Sale of mixed use property	Unchanged
83-IID	Character of gain on sale of rental property	Unchanged
84	Tax Simulation	Unchanged
85	Internet Assignment	Unchanged
86	Internet Assignment	Unchanged
87	Research Problem – Taxation of restrictive covenants	Unchanged
88	Research Problem – Sale of farm land	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
89-INT	Integrative problem based on Chapter 9 #89 and Chapter 10 #74	Modified
90-C	Comprehensive problem - effect of eight property transactions on taxable income of a corporation	Unchanged
<b>91-C-COMM</b>	Comprehensive problem - effect of seven property transactions on taxable income of an individual	Unchanged
92-DC-CT	Qualified small business stock - gift of unrealized gain shares	Unchanged
93-DC-CT	Year-end tax planning with net capital loss position	Unchanged
94-TPC-CT	Net Capital gain and loss positions - exploring alternative strategies	Unchanged
95-TPC-COMM	Sale of firm's assets for a single price	Unchanged
<b>96-TPC-COMM</b>	Sale of a business - assets vs. stock	Unchanged
<b>97-EDC-COMM</b>	Sale of a business asset - focuses on SSTS #1 and 3	Unchanged

---

## CHAPTER 11

### PROPERTY DISPOSITIONS

---

#### DISCUSSION QUESTIONS

1. In determining the amount of a realized gain or loss to be recognized in the current year, certain types of gains and losses are deferred while others are disallowed. What is the difference between deferring a gain or loss realized in the current period and disallowing the recognition of a current period loss? Give at least one example of each that has been studied to date in this course.

**A deferred gain or loss is one which does not affect current year taxable income. However, a deferred gain or loss will have an effect on taxable income in a subsequent tax year.**

**A disallowed loss is a loss which does not affect the current year taxable income, nor does it affect a future year's taxable income. That is, it is never deductible.**

**Examples of deferred losses: A wash sale is a current period loss that is deferred through the basis of the shares acquired.**

**A suspended loss from a passive activity is deferred and deducted against future passive income or deducted when the activity is sold in a fully taxable transaction.**

**Examples of disallowed losses: A personal use loss is a loss on the sale of a personal use asset and is never deductible.**

**A related party loss is a loss on the sale of an asset to a related party and is never deductible for the taxpayer realizing the loss. The disallowed loss may be used to offset subsequent gains on sale of the property by the purchaser, but the offset is not fully guaranteed.**

2. What effect does the assumption of a seller's debt have on the amount realized from the disposition of a property?

**The assumption of a seller's debt is equivalent to the buyer paying the seller cash and the seller using the cash to pay off the debt. Therefore, assumptions of debt are part of the sales price of the property and increase the amount realized from the disposition.**

3. Are brokerage commissions paid on the sale of stock a current period expense? Explain.

**Brokerage commissions paid on the sale (or purchase) of stock are never current period expenses. Commissions paid to acquire stock are added to the basis of the stock as part of the cost of obtaining the stock. When the stock is sold, the basis is deducted against the amount realized from the sale. The commissions paid on the sale reduce the amount realized from the sale and affect the gain or loss on the sale of the stock.**

4. In a transaction in which the seller of property agrees to take other property from the buyer as part of the sales price, why is the buyer's adjusted basis unimportant in determining the amount realized by the seller?

The buyer's basis in other property represents the buyer's unrecovered capital investment in the property. It is based on the initial cost of the property to the buyer adjusted for changes in capital investment during the time it was held. Therefore, the buyer's basis is not reflective of the property's fair market value. In bargaining for the property, the seller is concerned with the amount that he or she can obtain from the sale of the property; i.e. the fair market value of the buyer's property is what the seller is bargaining for in the transaction. Thus, the fair market value of the property received by the seller is part of the bargained sales price of the property, not the buyer's basis.

5. What is the purpose of the capital gain-and-loss netting procedure?

The purpose of the capital gain and loss netting procedure is to reduce all of a taxpayer's capital gain and loss transactions for a year to either a net gain or a net loss position. That is, the netting procedure summarizes all capital asset transactions for the year into a net figure. The treatments of capital gains and losses are then applied to the net figure for the year, not to each individual capital asset transaction occurring during the year.

6. Why is a distinction made between long-term capital gain (loss) property and short-term capital gain (loss) property?

The current tax law only provides tax benefits to long-term capital gains of individuals. Short-term capital gains are treated as ordinary income. In addition, individual taxpayers with net capital losses are required to deduct short-term capital losses first in determining the \$3,000 maximum capital loss deduction. Therefore, capital gains and losses must be segregated into long-term and short-term gains and losses to determine whether the taxpayer can take the benefits accorded to long-term capital gains and to determine what capital losses he or she may deduct.

7. What is (are) the current tax advantage(s) of selling an asset at a long-term capital gain?

The current tax advantage is that *net* long-term capital gains are taxed at 15% (0% for 10% and 15% marginal tax rate taxpayers, 20% for 39.6% marginal rate taxpayers). In addition, 50% of the capital gain from the disposition of qualified small business stock is excluded. For qualified small business stock acquired after February 17, 2009, and before September 27, 2010, the exclusion percent is increased to 75%. The Tax Relief Act of 2010 increased the exclusion percentage to 100% for qualifying small business stock acquired after September 27, 2010 and before January 1, 2012 and was extended to January 1, 2014 by the Taxpayer Relief Act of 2012 and to January 1, 2015 by the Tax Increase Prevention Act of 2014. Finally, the 100% exclusion was made permanent for all property acquired after September 27, 2010 by the Protecting Americans from Tax Hikes Act of 2015. The stock must be issued after August 10, 1993, and be held for more than 5 years. Generally, only stock in manufacturing, retailing, and wholesaling businesses qualify for the exclusion. Only non-corporate investors are eligible to claim the exclusion.

8. Evaluate the following statement: Corporations can never deduct net capital losses.

**Corporations are only allowed to deduct capital losses against capital gain income. If a corporation has a net capital loss in one tax year, it cannot use that loss to reduce income in that year. However, a corporation is allowed to carryback a net capital loss 3 years and obtain a refund on any taxes paid on net capital gains during the 3-year carryback period. Any capital loss not used in the carryback period is then carried forward for 5 years and netted with other capital gains and losses in the netting procedure.**

9. Under what conditions may a taxpayer exclude a portion of a realized capital gain?

**A taxpayer that sells qualified small business stock can exclude 50% of the capital gain from the disposition of qualified small business stock. For qualified small business stock acquired after February 17, 2009, and before September 27, 2010, the exclusion percent is increased to 75%. The Tax Relief Act of 2010 increased the exclusion percentage to 100% for qualifying small business stock acquired after September 27, 2010 and before January 1, 2012, and was extended to January 1, 2014 by the Taxpayer Relief Act of 2012 and to January 1, 2015 by the Tax Increase Prevention Act of 2014. Finally, the 100% exclusion was made permanent for all property acquired after September 27, 2010 by the Protecting Americans from Tax Hikes Act of 2015. The stock must be issued after August 10, 1993, and be held for more than 5 years. Generally, only stock in manufacturing, retailing, and wholesaling businesses qualify for the exclusion. Only non-corporate investors are eligible to claim the exclusion.**

10. What basic tax-planning strategy should a taxpayer with a large net capital gain for the year pursue before the end of the year?

**A taxpayer in a net capital gain situation should consider selling any capital assets he or she has that have unrealized losses. This will reduce the amount of tax that will be paid on the capital gain income. However, if the taxpayer does not want to get rid of the loss stock permanently, he or she will have to be careful not to buy back any stock sold at a loss within 30 days or the wash sale rules to disallow the loss.**

11. How should taxpayers determine the basis of securities sold when their portfolios contain several purchases of the same stock at different prices? Explain.

**The general rule for determining the basis of securities that cannot be (or are not) specifically identified is that they are assumed to be sold on a first-in first-out (FIFO) order. However, a taxpayer wishing to get a particular result from a sale (for example, to generate a loss) can specifically identify the shares to be sold by notifying the broker in writing which shares are to be sold.**

12. When does a taxpayer realize a loss on a worthless security? What is the amount of realized loss? What rules govern the recognition of a loss on a worthless security? Explain.

**The last day of a tax year in which the security is determined to be worthless is the date of realization of the loss.**

**The amount of the realized loss is the adjusted basis of the security. Following the capital recovery concept, taxpayers may deduct the basis of their investments when those securities are determined to be worthless.**

**Generally, the recognized loss on worthless securities is a capital loss. Therefore, if an individual has no net capital gains for the year, the loss deduction is limited to \$3,000 annually. The last day of the tax year is the date of realization for determining the holding period for classification of whether the loss is long-term, mid-term, or short-**



**term. If the stock is classified as small business stock, the loss from worthlessness is deductible as an ordinary loss.**

## 13. What is Section 1231 property?

**A Section 1231 property is an asset that is held for more than 1 year and which is:**

- 1. Depreciable or real property used in a trade or business,**
- 2. Timber, coal, and domestic iron ore,**
- 3. Livestock; horses must be held more than 2 years, or**
- 4. Unharvested crops.**

## 14. What is the tax advantage of selling a Section 1231 property at a gain?

**A gain on a Section 1231 property is subject to the Section 1231 netting procedure. If the netting procedure results in a gain for the year, the gain is treated as a long-term capital gain. The long-term capital gain from the Section 1231 netting procedure becomes part of the capital gain and loss netting procedure. Within this procedure, there are two possible benefits. First, if the capital gain and loss procedure results in a net long-term capital gain, the tax rate applicable to the gain for an individual taxpayer is 15% (0% for 10% and 15% marginal tax rate taxpayers, 20% for 39.6% marginal rate taxpayers). Second, if the taxpayer has a net capital loss, the Section 1231 long-term capital gain effectively allows deduction of a loss which may have otherwise been limited.**

## 15. One primary problem in properly accounting for property dispositions is differentiating capital assets and Section 1231 property. Why is it important to correctly identify as either a capital asset or a Section 1231 property an asset that has been disposed of? Explain.

**Capital assets produce gains and losses that are always subject to the capital loss netting procedures and deduction rules. For individuals, adjusted net long-term capital gains are taxed at 15% (0% for 10% and 15% marginal tax rate taxpayers, 20% for 39.6% marginal rate taxpayers). Only \$3,000 of a net capital loss may be deducted in the current year. A corporation realizing a net capital loss cannot deduct any of it in the current year. The corporation must carry the loss forward to a year with a net capital gain.**

**Gains and losses from Section 1231 assets are also subject to a separate netting procedure. In the netting procedure, net Section 1231 losses are treated as ordinary losses which are fully deductible in the year incurred. Net Section 1231 gains are treated as long-term capital gains. Thus, the most important distinction between the two classes of assets is the treatment of losses. Incorrect categorization of losses on assets may lead to very different (and wrong) result, whereas a mis-categorization of a gain will not result in a great difference (if any) in taxable income for the current year.**

## 16. Explain the lookback rule as it applies to the Section 1231 netting procedure.

**The purpose of the lookback rule is to recapture any ordinary loss deductions taken on Section 1231 assets as ordinary income during the last 5 years. Therefore, when a taxpayer has a net Section 1231 gain for a year, the taxpayer must first recapture any Section 1231 loss deductions taken in the prior 5 years before any of the current period gain is given long-term capital gain treatment. The effect of the lookback rule is to subject Section 1231 gains and losses to two distinct nettings. The first netting determines the net Section 1231 gain or loss for transactions occurring during the year. When the result of this netting is a gain, the gain is then netted against any ordinary loss deductions during the prior 5 years.**

17. The chapter noted that all depreciable property is subject to the depreciation recapture rules. What is the intent of the depreciation recapture rules?

**The intent of the depreciation recapture rules is to reclassify gains which are due to the deduction of depreciation (an ordinary expense deduction) as ordinary income, rather than either capital gain or Section 1231 gain.**

**Section 1245 recaptures all gain which is due to the depreciation deduction as ordinary income. For there to be either a capital gain or a Section 1231 gain on a Section 1245 asset, the asset must be sold for more than its original cost. That is, only the true appreciation in the price of a Section 1245 gain is accorded capital gain or Section 1231 gain status.**

**Section 1250 recaptures excess depreciation as ordinary income. Excess depreciation is defined as the actual depreciation deducted less the allowable straight-line depreciation. Therefore, straight-line depreciation on Section 1250 assets can create capital gain or Section 1231 gain. As long as a straight-line depreciation is taken on a Section 1250 asset, no recapture occurs.**

18. How are the recapture provisions for Section 1245 and Section 1250 property different?

**Section 1245 recaptures all gain which is due to the depreciation deduction as ordinary income. For there to be either a capital gain or a Section 1231 gain on a Section 1245 asset, the asset must be sold for more than its original cost. That is, only the true appreciation in the price of a Section 1245 gain is accorded capital gain or Section 1231 gain status.**

**Section 1250 recaptures excess depreciation as ordinary income. Excess depreciation is defined as the depreciation deducted less the allowable straight-line depreciation. Therefore, straight-line depreciation on Section 1245 assets can create capital gain or Section 1231 gain. As long as a straight-line depreciation is taken on a Section 1250 asset, no recapture occurs.**

19. Are buildings always Section 1250 property? If not, explain the circumstances under which a building would not be Section 1250 property.

**Nonresidential buildings purchased before 1981 and after 1987 and residential rental property are always Section 1250 property. Buildings purchased after 1980 and before 1987 may be either Section 1245 or Section 1250 property, depending on the depreciation method used by the taxpayer. In order to be Section 1250 property, the taxpayer must have depreciated the property using the straight-line method. If the taxpayer used the regular ACRS method, the property is Section 1245 property. For example, an office building purchased in 1984 is Section 1250 property if it is depreciated using straight-line. However, if the office building is depreciated using the regular ACRS method, it is Section 1245 property. The same building purchased in 1978 or 1988 is Section 1250 property, regardless of the depreciation method.**

20. Some tax theorists have noted that in most cases, a sale of a depreciable asset will not be accorded capital gain treatment. What would prompt tax theorists to make this statement?

**This statement is mainly due to the Section 1245 recapture rule which recaptures all gain due to the depreciation deduction taken on an asset as ordinary income. With the use of accelerated depreciation under ACRS or MACRS, it is likely that gains will occur. In addition, the main type of assets qualifying as Section 1245 property are tangible personal property. This type of property is not likely to appreciate in value. Thus, gains on this type of property will most likely be recaptured as ordinary income.**

**The best chance for capital gain treatment is through the sale of a Section 1250 asset. Any gain due to straight-line depreciation is allowed to create capital gain or Section 1231 gain (which ultimately may be a long-term capital gain). In addition, the type of assets qualifying as Section 1250 property (depreciable real property) are more likely to appreciate in value than Section 1245 property. Thus, in most Section 1250 cases, one would expect that a major portion of any gain on sale would be either capital gain or Section 1231 gain.**

21. What is unrecaptured Section 1250 gain, and how is the gain taxed?

**Unrecaptured Section 1250 gain is the gain that would have been ordinary income if the property were Section 1245 property. The unrecaptured Section 1250 gain cannot exceed the net Section 1231 gain for the year (Section 1231 gain after lookback recapture rule). For individuals, unrecaptured Section 1250 gain is included in the long-term capital gain and loss netting and is taxed at a maximum rate of 25% (the provision does not apply to corporations).**

**PROBLEMS**

22. Determine the amount realized in each of the following property dispositions:

- a. Herbert sells some land he owns to Elroy in exchange for \$23,000 in cash and 2 breeding hogs worth \$1,500 each (adjusted basis of \$500 each). In closing the sale, Herbert incurs legal fees of \$600, title search costs of \$250, and document filing fees of \$50.

**The amount is realized is \$25,100:**

Cash received		\$ 23,000
Value of hogs (2 x \$1,500)		<u>3,000</u>
Gross sales price		\$ 26,000
Less: Legal fees	\$600	
Title search	<u>250</u>	
Filing fees	<u>50</u>	<u>(900)</u>
Amount realized		<u>\$ 25,100</u>

- b. Saada Corporation sells a building it owned to Paris, who finances the purchase by obtaining a \$200,000 loan and pays an additional \$20,000 in cash. As part of the sales agreement, Saada agrees to pay the \$4,000 in points that Paris had to pay to obtain the loan. The corporation incurs commission costs of \$12,000 and \$5,000 in legal fees in making the sale.

**The gross sales price is \$216,000. The \$200,000 loan and the \$20,000 cash payment is reduced by the \$4,000 of points Saada paid on Paris' loan. The \$17,000 (\$12,000 + \$5,000) of commissions and various legal fees reduce the amount realized to \$199,000:**

Cash received		\$ 20,000
Value of loan payable		<u>200,000</u>
Less: Points paid		<u>(4,000)</u>
Gross sales price		\$ 216,000
Less: Commissions	\$ 12,000	
Legal fees	<u>5,000</u>	<u>(17,000)</u>
Amount realized		<u>\$ 199,000</u>

- c. Andrew and Sandra agree to exchange land that each owns. Andrew's land is worth \$46,000, and Sandra's land is worth \$51,000. Therefore, in the exchange of the land, Andrew has to pay Sandra \$5,000.

**Andrew's amount realized is \$46,000 (\$51,000 value of land received less \$5,000 of cash paid). Sandra's amount realized is \$51,000 (\$46,000 value of land received plus \$5,000 of cash received).**

- d. Artworld, Inc., sells its building to Paula for \$22,000 in cash. As part of the sales agreement, Paula agrees to assume Artworld's \$90,000 mortgage on the property.

**Artworld's amount realized is \$112,000. Artworld receives \$22,000 of cash and has its \$90,000 mortgage assumed in the sale. The debt assumption is equivalent to the payment of \$90,000 of cash, which is then used to pay off the debt.**

23. Determine the amount realized in each of the following property dispositions:

- a. Umberto wants to buy Kevin's truck. Because Umberto has no cash and cannot obtain a loan to finance the purchase, Kevin agrees to let Umberto pay him \$320 a month for 6 months. In addition, Umberto agrees to put a new roof on Kevin's house as part of the truck purchase. Umberto estimates that his cost of reroofing the house will be \$750, although he would have charged Kevin \$2,500 if Kevin were a paying customer.

**Kevin's amount realized is \$4,420. The six payments of \$320, a total of \$1,920, and the \$2,500 fair market value of the new roof is what Kevin received for the roof. Umberto's cost (\$750) is not relevant to the value received by Kevin.**

Cash to be received (6 x \$320)	\$ 1,920
Value of new roof	2,500
Amount realized	<u>\$ 4,420</u>

- b. During the current year, a tornado totally destroys a warehouse that Ajax, Inc., uses in its manufacturing operation. The warehouse has a fair market value of \$195,000. Ajax's insurance company pays \$170,000 on the destruction of the warehouse. The president of Ajax is upset that the insurance company will not pay full fair market value, because Ajax had paid annual insurance premiums of \$10,000 for the last 10 years on the warehouse.

**Ajax's amount realized is the \$170,000 of insurance proceeds. The annual insurance premiums of \$10,000 are a current period business expense and are not a reduction in the amount realized from the casualty.**

- c. Paloma Pitchfork Company sells an apartment complex it owns to Greedy Investors, Inc. The terms of the sale calls for Greedy to pay \$40,000 cash, assume Paloma's \$520,000 mortgage debt on the property, and give Paloma 10,000 shares of Horticulture, Inc., common stock. Greedy had paid \$16 per share for the Horticulture stock, which is currently trading for \$5 per share.

**Paloma's amount realized consists of the \$40,000 cash plus the \$520,000 mortgage debt assumed plus the \$50,000 (10,000 shares x \$5) fair market value of the stock received, for a total amount realized of \$610,000.**

Cash received	\$
40,000	
Mortgage assumed	520,000
Value of common stock received (10,000 shares x \$5)	50,000
Amount realized	<u>\$ 610,000</u>

- d. Melinda and Nancy agree to exchange apartment buildings and the related mortgage debt on each building. Melinda's apartment building is worth \$250,000 and is encumbered by a mortgage of \$100,000. Nancy's building is worth \$300,000 and has a \$200,000 mortgage. In addition to exchanging the properties and the underlying debt, Nancy pays Melinda \$50,000 cash to complete the exchange.

**Melinda receives Nancy's building, which is worth \$300,000, cash of \$50,000, has her \$100,000 mortgage assumed, and assumes back Nancy's \$200,000 mortgage for an amount realized of \$250,000 (i.e., the fair market value of her building):**

**Similarly, Nancy receives Melinda's building, which is worth \$250,000, pays \$50,000 of cash, has her \$200,000 mortgage assumed and assumes back Melinda's \$100,000 mortgage for an amount realized of \$300,000 (i.e., the fair market value of her building):**

**Melinda:**

Value of Nancy's building	\$ 300,000
Cash received	50,000
Mortgage assumed	(200,000)
Mortgage assumed by Nancy	100,000
Amount realized	<u>\$ 250,000</u>

**Nancy:**

Value of Melinda's building	\$ 250,000
Cash paid	(50,000)
Mortgage assumed	(100,000)
Mortgage assumed by Melinda	200,000
Amount realized	<u>\$ 300,000</u>

24. Tuyen is negotiating the sale of her lake front property near Wabasha. Nils is offering
- Cash of \$10,000
  - A parcel of land near Red Wing valued at \$5,000 with an adjusted basis of \$3,000
  - A ski boat valued at \$9,000 with an adjusted basis of \$15,000
  - Installation of new heating and air conditioning in Tuyen's Rochester residence (Nils's labor and equipment costs are valued at \$4,500)
  - Payment of \$2,000 in real estate taxes due on the property
  - Assumption of the \$120,000 balance of the mortgage on the property
  - Payment of the \$900 in attorney fees and \$50 in filing fees to complete the transaction

In addition, Tuyen is offering to transfer her pontoon boat and outboard motor to Nils. The boat and motor have a fair market value of \$8,500 and an adjusted basis of \$10,000. Also, she would assume the \$3,000 mortgage balance on the Red Wing real estate

Tuyen's brother tells her she should not accept an offer of less than \$150,000 for the Wabasha property. Write a letter to Tuyen explaining how much she would realize if she accepts Nils' offer as presented.

**The letter should be in good business form and contain a brief explanation of how the amount realized is determined. The amount realized needs to be compared to the \$150,000 suggested by Tuyen's brother.**

**Determination of amount realized by Tuyen:**

Cash receipt	\$ 10,000
Value of parcel of land near Red Wing	5,000
Ski boat value	9,000
Value of heating and air conditioning installation	4,500
Real estate taxes owed by Tuyen, paid by Nils	2,000
Mortgage assumed by Nils	120,000
Tuyen's attorney fees (\$900), filing fees (\$50) paid by Nils	950
Less: Value of boat and motor transferred to Nils	(8,500)
Mortgage assumed on the Red Wing land	(3,000)
Amount realized	<u>\$139,950</u>



25. Determine the amount of gain or loss realized and the amount of gain or loss to be recognized in each of the following dispositions:

- a. On October 1, Rufus Partnership sells land to Gerald for which it had paid \$32,000. Gerald agrees to pay Rufus \$15,000 and to assume Rufus's \$13,000 mortgage on the land. In addition, Gerald agrees to pay the \$1,000 in property taxes on the land for the entire year.

**Rufus realizes and recognizes a loss of \$3,250 on the sale to Gerald. Gerald's amount realized consists of the \$15,000 cash plus the \$13,000 mortgage assumption plus the \$750 [ $\$1,000 \times (9 \div 12)$ ] of Rufus's property taxes which are paid by Gerald. Rufus's \$3,250 realized loss is calculated as follows:**

<b>Amount realized (<math>\\$15,000 + \\$13,000 + \\$750</math>)</b>	<b>\$ 28,750</b>
<b>Adjusted basis</b>	<b>(32,000)</b>
<b>Realized loss on sale</b>	<b><u>\$ (3,250)</u></b>

**The realized loss of \$3,250 is recognized by the partnership. The land is either trade or business use (Section 1231) or investment property (capital loss).**

- b. Carrie sells stock to her brother Dolph for \$4,000 that had cost her \$9,000. Several years later, Dolph sells the stock for \$13,000.

**Carrie has a realized loss of \$5,000 ( $\$4,000 - \$9,000$ ) that is disallowed because it is a related party sale. Dolph's realized gain is \$9,000 ( $\$13,000 - \$4,000$ ). However, Dolph is allowed to reduce his realized gain by Carrie's disallowed loss, resulting in a recognized gain of \$4,000 ( $\$9,000 - \$5,000$ ).**

- c. Jill wants to refurnish her new home. As part of her refurnishing plan, she sells all her old living room furniture for \$1,800; it had cost her \$4,200. She uses the \$1,800 as a down payment on new furniture costing \$6,000.

**Jill has a \$2,400 realized loss ( $\$1,800 - \$4,200$ ) on the sale of the furniture. Because the furniture is a personal use asset, the legislative grace concept does not allow Jill to recognize the loss.**

- d. Upon obtaining a job in New City, Gary sells his house for \$130,000. He pays selling expenses of \$12,000. Gary had paid \$60,000 for the house and had added a den at a cost of \$22,000 and a swimming pool costing \$16,000.

**Gary's amount realized is \$118,000 ( $\$130,000 - \$12,000$ ). His adjusted basis is \$98,000 ( $\$60,000 + \$22,000 + \$16,000$ ). The addition of the den and the swimming pool increase Gary's adjusted basis in the property. Gary has a realized gain of \$20,000 ( $\$118,000 - \$98,000$ ) on the sale. In general, realized gains are recognized. However, if Gary qualifies, all or part of the \$20,000 gain is excluded from income. This is discussed in Chapter 12.**

26. Determine the amount of gain or loss realized and the amount of gain or loss to be recognized in each of the following dispositions:

- a. Jorge owns 800 shares of Archer Company stock. He had purchased 300 of the shares for \$9,000 and 500 of the shares for \$10,000. During the current year, Jorge instructs his broker to sell 400 of the shares when their market value hits \$29. He pays a \$300 commission on the sale.

**Jorge has a realized and recognized gain on the sale of \$300:**

Amount realized [(400 shares x \$29) - \$300]	\$ 11,300
Basis of shares sold (FIFO):	
300 shares from 1st purchase	\$ 9,000
100 shares from 2nd purchase (100 x \$20)	<u>2,000</u>
Realized and recognized gain	<u><u>\$ 300</u></u>

- b. Alana owns 300 shares of Courtney Common Stock that had cost her \$6,000. On February 1, she sells the 300 shares for \$4,800 and pays a \$300 commission on the sale. On February 19, Alana purchases 500 shares of Courtney common stock for \$5,300 plus a \$400 commission.

**Alana has realized a loss of \$1,500 [(\$4,800 - \$300) - \$6,000] on the sale of the 300 shares of stock. However, none of the loss is recognized because Alana replaced the shares of stock within 30 days of the sale at a loss. Under the wash sale rules, the \$1,500 of realized loss is added to the basis of the replacement shares, thus deferring recognition of the loss until the replacement shares are sold. Alana's basis in the 500 shares purchased on February is determined as follows:**

$$\begin{aligned}\text{Total cost} &= \$5,300 + \$400 = \$5,700 \\ \text{Cost per share} &= \$5,700 \div 500 = \$11.40\end{aligned}$$

Basis of 500 shares	
300 wash sale shares	= (300 x \$11.40) + \$1,500
200 shares	= (200 x \$11.40)
Total Basis	<u><u>\$ 7,200</u></u>

- c. Janet went to the local flea market one Saturday morning and purchased a painting for \$20. Although she doesn't really want the painting, she feels that the frame alone is worth \$20. When she returns home, she takes the old painting out of the frame and finds another painting hidden in the back. She takes the new painting to a local art dealer who tells her it is almost certainly a Pistachio and worth at least \$20,000. Janet decides that she will wait a couple of years, get another expert's opinion, and see if she can sell the painting for more than \$20,000.

**Janet has not realized any income from the painting. Until she disposes of the painting in an arm's-length transaction, the value of the painting has not been realized.**

- d. Enrique owns some land that he is holding as an investment. A local developer wants to build a housing project on the north side of his land. The local utility company wants to run utility lines along the east side of Enrique's land. Enrique had paid \$8,000 for the land but does not want to sell it yet because he thinks the housing project will greatly enhance its value. He agrees to accept \$2,000 from the utility company for an easement to run its lines along the edge of his property. Enrique estimates that the lines will use up about 1/50 of his land.

**The receipt of a payment for an easement is not a realization. Enrique's property rights in the land have not changed (no change in the form of the property or in Enrique's property rights). The \$2,000 payment is a return of investment, which reduces his basis in the land to \$6,000.**

27. During the current year, James sells some land he purchased in 2011 as an investment. He had paid \$4,000 in cash and borrowed \$22,000 to buy the land. He had paid legal fees of \$440 and commissions of \$560 on the purchase. He sells the land on October 1 to DeWayne, who gives James 200 shares of Aardvark common stock with a fair market value of \$9,600 (DeWayne had paid \$3,700 for the stock) and assumes James's debt on the land, which is \$20,800 at the time of sale. James pays legal fees of \$400 and \$1,800 of commissions on the sale. DeWayne pays legal fees of \$575 and commissions of \$980 related to the purchase. In addition, DeWayne agrees to pay the property taxes of \$800 on the land for the entire year. Assume you are a staff accountant in a CPA firm. Write a memorandum to your supervisor explaining James's gain or loss on the land sale, James's basis in the common stock received, DeWayne's gain or loss on the transaction, and DeWayne's basis in the land.

**James' gain is \$1,800:**

Gross sales price (\$9,600 + \$20,800 + \$600*)	\$ 31,000
Less: Selling expenses (\$400 + \$1,800)	(2,200)
Amount realized	<u>\$ 28,800</u>
Adjusted basis (\$4,000 + \$22,000 + \$440 + \$560)	(27,000)
Realized (and recognized) gain on sale	<u>\$ 1,800</u>

\* [\$800 x (9 ÷ 12)]

**James' basis in the 200 shares of Aardvark stock is its fair market value \$9,600.**

**DeWayne's realized and recognized gain relates only to the stock exchanged:**

Gross sales price (value received in the exchange)	\$ 9,600
Less: Adjusted basis	(3,700)
Realized and recognized gain	<u>\$ 5,900</u>

**DeWayne's basis in the land is \$32,555:**

Gross sales price	\$ 31,000
Plus: Expenses paid to acquire land (\$575 + \$980)	1,555
Basis	<u>\$ 32,555</u>

**DeWayne's payment of James' property taxes of \$600 [\$800 x (9 ÷ 12)] is part of the agreed upon selling price of the property. The remaining \$200 (\$800 - \$600) of property taxes DeWayne pays is a deductible property tax.**

28. Elvira owns an office building, and Jared Partnership owns an apartment building. Each property is encumbered by a mortgage. Elvira and Jared Partnership agree to exchange their properties and mortgages, with any difference to be paid in cash. The fair market values, mortgages, and adjusted bases for the properties are as follows:

	<u>Elvira's Building</u>	<u>Jared Partnership Building</u>
Fair market value	\$ 220,000	\$ 250,000
Mortgage debt	80,000	150,000
Adjusted basis	100,000	175,000

- a. Write a letter to Elvira explaining who will have to pay cash to complete the exchange, the amount of her gross selling price, and the amount of gain or loss she will realize on the exchange.

	<u>Elvira's Building</u>	<u>Jared Partnership Building</u>	<u>Difference</u>
Fair market value	\$ 220,000	\$ 250,000	\$ 30,000
Mortgage debt	(80,000)	(150,000)	(70,000)
Equity in building	<u>\$ 140,000</u>	<u>\$ 100,000</u>	<u>\$ (40,000)</u>

**Jared Partnership will need to pay Elvira \$40,000 cash to complete the exchange. Elvira realizes a gross selling price of \$220,000:**

Cash received from Jared	\$ 40,000
Value of building received	250,000
Mortgage assumed by Jared	80,000
Less: Assumption of Jared's mortgage	(150,000)
Gross selling price	<u>\$ 220,000</u>

**Elvira's gain realized on the exchange is \$120,000:**

Gross selling price	\$ 220,000
Less: Adjusted basis	(100,000)
Realized gain	<u>\$ 120,000</u>

- b. Write a letter to Jared Partnership explaining who will have to pay cash to complete the exchange, the amount of the gross selling price of its property, and the amount of gain or loss it will realize on the exchange.

**Jared Partnership will need to pay Elvira \$40,000 to complete the exchange. Jared realizes a gross selling price of \$250,000:**

Value of land received	\$ 220,000
Mortgage assumed by Elvira	150,000
Less: Assumption of Elvira's mortgage	(80,000)
Less: Cash paid to Elvira	(40,000)
Gross selling price	<u>\$ 250,000</u>

**Jared's gain realized on the exchange is \$75,000:**

Gross selling price	\$ 250,000
Less: Adjusted basis	(175,000)
Realized gain	<u>\$ 75,000</u>

29. Guerda owns 1,500 shares of Ditchdirt common stock. During the current year, she sells 500 shares of the stock for \$15 per share and pays a commission of \$300 on the sale. Guerda had purchased the 1,500 shares as follows:

Purchase Date	# of Shares	Purchase Price	Commissions Paid	Cost Per Share
1/18/14	200	\$ 1,600	\$ 200	\$ 9
5/12/14	100	1,100	100	\$12
9/11/14	300	3,000	300	\$11
2/15/15	400	5,500	500	\$15
12/31/15	500	2,700	300	\$ 6

What is Guerda's gain or loss on the sale of the stock?

**Absent specific identification of the shares sold, the basis of the shares is determined on a FIFO basis. Therefore, the first step is to calculate the cost per share for each date Guerda purchased the Ditchdirt stock.**

$$\begin{aligned}
 1/18/14 &- \$1,600 + \$200 = \$1,800 \div 200 = \$ 9 \text{ per share} \\
 5/12/14 &- \$1,100 + \$100 = \$1,200 \div 100 = \$12 \text{ per share} \\
 9/11/14 &- \$3,000 + \$300 = \$3,300 \div 300 = \$11 \text{ per share} \\
 2/15/15 &- \$5,500 + \$500 = \$6,000 \div 400 = \$15 \text{ per share} \\
 12/31/15 &- \$2,700 + \$300 = \$3,000 \div 500 = \$ 6 \text{ per share}
 \end{aligned}$$

**The basis of the first 500 shares purchased are used to calculate gain (loss) on the sale:**

**Basis of first 500 shares purchased:**

1/18/14 purchase (200 Shares x \$ 9)	\$ 1,800
5/12/14 purchase (100 Shares x \$12)	1,200
9/11/14 purchase (200 Shares x \$11)	2,200
<b>Total basis of 500 shares</b>	<b><u>\$ 5,200</u></b>

**Calculation of Gain on Sale:**

Amount realized [(500 x \$15) - \$300]	\$ 7,200
Adjusted basis of shares sold	(5,200)
<b>Gain on sale</b>	<b><u>\$ 2,000</u></b>

30. Return to the facts of problem 29. Assume that Guerda later sells an additional 200 shares of the Ditchdirt stock for \$20 per share, paying a commission of \$600 on the sale. What is her gain or loss on the sale of the stock?

**Guerda's gain on sale is \$800:**

Amount realized [(200 x \$20) - \$600]	\$ 3,400
Adjusted basis of 200 shares (FIFO):	
9/11/14 Purchase (100 shares x \$11)	\$ 1,100
2/15/15 Purchase (100 shares x \$15)	1,500
<b>Gain on sale</b>	<b><u>\$ 800</u></b>

31. Return to the facts of problem 29. Assume that Guerda sells the remaining 800 shares of Ditchdirt stock for \$10 per share and pays a commission of \$400 on the sale. What is her gain or loss on the sale?

**Guerda has a loss of \$1,650 on the sale of the stock purchased on 2/15/15:**

Amount realized	$\{[(300 \times \$10) - \$400 \times (300 \div 800)]\}$	\$ 2,850
Adjusted basis	$(300 \text{ shares} \times \$15)$	(4,500)
Loss on sale		<u>\$ (1,650)</u>

**Guerda has a gain of \$1,750 on the sale of the stock purchased on 12/31/15:**

Amount realized	$\{[(500 \times \$10) - \$400 \times (500 \div 800)]\}$	\$ 4,750
Adjusted basis	$(500 \text{ shares} \times \$6)$	(3,000)
Gain on sale		<u>\$ 1,750</u>

32. Return to the facts of problem 29. What tax-planning strategy can be used to achieve more favorable tax results? Use this strategy to determine Guerda's gain or loss on the sale.

**Guerda should use the specific identification method and use the shares with the highest per share basis to achieve a more favorable result from selling the 500 shares.**

Purchase Date	# of Shares	Total Cost	Cost Per Share
1/18/14	200	\$ 1,800	\$ 9
5/12/14	100	1,200	12
9/11/14	300	3,300	11
2/15/15	400	6,000	15
12/31/15	500	3,000	6

The above table shows that the 2/15/15 shares with a basis of \$15 per share should be identified as sold first. The next 100 shares should be identified from the \$12 per share, 5/12/14 purchase. This identification results in a total adjusted basis of \$7,200. Therefore, Guerda realizes no gain or loss on the sale of the stock.

**Calculation of loss realized on the sale:**

Amount realized	$[(500 \times \$15) - \$300]$	\$ 7,200
Adjusted basis of shares sold:		
2/15/15 purchase (400 shares x \$15)	\$ 6,000	
5/12/14 purchase (100 shares x \$12)	<u>1,200</u>	(7,200)
Loss realized on the sale		<u>\$ -0-</u>

33. Classify each of the following assets as ordinary income property, capital asset property, Section 1231 property, or personal use property. If more than one classification is possible, explain the circumstances that would determine the proper classification.

- a. Sarah is a sculptor. During the current year, she gives one of her statues to her niece as a gift.

**The statue is ordinary income property to either the creator of the property or anyone who acquires the property by gift. For a sculptor, a statue is an item of inventory which if sold, produces ordinary income.**

- b. Petros sells facsimiles of Greek artifacts in a store he owns. Because of a cash-flow problem, he sells some accounts receivable to a discounter for 75% of face value.

**Receivables are ordinary income property.**

- c. Lana is a college professor. She owns an apartment building and rents apartments to students.

**An apartment building is a capital asset if it is held for the production of income (i.e. as an investment). However, if Lana's rental activities constitute a trade or business, the apartment building is a Section 1231 asset.**

- d. Ryan uses his automobile 75% of the time in his job as a real estate salesperson. The remaining use of the automobile is for personal purposes.

**The automobile is a mixed-use asset. The business use portion (75%) is a Section 1231 asset. The remaining 25% is a personal use asset.**

- e. Fred owns a used car business. During the current year, he purchases a piece of land across the street from his used car business. Fred intends to expand his business and feels that he will ultimately need the space for the extra inventory he wants to purchase over the next few years.

**Until Fred's uses the land in his trade or business it is considered an investment. Therefore, the land is a capital asset.**

- f. Althea gets a tip from a friend that a new golf course is going to be developed south of town. Because she thinks the surrounding land is sure to appreciate in value after the golf course is built, Althea purchases several plots of land near where her friend tells her the golf course is to be built.

**Althea's speculation in the land is a production of income activity (i.e., she holds the land for investment). Therefore, the land is a capital asset.**



34. Classify each of the following assets as ordinary income property, capital asset property, Section 1231 property, or personal use property. If more than one classification is possible, explain the circumstances that would determine the proper classification.

- a. Letters written by then-Vice President Truman to Helena Desponsa on the day Franklin Delano Roosevelt died. Desponsa still holds the letters.

**The letters are not capital assets in Desponsa's possession. They were gifts from Truman. They are ordinary income property if Desponsa sells them or contributes them to a qualified charity. Her adjusted basis in the letters is zero (\$0).**

- b. Ritva is a home-building contractor. She built her own principal residence.

**The house is considered a personal use asset and is a capital asset to Ritva. If Ritva sells the property for more than the cost to build it, she will realize a capital gain. Whether she has to recognize the gain is discussed in Chapter 12. If she sells it at a loss, it is not deductible.**

- c. Domingos, a real estate broker, owns undeveloped land as an investment.

**Because Domingos is in the real estate business, the land is inventory and the income on the resale of the land is ordinary income. However, if Domingos can demonstrate that the land is held personally and not as a part of his realty endeavors, the land is a capital asset.**

- d. Chas Automotive Plaza, Inc., owns cars held for resale to customers.

**The cars are inventory. Therefore, they are ordinary income property.**

- e. Arcie, Inc., buys a utility van from Chas Automotive Plaza to use in its concrete installation business.

**The van is depreciable business use property. It is Section 1231 property. Any gain realized on the sale of this property will be ordinary income to the extent of the prior depreciation deducted on the van (i.e., depreciation recapture).**

- f. Anne Marie Arcie, the president of Arcie, Inc., buys a car to use for commuting to the corporate offices from her home.

**The car is a personal use asset. It is a capital asset in Anne Marie's possession. If Anne Marie sells the car at a gain, she will recognize a capital gain. If she sells the car at a loss, the loss is not deductible.**

35. Spencer purchases 100 shares of Reality Virtual Corporation common stock for \$1,200 on July 30, 2016. He sells 75 shares of this stock for \$525 on December 27, 2016. On January 12, 2017, Spencer purchases 300 shares of Reality Virtual stock for \$2 per share.

- a. What are the tax effects of these transactions?

**The December 27 sale is a wash sale because Spencer purchased substantially identical shares within 30 days of the realized loss. His basis in the stock sold is \$900 [ $\$1,200 \times (75 \div 100)$ ] and his realized loss of \$375 ( $\$525 - \$900$ ) is not recognized. The loss is added to the basis of the shares repurchased on January 12, 2017.**

Amount realized	\$ 525
Less: Adjusted basis ( $75 \times \$12$ )	(900)
Realized loss on sale	<u>\$ 375</u>
Disallowed loss	(375)
Recognized loss	<u><u>\$ -0-</u></u>

- b. What is the adjusted basis of Spencer's stock on April 15, 2017, when the FMV of the stock is \$9 per share?

**Spencer's total adjusted basis of the stock is \$1,275.**

	Cost Basis	Per Share
25 shares purchased 7/30/16 ( $\$12 \times 25$ )	\$ 300	\$12
225 shares purchased 1/12/17 ( $\$2 \times 225$ )	450	2
75 shares from the wash sale [ $(\$2 \times 75) + \$375$ ]	525	7
Total basis of the 325 shares of stock	<u><u>\$ 1,275</u></u>	

36. Mort begins investing in stocks in 2015. Listed here are his stock transactions for 2015 and 2016. Determine Mort's gain or loss on his stock transactions for 2015 and 2016. In addition, for each sale of stock, determine whether the gain or loss is short-term or long-term.

Stock	Transaction Date	Transaction	Price Per Share	Commissions Paid
Pepper Farm	5/24/15	Purchased 50 shares	\$ 8	\$ 50
Acala Steel	10/5/15	Purchased 200 shares	14	200
Horton Inc.	12/10/15	Purchased 300 shares	3	100
Acala Steel	12/28/15	Sold 50 shares	18	70
Horton Inc.	2/4/16	Purchased 200 shares	2	30
Pepper Farm	2/15/16	Sold 25 shares	12	25
Horton Inc.	3/1/16	Sold 100 shares	2	20
Pepper Farm	8/13/16	Sold 25 shares	13	35
Angor Mills	11/11/16	Purchased 800 shares	6	400
Angor Mills	12/4/16	Sold 300 shares	9	250
Horton Inc.	12/19/16	Sold 400 shares	7	250

### 2015 Sales:

#### 12/28/15 - Sold 50 Shares of Acala Steel

Amount realized  $[(50 \times \$18) - \$70]$  \$ 830

Adjusted basis:

$[(200 \times \$14) + \$200] = \$3,000 \div 200 = \$15 \times 50$  (750)

Gain on sale \$ 80

Holding Period: 10/5/15 - 12/28/15  $\leq$  12 months = Short-Term Capital Gain

Acala Steel shares remaining =  $200 - 50 = 150$

### 2016 Sales:

#### 2/15/16 - Sold 25 shares of Pepper Farm

Amount realized  $[(25 \times \$12) - \$25]$  \$ 275

Adjusted basis:

$[(50 \times \$8) + \$50] = \$450 \div 50 = \$9 \times 25$  (225)

Gain on sale \$ 50

Holding Period: 5/24/15 - 2/15/16  $\leq$  12 months = Short-Term Capital Gain

Pepper Farm shares remaining =  $50 - 25 = 25$

**3/1/16 Sale - Sold 100 Shares of Horton Inc.**

Amount realized [(100 x \$2) - \$20]	\$ 180
Adjusted basis:	
[(300 x \$3) + \$100] = \$1,000 ÷ 300 = \$3.33 x 100	(333)
Realized loss on sale	\$ 153
Disallowed loss (2/4/16 purchase causes a wash sale)	(153)
Recognized loss	<u>\$ -0-</u>

Basis of 2/4/16 purchase:

Purchase price - [(200 x \$2) + \$30] = \$430 ÷ 200 = \$2.15/share

100 Wash sale shares [(100 x \$2.15) + \$153]	\$ 368
100 Shares (100 x \$2.15)	215
Total basis of 2/4/16 shares	<u>\$ 583</u>

Horton Inc. shares remaining: 200 shares (12/10/15) + 200 shares (2/4/16)  
= 400 shares

**8/13/16 Sale - Sold 25 Shares of Pepper Farm**

Amount realized [(25 x \$13) - \$35]	\$ 290
Adjusted basis (25 x \$9)	(225)
Gain on sale	<u>\$ 65</u>

Holding Period: 5/24/15 - 8/13/16 > 12 months = Long-Term Capital Gain

**12/4/16 Sale - Sold 300 shares of Angor Mills**

Amount realized [(300 x \$9) - \$250]	\$ 2,450
Adjusted basis:	
[(800 x \$6) + \$400] = \$5,200 ÷ 800 = \$6.50 x 300	(1,950)
Gain on sale	<u>\$ 500</u>

Holding Period: 11/11/16 - 12/4/16 ≤ 12 months = Short-Term Capital Gain

Angor Mills shares remaining = 800 - 300 = 500

**12/19/16 Sale - Sold 400 Horton Shares**

Amount realized [(400 x \$7) - \$250]		\$ 2,550
Adjusted basis:		
From 12/10/15 Purchase (200 x \$3.33)	\$ 667	
From 2/4/16 Purchase (\$368 + \$215)	<u>583</u>	(1,250)
Gain on sale		<u>\$ 1,300</u>

Holding Period:

12/10/15 Purchase held > 12 months = Long-Term Capital Gain

2/4/16 Purchase:

Because the basis of 100 of the shares is made by reference to the basis of the wash sale shares, the 100 shares are deemed to be held from 12/10/15, resulting in a holding period > 12 months. Thus, gain on the sale of the 100 wash sale shares is a long-term capital gain. The other 100 shares purchased on 2/4/16 have been held < 12 months. Therefore, the gain on the sale of the 100 shares is a short-term capital gain.

The short-term capital gain is \$423:

Amount realized [\$2,550 x (100 ÷ 400)]	\$ 638
Adjusted basis	(215)
Short-term capital gain	<u>\$ 423</u>

The remaining \$877 (\$1,300 - \$423) is long-term capital gain

37. For each of the following capital asset dispositions, determine whether the taxpayer has realized a gain or loss on the disposition and whether that gain or loss is short-term or long-term:

- a. Ari receives some stock from his grandfather Stephan for Christmas. Stephan paid \$4,300 for the stock 3 years earlier. The stock has a fair market value of \$7,000 on December 24. Ari sells it on December 28 for \$7,100 and pays a commission of \$500 on the sale.

**Ari's realized gain is \$2,300. Because Ari's basis in the stock is a carryover of his grandfather's basis, Ari includes the amount of time Stephan held the property in his holding period. Therefore, Ari has held the shares more than 12 months and the gain is a long-term capital gain.**

Amount realized (\$7,100 - \$500)	\$ 6,600
Adjusted basis (Stephan's basis)	(4,300)
Realized gain on sale	<u>\$ 2,300</u>

- b. Joan owns 600 shares of Archibald Common Stock that she purchased in 2013 for \$7,920. On July 1, 2016, Archibald declares and distributes a 10% stock dividend. Joan sells the 660 shares of Archibald stock on November 14, 2016, for \$13,400 and pays a \$700 commission on the sale.

**Joan has a realized gain of \$4,780 on the sale of the 660 shares. Although the 60 shares received in the stock dividend have only been held since July 1, their basis is made by reference to the basis of the original 600 shares. Thus, they are deemed to be held since 2013 (more than 12 months) and the \$4,780 gain is a long-term capital gain.**

Amount realized (\$13,400 - \$700)	\$ 12,700
Adjusted basis	(7,920)
Realized gain on sale	<u>\$ 4,780</u>

- c. On April 1, 2016, LeRoy sells to his son for \$3,000 shares of stock for which he had paid \$8,000 two years earlier. His son sells the shares for \$11,000 on June 14, 2016.

**Leroy has a realized loss of \$5,000 (\$3,000 - \$8,000) on the sale to his son. However, the loss is disallowed as a related party sale. The son has a realized gain of \$8,000 (\$11,000 - \$3,000) on the sale. The son reduces the \$8,000 gain by Leroy's disallowed loss, recognizing a gain of \$3,000 (\$8,000 - \$5,000). The gain is short-term because the son has held the stock for less than 12 months. The son's basis is not made by reference to his father's basis and therefore, he does not get his father's holding period.**

- d. Lee owns 800 shares of Bolstead, Inc., stock that she purchased for \$20,000 on October 11, 2015. On July 5, 2016, Lee sells 400 shares of Bolstead stock for \$7,000. On July 27, 2016, she purchases an additional 600 shares of Bolstead stock for \$6,000. On December 3, 2016, she sells the remaining 1,000 shares of Bolstead stock for \$12,000.

The July 5 sale is a wash sale. Lee's basis in the 800 shares acquired on October 11, 2015 is \$25 per share and her basis in the 400 shares sold is \$10,000 ( $400 \times \$25$ ). The \$3,000 ( $\$7,000 - \$10,000$ ) loss is added to the basis of the 600 shares purchased on July 5. The December 3 sale is a taxable sale. However, 200 of the 600 shares purchased on July 5 have been held short-term and the remaining 400 shares produce long-term losses (held > 12 months) because their basis is made, in part, by reference to the shares purchased in 2015. Thus, separate gain or loss calculations must be made.

#### 400 Shares Purchased 10/11/15:

Amount realized	$[\$12,000 \div 1,000 = \$12 \times 400]$	\$ 4,800
Adjusted basis	$[\$20,000 \div 800 = \$25 \times 400]$	(10,000)
Long-term capital loss on 12/3/16 sale		<u>\$ (5,200)</u>

#### 400 Wash Sale Shares:

Amount realized	$[\$12,000 \div 1,000 = \$12 \times 400]$	\$ 4,800
Adjusted basis		
Purchase price	$[\$6,000 \div 600 = \$10 \times 400]$	\$ 4,000
Wash sale loss		<u>3,000</u>
Long-term capital loss on 12/3/16 sale		<u>\$ (2,200)</u>

#### 200 Shares Purchased 7/27/16:

Amount realized	$[\$12 \times 200]$	\$ 2,400
Adjusted basis	$[\$6,000 \div 600 = \$10 \times 200]$	(2,000)
Short-term capital gain on 12/3/16 sale		<u>\$ 400</u>

38. For each of the following capital asset dispositions, determine whether the taxpayer has realized a gain or loss and whether that gain or loss is short-term or long-term:

- a. Larry's aunt June dies on May 4, 2016. He inherits some land that she purchased in 1997 for \$2,000. On May 4, 2016, the land is worth \$40,000. Larry receives title to the land on October 15, 2016, and sells it on November 27, 2016, for \$40,000. He pays \$3,000 in commissions and other selling expenses.

**Larry has a long-term capital loss of \$3,000. Larry's basis in the land is the fair market value on the date of death, \$40,000. Even though Larry held the land for less than two months, inherited property is always deemed to be held long-term.**

Amount realized (\$40,000 - \$3,000)	\$ 37,000
Adjusted basis	(40,000)
Long-term capital loss	<u>\$ (3,000)</u>

- b. Sterling receives 4,000 shares of Suburb Corporation stock as a birthday present from his mother-in-law on May 6, 2016. His mother-in-law had paid \$18,000 for the stock 8 years earlier. On May 6, 2016, the stock has a fair market value of \$4,000. On June 18, 2016, Sterling sells 1,000 shares of the stock for \$800.

**Because the shares of stock have declined in value, the split basis rule for gifts applies. Sterling's basis for gain is \$4.50 per share (\$18,000 ÷ 4,000) and his basis for loss is \$1 per share (\$4,000 ÷ 4,000). Sterling sold the 1,000 shares for \$800, resulting in a loss of \$200 [\$800 - (1,000 × \$1)]. Because Sterling uses the fair market value on the date of the gift as his basis, the sale of the 1,000 shares is a short-term capital loss since the stock was held ≤ 12 months (May 6 to June 18).**

- c. Assume the same facts as in part b. Suburb Corporation becomes the target of a takeover attempt in July, and its stock soars. Sterling sells the remaining 3,000 shares for \$19,000 on August 6, 2016.

**Sterling has a gain of \$5,500 on the sale of the stock [\$19,000 - (3,000 × \$4.50)]. Because Sterling's basis is his mother-in-law's basis, he gets her holding period and the gain is a long-term capital gain (held > 12 months).**



- d. Bert owns 1,000 shares of Crooner Capital Corporation common stock for which he paid \$8,000 in 2009. On March 13, 2015, Crooner declares a dividend of 1 share of preferred stock for each 10 shares of common stock owned. On the date the preferred shares are distributed, Crooner's common shares are selling for \$7 per share, and its preferred shares are selling for \$10 per share. On November 14, 2016, Bert sells the 100 preferred shares for \$1,100.

**The basis in the preferred shares is \$1,000. The \$8,000 original basis of the common shares is allocated between the common and the preferred based on the relative market values at the date of distribution.**

FMV of Common (1,000 x \$7)	=	\$ 7,000
FMV of Preferred ( 100 x \$10)	=	<u>1,000</u>
Total FMV		<u>\$ 8,000</u>

**Preferred stock allocation (\$1,000 ÷ \$8,000) x \$8,000 = \$1,000**

**Bert's \$100 (\$1,100 - \$1,000) gain on the sale is a long-term capital gain (held > 12 months). The \$1,000 of basis obtained from the common is considered held from the date of the common purchase because the basis is made by reference to the basis of the common shares.**

39. Rudy has the following capital gains and losses for the current year. What is the effect of the capital asset transactions on his taxable income? Explain, and show any calculations.

Short-term capital loss	\$ 15,500
Long-term capital gain	11,600
Long-term capital loss	4,500

Rudy has a net short-term capital loss of \$15,500 and a net long-term capital gain of \$7,100. Because the short-term and long-term positions are opposite, they are netted together, producing a net short-term capital loss of \$8,400. Only \$3,000 of the loss is deductible. The remaining \$5,400 of loss is carried forward and retains its character as a short term capital loss.

Short-term capital loss		\$ (15,500)
Long-term capital gain	\$ 11,600	
Long-term capital loss	<u>(4,500)</u>	7,100
Net short-term capital loss		<u>\$ (8,400)</u>
Net short-term capital loss deduction (maximum)		<u>\$ 3,000</u>
Short-term capital loss carryforward		<u>\$ 5,400</u>

40. Judith Corporation has the following gains and losses from sales of capital assets during the current year. What is the effect of the capital asset transactions on Judith's taxable income? Explain, and show any calculations.

Short-term capital gain	\$ 2,700
Short-term capital loss	5,600
Long-term capital loss	200

Judith Corporation has a net short-term capital loss of \$2,900 and a net long-term capital loss of \$200. Because the short-term and long-term positions are both losses, no further netting is necessary. Judith's capital loss deduction is zero. The corporation may carry back any unused losses and offset any net capital gains the corporation had in the prior three years. Any unused capital loss from the 3-year carryback period may be carried forward. Corporate capital loss carryovers are treated as short-term capital losses regardless of their original character.

Short-term capital gain	\$ 2,700	
Short-term capital loss	<u>(5,600)</u>	
Net short-term capital loss		<u>\$ (2,900)</u>
Long-term capital loss		<u>\$ (200)</u>
Capital loss deduction		\$ -0-

41. Return to the facts of problem 40. Assume that Judith is an individual taxpayer. What is the effect of the capital asset transactions on Judith's taxable income? Compare this result with the result in problem 40.

	<u>Gain/Loss Calculation</u>	<u>Capital Loss Limit</u>	<u>Capital Loss Carryforward</u>
Short-term capital gain	\$ 2,700		
Short-term capital loss	(5,600)		
Net short-term capital loss	<u>\$ (2,900)</u>	\$ 2,900*	\$ -0-
Long-term capital loss	(200)	100	(100)
Total capital losses	<u>\$ (3,100)</u>	<u>\$ 3,000</u>	<u>\$ (100)</u>

\* Short-term capital loss must be used first

Individual taxpayers are permitted to deduct up to \$3,000 of capital losses annually. Losses in excess of \$3,000 can only be carried forward. Corporations cannot deduct any net capital losses. However, they can be carried back 3 years and then forward for 5 years to be applied against recognized net capital gains. The corporation receives a refund for the applicable tax liability when the capital losses are carried back. Carryovers of individual capital losses retain their character and can be carried forward indefinitely. Corporate capital loss carryovers are treated as short-term capital losses regardless of their original character.

42. Tate has the following gains and losses from sales of capital assets during the current year. What is the effect of the capital asset transactions on Tate's taxable income? Explain, and show any calculations.

Short-term capital gain	\$ 3,600
Long-term capital gain	8,400
Long-term capital loss	5,200

Tate has a net short-term capital gain of \$3,600 and a net long-term capital gain of \$3,200. Because the short-term and long-term positions are both gains, no further netting is necessary. The \$3,600 short-term capital gain is added to gross income. The \$3,200 long-term capital gain is also added to gross income, although it is taxed at 15% (0% if he is in the 10% or 15% tax rate bracket, 20% if he is in the 39.6% tax rate bracket). Tate's taxable income increases by \$6,800 (\$3,600 + \$3,200)

Short-term capital gain		<u>\$ 3,600</u>
Long-term capital gain	\$ 8,400	
Long-term capital loss	<u>(5,200)</u>	
Net long-term capital gain		<u>\$ 3,200</u>

43. Troy has the following gains and losses from sales of capital assets during the current year. What is the effect of the capital asset transactions on his taxable income? Explain, and show any calculations.

Short-term capital gain	\$ 7,800
Short-term capital loss	9,000
Long-term capital gain	5,400
Long-term capital loss	2,100

**Troy has a net short-term capital loss of \$1,200 and a net long-term capital gain of \$3,300. Because the short-term and long-term positions are opposite, the two positions are netted, resulting in a \$2,100 net long-term gain. The \$2,100 long-term capital gain is added to gross income, although it is taxed at 15% (0% if he is in the 10% or 15% tax rate bracket, 20% if he is in the 39.6% tax rate bracket).**

Short-term capital gain	\$ 7,800	
Short-term capital loss	<u>(9,000)</u>	\$ (1,200)
Long-term capital gain	\$ 5,400	
Long-term capital loss	<u>(2,100)</u>	3,300
Net long-term capital gain		<u><u>\$ 2,100</u></u>

44. Rollie has the following capital gains and losses during the current year:

Short-term capital gain	\$ 3,000
Collectibles gain	4,000
Long-term capital gain	11,000
Long-term capital loss	6,000

Rollie is married and has a taxable income of \$155,000 before considering the effect of his capital gains and losses. What is the effect of Rollie's capital gains and losses on his taxable income and his income tax liability?

**Rollie has a \$3,000 short-term capital gain and a \$9,000 long-term capital gain:**

Short-term capital gain		<u><b>\$ 3,000</b></u>
Long-term capital gain	\$ 11,000	
Long-term capital loss	(6,000)	
Collectibles gain	<u>4,000</u>	
Net long-term capital gain		<u><b>\$ 9,000</b></u>

The capital gains are added to gross income, increasing his taxable income to \$164,000. The short-term capital gain is taxed at Rollie's 28% marginal tax rate. The net long-term capital gain consists of an adjusted net capital gain of \$5,000 (\$9,000 - \$4,000) and a \$4,000 collectibles gain:

$$\begin{aligned}
 &28\% \text{ rate gain} &&= \$4,000 \\
 &\text{Adjusted net capital gain} &&= \$9,000 - \$4,000 = \$5,000
 \end{aligned}$$

The \$5,000 adjusted net capital gain is taxed at 15%. The \$4,000 collectibles gain is taxed at 28% (equal to the marginal tax rate). Rollie's income tax liability increases by \$2,710:

Tax on short-term capital gain -	\$3,000 x 28%	\$ 840
Tax on adjusted net capital gain -	\$5,000 x 15%	750
Tax on collectibles gain -	\$4,000 x 28%	1,120
Tax on capital gains		<u><b>\$2,710</b></u>

45. Loretta has the following capital gains and losses during the current year:

Short-term capital loss	\$ 4,000
Collectibles gain	10,000
Long-term capital gain	8,000
Long-term capital loss carryover	2,000

Loretta is single and has a taxable income of \$200,000 before considering the effect of her capital gains and losses. What is the effect of Loretta's capital gains and losses on her taxable income and her income tax liability?

**Loretta has a \$4,000 short-term capital loss and a \$16,000 net long-term capital gain. The short-term loss and the long-term gain are netted, resulting in a \$12,000 net long-term capital gain for the year:**

Short-term capital loss		\$ (4,000)
Collectibles gain	\$ 10,000	
Long-term capital gain	8,000	
Long-term capital loss carryover	<u>(2,000)</u>	16,000
Net long-term capital gain		<u>\$ 12,000</u>

The \$12,000 gain is added to gross income, increasing Loretta's taxable income to \$212,000. The net long-term capital gain of \$12,000 consists of an adjusted net capital gain of \$8,000 and a 28% tax rate gain of \$4,000:

28% rate gain	= \$10,000 - \$4,000 - \$2,000	= \$4,000
Adjusted net capital gain	= \$12,000 - \$4,000	= \$8,000

The adjusted net capital gain is taxed at 15%. Because Loretta is in the 33% marginal tax rate bracket, the \$4,000 net 28% tax rate gain is taxed at 28%. Loretta's income tax liability increases by \$2,320:

Tax on adjusted net capital gain - \$8,000 x 15%	\$1,200
Tax on 28% tax rate gain - \$4,000 x 28%	1,120
Tax on capital gains	<u>\$2,320</u>

46. Samantha has the following capital gains and losses during the current year:

Short-term capital loss	\$ 7,000
Short-term capital gain	5,000
Collectibles loss	11,000
Long-term capital gain	8,000
Long-term capital loss	4,000

Samantha is married and has a taxable income of \$119,000 before considering the effect of her capital gains and losses. What is the effect of Samantha's capital gains and losses on her taxable income and her income tax liability?

**Samantha has a \$2,000 short-term capital loss and a \$7,000 long-term capital loss:**

Short-term capital loss	\$ (7,000)	
Short-term capital gain	<u>5,000</u>	<u><u>\$(2,000)</u></u>
Collectibles loss	\$ (11,000)	
Long-term capital gain	8,000	
Long-term capital loss	<u>(4,000)</u>	<u><u>\$(7,000)</u></u>

Because the short-term and long-term positions are losses, no further netting is necessary. Samantha deducts \$3,000 of the loss for adjusted gross income and carries the remaining \$6,000 of loss to next year. The \$3,000 loss deduction is composed of the \$2,000 short-term loss and \$1,000 of the long-term loss. The \$6,000 capital loss carryforward is a long-term capital loss.

The \$3,000 capital loss deduction reduces her taxable income to \$116,000. Samantha's marginal tax rate is 25%. The capital loss deduction saves Samantha \$750 (\$3,000 x 25%) in taxes.

47. Jie has the following capital gains and losses during the current year:

Short-term capital loss	\$ 2,000
Collectibles gain	3,000
Unrecaptured Section 1250 gain	8,000
Long-term capital gain	12,000
Long-term capital loss carryover	7,000

Jie is married and has a taxable income of \$172,000 before considering the effect of her capital gains and losses. What is the effect of Jie's capital gains and losses on her taxable income and her income tax liability?

**Jie has a \$2,000 short-term capital loss and an \$16,000 net long-term capital gain. The short-term loss and the long-term gain are netted, resulting in a \$14,000 net long-term capital gain for the year:**

Short-term capital loss		\$ (2,000)
Long-term capital gain	\$12,000	
Unrecaptured Section 1250 gain	8,000	
Collectibles gain	3,000	
Long-term capital loss carryover	<u>(7,000)</u>	16,000
Net long-term capital gain		<u>\$ 14,000</u>

The \$14,000 net long-term capital gain is added to gross income, increasing Jie's taxable income to \$186,000. In calculating the tax on the capital gains, the 28% rate gain is negative \$6,000. The negative 28% rate gain reduces the unrecaptured Section 1250 gain to \$2,000. The adjusted net capital gain is \$12,000.

28% rate gain	= \$ 3,000 - \$2,000 - \$7,000	= \$ (6,000)
Unrecaptured Section 1250 gain	= \$ 8,000 - \$6,000	= \$ 2,000
Adjusted net capital gain	= \$14,000 - \$2,000	= \$12,000

The \$12,000 adjusted net capital gain is taxed at 15%. Jie's marginal tax rate is 28%. Therefore, the \$2,000 unrecaptured Section 1250 gain is taxed at the 25% maximum rate. Jie's income tax liability increases by \$2,300:

Tax on adjusted net capital gain - \$12,000 x 15%	\$ 1,800
Tax on unrecaptured Section 1250 gain - \$2,000 x 25%	500
Tax on capital gains	<u>\$ 2,300</u>



48. Yorgi purchases qualified small business stock in Gnu Company, Inc., on September 15, 2008, for \$50,000. She sells the shares for \$400,000 on December 30, 2016. The stock retains its qualified small business status through the date of the sale.

- a. Determine the amount of realized and recognized gain on the sale.

**Yorgi realizes a gain of \$350,000 (\$400,000 - \$50,000) on the sale of the qualified small business stock. Yorgi held the stock for more than 5 years. Therefore, 50% of the realized gain is excluded from capital gain income and her net long-term capital gain is \$175,000 (\$350,000 gain - \$175,000 exclusion).**

- b. What is Yorgi's effective tax rate on this transaction? (Assume her marginal tax rate is 33%.)

**The \$175,000 recognized gain on qualified small business stock is taxed at the 28% maximum capital gains tax rate. The tax liability attributable to the gain is \$49,000 (\$175,000 x 28%). The effective tax rate on the \$350,000 realized gain is 14% (\$49,000 ÷ \$350,000).**

49. Return to the facts of Problem 48. Assume that Yorgi has a net capital loss of \$80,000 from her other capital asset transactions in 2016. What is the effect of the sale of the stock on Yorgi's tax liability if her marginal tax rate is 33%.

**As in Problem 48, Yorgi can exclude 50% of the entire realized capital gain income from the sale of qualified small business stock. Since the 50% gain exclusion is deducted before the capital gain netting procedure is performed, Yorgi is allowed to further reduce the amount of her net long-term capital gain by the \$80,000 capital loss from other capital loss transactions.**

Realized gain on sale of stock (\$400,000 - \$50,000)	\$ 350,000
Less: 50% exclusion on gain on small business stock	(175,000)
Net realized capital gain remaining after exclusion	\$ 175,000
Less: Net capital loss from other transactions	(80,000)
Net realized taxable long-term capital gain	\$ 95,000
Maximum tax rate on qualified small business stock	x 28%
Tax on net long-term capital gain	<u>\$ 26,600</u>

**Note: The results of this problem will be the same regardless of the position of the \$80,000 capital loss from other transactions. This is because the capital gains exceed the capital losses.**

50. Return to the facts of problem 48. Assume that Yorgi purchased the qualified small business stock in Gnu Company, Inc., on September 15, 2009, and sells the shares for \$400,000 on December 30, 2016.

- a. Determine the amount of realized and recognized gain on the sale.

**Yorgi realizes a gain of \$350,000 (\$400,000 - \$50,000) on the sale of the qualified small business stock. Yorgi held the stock for more than 5 years and acquired the stock after February 17, 2009, and before September 27, 2010. Therefore, 75% of the realized gain is excluded from capital gain income and her net long-term capital gain is \$87,500 (\$350,000 gain - \$262,500 exclusion).**

- b. What is Yorgi's effective tax rate on this transaction? (Assume her marginal tax rate is 33%.)

**The \$87,500 recognized gain on qualified small business stock is taxed at the 28% maximum capital gains tax rate. The tax liability attributable to the gain is \$24,500 (\$87,500 x 28%). The effective tax rate on the \$350,000 realized gain is 7% (\$24,500 ÷ \$350,000).**

51. Return to the facts of problem 50. How would your answer change if Yorgi purchased the qualified small business stock in Gnu Company, Inc. on September 15, 2011, and sells the shares for \$400,000 on December 31, 2016?

**Yorgi realizes a gain of \$350,000 (\$400,000 - \$50,000) on the sale of the qualified small business stock. Yorgi held the stock for more than 5 years and acquired the stock after September 27, 2010. Therefore 100% of the realized gain is excluded from capital gain income and her net long-term capital gain is \$-0- (\$350,000 gain - \$350,000 exclusion). The effective tax rate on the \$350,000 realized gain is 0 percent (\$0 ÷ \$350,000).**

52. During August 2010, Madeline invests \$400,000 in Qual Company, Inc., buying 100,000 shares of stock. Her broker tells her this will be an excellent investment because the securities are qualified small business stock. He predicts the stock will triple in value over the next three years. At the end of 2013, Madeline's shares are valued at \$700,000. Madeline is encouraged. She decides to cash out of this investment in December 2016 if the stock continues to appreciate. Madeline comes to you for advice. Write a letter advising her what she should do.

**If the stock triples in value as predicted by her stockbroker, Madeline will realize a gain of \$800,000  $[(\$400,000 \times 3 = \$1,200,000) - \$400,000]$  on sale in December 2015. Madeline's investment can be qualified small business stock only if she holds it for 5 years. Individuals may exclude 50% of the realized gain on qualified small business stock. By not holding the stock 5 years, Madeline will be taxed at 15% on the \$800,000 gain. She will pay \$120,000  $(\$800,000 \times 15\%)$  in tax on the gain if she sells the stock in December 2014. However, if she purchases other qualified small business stock costing at least \$1,200,000 (the selling price) within 6 months of the sale, she can defer the entire gain on the stock and the holding period of the new stock will include the time she held the Qual Company stock.**

**If Madeline holds the stock until after August 2015, the stock will be qualified small business stock and she can exclude 75% of any gain on the sale. If she can still sell the stock for \$1,200,000 at this time, she can exclude \$600,000 of the gain. The remaining gain is taxed at 28%, resulting in \$56,000  $(\$200,000 \times 28\%)$  in taxes. By holding the stock an additional 1½ years, she will save \$64,000  $(\$120,000 - \$56,000)$  in taxes.**

**Madeline should not sell the stock until after August 2015 if she expects the stock to at least maintain its value. However, if the stock price is expected to drop before this time, she may want to consider selling in December 2014. For example, if the stock is projected to be worth only \$750,000 in August 2015, she will have a \$350,000  $(\$750,000 - \$400,000)$  gain on the sale. She excludes \$262,500 of the gain and pays a tax of \$24,500  $(\$87,500 \times 28\%)$  on the \$87,500 of gain remaining after the exclusion. Her realization net of tax is \$725,500  $(\$750,000 - \$24,500)$ . If she sells the stock in December 2014, her realization net of tax is \$1,080,000  $(\$1,200,000 - \$120,000)$ . Therefore, the decision to sell the stock in December 2014 or hold it until after August 2015 is dependent on what the price of the stock is expected to be in the future.**

53. In 2009, RAD Partnership was organized by three equal partners: 2 individuals (Rachael and Adam) and Depesh Corporation. On January 10, 2009, RAD Partnership purchases 18,000 shares of qualified small business stock in Miltown Corporation for \$36,000. On December 2, 2016, RAD sells all of the Miltown Corporation stock for \$180,000. Rachael, Adam and Depesh Corporation each have a net capital loss from other transactions of \$20,000. What are the tax implications of the sale for:

a. RAD Partnership

**RAD Partnership is a conduit entity. It reports the gain on the qualified small business stock on its information tax return as a separately stated item. Each of its partners will be allocated one-third of the gain from the stock sale. Whether the qualified small business stock exclusion applies to the transaction is determined at the partner level. The exclusion applies to the extent that (i) the partnership held the qualified small business stock for more than 5 years, (ii) the partner has held his or her partnership interest on the date on which the partnership acquired the stock and at all times thereafter, and (iii) the partner is a non-corporate entity. Rachel, Adam, and Depesh Corporation are each allocated one third of the total gain from the stock sale:**

<b>Sale proceeds:</b>	<b>\$ 180,000</b>
<b>Adjusted basis:</b>	<b>(36,000)</b>
<b>Total capital gain</b>	<b><u>\$ 144,000</u></b>
<b>Each partner's share of the gain</b>	<b><u>\$ 48,000</u></b>

b. Rachael

c. Adam

**Both Rachel's and Adam's entire gain qualifies for exclusion because it does not exceed the greater of (1) \$10,000,000 or (2) ten times their share of the adjusted basis in the stock. Rachael and Adam each exclude \$24,000 (\$48,000 x 50%) of the gain, resulting in a \$24,000 recognized long-term capital gain. Each of them may offset the \$24,000 long-term capital gain by their respective \$20,000 capital loss, leaving each of them with a \$4,000 net long-term capital gain. The gain is taxed at a maximum rate of 28%. Their tax liability is \$1,120 (\$4,000 x 28%).**

d. Depesh Corporation

**Only non-corporate taxpayers qualify for the small business stock exclusion. Depesh Corporation nets the \$48,000 gain with its \$20,000 capital loss resulting in a \$28,000 net capital gain. The \$28,000 net capital gain is taxed at its regular corporate income tax rates.**

54. Marnie buys 500 shares of qualified small business stock in H.R. Pizza, Inc., on September 10, 2008 for \$20,000. She sells the 500 shares for \$120,000 on October 2, 2016. Marnie's other capital asset transactions consist of a \$7,000 short-term capital loss, a \$25,000 long-term capital gain and an \$8,000 long-term capital loss carryover from 2015. Marnie is single, and her taxable income is \$110,000 without considering her capital asset transactions. What is the effect of the sale of the stock on Marnie's 2016 income tax liability?

**Because Marnie has held qualified small business stock for more than five years and her gain does not exceed the greater of (1) \$10,000,000 or (2) ten times her adjusted basis in the stock, Marnie can exclude 50% of the \$100,000 (\$120,000 - \$20,000) gain on the sale. The remaining \$50,000 gain is a long-term capital gain in the capital gain and loss netting.**

**Marnie has a \$7,000 short-term capital loss and a \$67,000 long-term capital gain. The short-term loss and the long-term gain are netted, resulting in a net long-term capital gain of \$60,000:**

Short-term capital loss			\$ (7,000)
Long-term capital gain	\$ 25,000		
Gain on qualified small business stock	50,000		
Long-term capital loss carryover	<u>(8,000)</u>		67,000
Net long-term capital gain			<u>\$ 60,000</u>

The \$60,000 net capital gain is added to her gross income, increasing taxable income to \$170,000. The gain on qualified business stock is part of the 28% tax rate gain, which is \$35,000 (\$50,000 - \$7,000 - \$8,000). Marnie's adjusted net capital gain is \$25,000 (\$60,000 - \$35,000).

28% rate gain	=	\$50,000 - \$ 7,000 - \$8,000	=	\$35,000
Adjusted net capital gain	=	\$60,000 - \$35,000	=	\$25,000

The adjusted net capital gain is taxed at 15%. The 28% tax rate gain is the gain on the qualified small business stock reduced by the net-short capital loss and the long-term capital loss carryover. The effect of the netting is to tax only \$35,000 of the gain on the qualified small business stock. Because Marnie is in the 28% marginal tax rate bracket, the \$35,000 gain is taxed at the maximum 28% rate. Marnie pays \$9,800 in tax on the sale of the qualified small business stock and \$3,750 (\$25,000 x 15%) on the remaining \$25,000 (\$60,000 - \$35,000) long-term capital gain.

Tax on adjusted net capital gain	(\$25,000 x 15%)	\$ 3,750
Tax on qualified small business stock	(\$35,000 x 28%)	9,800
Increase in tax liability due to capital gains		<u>\$13,550</u>

55. Neila sells 500 shares of Bolero Corporation stock for \$10,500 and pays \$500 in sales commissions on September 23 of the current year. She acquired the stock for \$4,700 plus \$300 in commissions five years ago. Neila owns the following securities in December of the current year.

<u>Security</u>	<u>Number of Shares</u>	<u>Purchase Date</u>	<u>Basis</u>	<u>Market Value</u>
Rondo Corporation	200	2/13/13	\$ 3,000	\$ 6,000
Hartley, Inc.	300	4/11/15	11,000	5,000
Flescher Company	400	7/18/16	24,000	20,000

Write a memorandum to Neila recommending an optimal year-end tax-planning strategy for her capital gains and losses.

**Neila realizes a \$5,000  $[(\$10,500 - \$500) - (\$4,700 + \$300)]$  long-term capital gain on the September 23 sale. When a taxpayer is in a net capital gain position prior to the end of the tax year, the normal strategy is take losses on capital assets to offset the capital gain. Therefore, Neila is in a position to sell some of her securities that currently have unrealized losses.**

**If Neila sells the Hartley Inc., shares, she will realize a \$6,000 long-term capital loss. This will change her net capital gain/loss position to a \$1,000  $(\$5,000 - \$6,000)$  net capital loss. Selling the Flescher Company stock will result in a \$4,000 short-term capital loss. Because of the \$3,000 capital loss deduction limitation, Neila should sell only 200 of the Flescher shares, which will produce \$2,000 short-term loss on the sale and a \$3,000 net capital loss.**

**Neila could also sell the 400 Flescher shares. She would then need to sell 200 of the Hartley, Inc. shares, which would produce a \$4,000 loss. Netting the \$4,000 loss on the Flescher shares and the \$4,000 loss on the Hartley shares with the \$5,000 gain on the September 23 sale results in a net capital loss of \$3,000, which is the maximum amount she can deduct.**

56. Ansel sells 400 shares of Sharpe, Inc., common stock on October 12, 2016 for \$11,800 and pays \$600 in commissions on the sale. He acquired the stock for \$18,400 plus \$800 in commissions on July 8, 2015. Ansel owns the following securities in December 2016:

<u>Security</u>	<u>Number of Shares</u>	<u>Purchase Date</u>	<u>Basis</u>	<u>Market Value</u>
Telio Corporation	400	2/13/13	\$ 2,000	\$ 7,000
Perry, Inc.	300	8/11/14	12,000	27,000
Header Company	600	4/13/16	14,000	20,000

What actions should Ansel take to optimize his capital gains and losses for 2016?

**Ansel realizes a \$8,000  $[(\$11,800 - \$600) - (\$18,400 + \$800)]$  long-term capital loss on the sale of the stock. Because Ansel can only deduct \$3,000 in capital losses, Ansel should sell some of the stocks he owns with unrealized gains to offset the \$8,000 loss. Optimally, he will sell stocks to create a \$5,000 gain.**

**All of the stocks in Ansel's portfolio have unrealized gains. However, due to the holding period rules, the Telio stock and the Perry stock would produce a long-term capital gain (held > 12 months), and the Header Company stock would produce a short-term capital gain. Because long-term gains are taxed at 15% (0% or 20%, depending on the taxpayer's marginal tax rate), they generally should not be used to offset capital losses. Short-term gains are taxed as ordinary income. Therefore, Ansel will gain the most benefit by selling Header Company shares. If Ansel sells 500 of the Header corporation shares, he will realize a \$5,000  $[(\$20,000 - \$14,000) - (500 \div 600)]$  short-term capital gain. Netting the short-term gain against the \$8,000 long-term loss results in a \$3,000 net capital loss for the year. Ansel can deduct the \$3,000 net capital loss for adjusted gross income.**

57. Opal's neighbor, Jilian, persuades her to invest in Schaaake Corporation, a new venture, on March 4, 2015. Opal pays \$15,000 for 3,000 shares of common stock. On February 6, 2016, Schaaake Corporation declares bankruptcy and closes its doors forever. Opal never receives a return on her investment or a reimbursement of her original investment. What are the tax consequences to Opal?

**Opal realizes a \$15,000 long-term capital loss on the worthless securities in 2016. Opal is deemed to have realized the loss on the last day of the tax year in which the security is determined to be worthless (2016). The realized loss is equal to the basis of the worthless security. The stock is long-term because the holding period is more than 12 months (March 4, 2015, through December 31, 2016). Opal can deduct only \$3,000 of the loss, unless she has capital gains to offset some or all of the \$15,000 capital loss.**

58. Fred's Foam Foundations (FFF) is a sole proprietorship that Fred started in 2011. Before the current year, FFF had not disposed of any property it owned. During the current year, FFF has the following gains and losses:

Casualty Loss on foam truck	\$ 3,200
Section 1231 gains	\$ 9,400
Section 1231 losses	\$ 3,000

What is the effect of these transactions on Fred's taxable income? Explain, and show the calculations.

**The Section 1231 netting results in an ordinary loss of \$3,200 and a net long-term capital gain of \$6,400. The \$3,200 ordinary loss is deducted directly from Fred's gross income. The \$6,400 is combined with Fred's other capital gains and losses in the capital gain and loss netting procedure.**

**Step 1 Netting:**

Casualty loss on foam truck (Ordinary Loss)	<u><b>\$3,200</b></u>
---	-----------------------

Because the 1st netting results in a loss, the loss is ordinary. It is not carried to the second netting.

**Step 2 Netting:**

Section 1231 gains	\$ 9,400	
Section 1231 losses	<u>(3,000)</u>	
Net Section 1231 gain - Long-term capital gain		<u><b>\$6,400</b></u>

**Step 3 Netting:**

**Because Fred has never sold any property before the current year, there are no ordinary loss deductions to recapture under the lookback rule. The entire \$6,400 net Section 1231 gain is a long-term capital gain.**



59. Refer to the facts in problem 58. In the following year, FFF has these gains and losses:

Casualty gain on building	\$ 5,000
Section 1231 gains	\$ 3,000
Section 1231 losses	\$ 17,000

What is the effect of these transactions on Fred's taxable income? Explain, and show the required calculations.

**The Section 1231 netting results in an ordinary loss deduction of \$9,000, reducing Fred's taxable income by \$9,000.**

**Step 1 Netting:**

Net casualty gain	<u>\$ 5,000</u>
-------------------	-----------------

**Step 2 Netting:**

Net casualty gain from step 1	\$ 5,000
Section 1231 gains	3,000
Section 1231 losses	(17,000)
Net section 1231 loss	<u>\$ (9,000)</u>

The net casualty gain from step 1 is combined with other Section 1231 gains and losses in step 2. This allows the net casualty gain to be offset against other Section 1231 gains and losses. Because there is a net Section 1231 loss for the year, there is no lookback recapture rule to apply.

60. In 2016, Sondra Corporation recognizes \$18,000 in Section 1231 gains and \$10,000 in Section 1231 losses. In 2011, Sondra reported \$12,000 in Section 1231 losses and no Section 1231 gains. No other Section 1231 gains or losses were recognized by Sondra during the 2011-2015 period. What is the tax treatment of Sondra's 2016 Section 1231 gains and losses?

**The Section 1231 netting results in 2016 ordinary income of \$8,000 due to the \$12,000 of nonrecaptured net Section 1231 losses from 2011.**

**Step 1 Netting:**

**No casualty gains or losses. Go to Step 2.**

**Step 2 Netting:**

Section 1231 gains	\$ 18,000
Section 1231 losses	(10,000)
Net Section 1231 gain	<u>\$ 8,000</u>

**Step 3 Netting:**

**The net Section 1231 gain from 2016 is recaptured as ordinary income due to the 2011 net Section 1231 loss of \$12,000. The remaining 2011 Section 1231 loss of \$4,000 (\$12,000 - \$8,000) will never be recaptured because 2011 is not part of the preceding 5-year period for the tax year 2017.**

61. Dawn started her own rock band on January 2, 2014. She acquired all her equipment on January 2, 2014, and did not dispose of any of it before 2016. On April 15, 2016, the band's amplifier, speakers, and other electronic equipment, are stolen after a concert. The stolen equipment's basis is \$15,000, and its fair market value before the theft is \$23,000. The insurance company reimburses Dawn \$23,000. Her road bus runs off the highway on September 13, 2016. The basis of the bus is \$60,000. Its fair market value before the accident is \$80,000, and the fair market value after the accident is \$70,000. The insurance company reimburses Dawn \$4,000 for the bus accident. Dawn's other gains and losses during 2016 are:

Section 1231 Gains	\$ 8,000
Section 1231 Losses	9,000

What is the effect of these transactions on Dawn's 2016 taxable income? Explain and show your calculations.

**The theft and the accident both constitute casualties. The casualty loss for property partially destroyed is the lesser of: (i) the adjusted basis in the property suffering the casualty, or (ii) the reduction in the fair market value of that property. The loss for business use property stolen is the property's adjusted basis. This casualty amount is reduced by the amount of any insurance proceeds received by reason of the casualty:**

**Stolen Equipment:**

Insurance Proceeds	\$ 23,000	
Adjusted Basis in Equipment	<u>(15,000)</u>	
Casualty Gain		\$ 8,000

**Bus Accident:**

Insurance Proceeds	\$ 4,000	
Reduction in Fair Market Value of Bus	<u>(10,000)</u>	
Casualty Loss		(6,000)
Net Casualty gain		<u>\$ 2,000</u>

**Section 1231 casualty gains and losses are first netted against each other. If there is a net gain, then that gain is treated as a Section 1231 gain. If there is a net loss, then the gains are treated as ordinary gains and the losses are treated as ordinary business losses. In this case, the net casualty gain of \$2,000 is treated as a Section 1231 gain.**

**Because the Section 1231 gains (\$8,000 + \$2,000) exceed the Section 1231 loss (\$9,000), the \$1,000 net Section 1231 gain is taxed as a long-term capital gain.**

Net Casualty gain	\$ 2,000
Section 1231 gains	8,000
Section 1231 losses	<u>(9,000)</u>
Net Section 1231 gain (Long-term capital gain)	<u>\$ 1,000</u>

62. Rhinelander Corporation has the following net Section 1231 gains and losses for 2011 through 2015:

2011	\$ 8,000
2012	(6,000)
2013	(13,000)
2014	11,000
2015	15,000

- a. What is the proper characterization of the net Section 1231 gains and losses for 2011 - 2015 for Rhinelander Corporation?

**The Section 1231 gain in 2011 is a long-term capital gain (there are no prior year losses to apply the lookback rule). The losses in 2012 and 2013 are deducted in those years as ordinary losses.**

**In 2014, the \$11,000 Section 1231 gain is ordinary income under the lookback rule. The \$6,000 ordinary loss deduction in 2012 and \$5,000 of the ordinary loss deduction in 2013 is recaptured as ordinary income. This leaves a net Section 1231 loss of \$8,000 (\$13,000 - \$5,000) remaining from 2013 which is still subject to recapture.**

**In 2015, \$8,000 of the \$15,000 gain is ordinary income under the lookback rule. Because the 2013 ordinary loss is fully recaptured, the remaining \$7,000 gain is a long-term capital gain.**

- b. Assume that in 2016, Rhinelander has a net Section 1231 gain of \$9,000. What is the proper characterization of the \$9,000 gain?

**The \$9,000 gain is a long-term capital gain. All ordinary loss deductions in the previous 5 years have been recaptured.**

63. The Gladys Corporation buys equipment (7-year MACRS property) costing \$574,000 on May 12, 2016. In 2019, new and improved models of the equipment make it obsolete, and Gladys sells the old equipment for \$34,000 on December 27, 2019.

- a. What is the character of Gladys Corporation's gain or loss on the sale assuming that it takes the maximum cost-recovery deductions allowable on the equipment?

NOTE: The depreciation calculations for this problem were done for problem 48, Chapter 10.

**From problem 48 in Chapter 10, the depreciation taken on the asset to the date of sale is \$546,262, resulting in an adjusted basis in the equipment of \$27,738 (\$574,000 - \$546,262). This results in a gain of \$6,262 on the sale. The equipment is Section 1245 property. Because the depreciation is greater than the realized gain, all of the gain is recaptured as ordinary income.**

Amount realized	\$ 34,000
Adjusted basis (\$574,000 - \$546,262)	(27,738)
Gain realized on sale	\$ 6,262
Section 1245 recapture	(6,262)
Section 1231 gain	<u>\$ -0-</u>

- b. What is the character of Gladys Corporation's gain or loss on the equipment assuming that it takes the minimum cost-recovery deduction allowable on the equipment?

**Straight-line depreciation is \$172,200, resulting in an adjusted basis of \$401,800 (\$574,000 - \$172,200). This results in a loss on the sale of \$367,800. Although the equipment is Section 1245 property, the recapture rules apply only to gains caused by ordinary depreciation deductions. Losses on Section 1245 assets are Section 1231 losses.**

Amount realized	\$ 34,000
Adjusted basis (\$574,000 - \$172,200)	(401,800)
Loss realized on sale	<u>\$ (367,800)</u>
Section 1231 loss	<u>\$ (367,800)</u>

64. Avalon Inc., buys equipment costing \$150,000 in 2013 and sells it in 2016. Avalon deducts \$94,000 in depreciation on the equipment before the sale. What is the character of the gain or loss on the sale of the equipment if the selling price is

**Equipment is Section 1231 property. It is also subject to recapture under Section 1245. Any gain on the sale must be recaptured as ordinary income to the extent of the \$94,000 in depreciation that has been deducted on the equipment. The adjusted basis of the equipment is \$56,000 (\$150,000 - \$94,000) at the date of sale.**

- a. \$90,000?

**Avalon realizes a \$34,000 gain on the sale. The entire gain is recaptured as ordinary income:**

Amount realized	\$ 90,000
Adjusted basis (\$150,000 - \$94,000)	(56,000)
Gain on sale	<u>\$ 34,000</u>
Section 1245 - Ordinary income	34,000
Section 1231 gain	<u><u>\$ -0-</u></u>

- b. \$155,000?

**Avalon realizes a \$99,000 gain on the sale. The \$94,000 of depreciation is recaptured as ordinary income, leaving a \$5,000 Section 1231 gain:**

Amount realized	\$155,000
Adjusted basis (\$150,000 - \$94,000)	(56,000)
Gain on sale	<u>\$ 99,000</u>
Section 1245 - Ordinary income	94,000
Section 1231 gain	<u><u>\$ 5,000</u></u>

- c. \$40,000?

**Avalon realizes a \$16,000 loss on the sale. The \$16,000 loss is a Section 1231 loss — depreciation recapture applies only to gains:**

Amount realized	\$ 40,000
Adjusted basis (\$150,000 - \$94,000)	(56,000)
Loss on sale	<u><u>\$ (16,000)</u></u>

65. Maria sells the automobile she uses in her job as a marketing representative for \$3,000. The car cost \$15,000 four years earlier. Maria uses the automobile 80% of the time in her job and 20% of the time for personal purposes. At the date of sale, Maria had taken \$10,000 in depreciation on the automobile. Write a letter to Maria explaining the amount and character of her realized gain or loss from the sale and how much she must recognize for tax purposes.

**Because Maria uses the automobile for business and personal purposes, the basis and the sale of the automobile must be broken into the portions attributable to both uses:**

		<b>Total</b>	<b>80% Business</b>	<b>20% Personal</b>
<b>Selling price</b>		<u>\$ 3,000</u>	<u>\$ 2,400</u>	<u>\$ 600</u>
<b>Adjusted basis</b>				
Initial basis	\$ 15,000		\$ 12,000	\$ 3,000
Depreciation	<u>(10,000)</u>	<u>5,000</u>	<u>(10,000)</u>	<u>-0-</u>
<b>Gain (Loss) on sale</b>		<u>\$ (2,000)</u>	<u>\$ 400</u>	<u>\$ (2,400)</u>

The \$400 gain on the business portion of the automobile is a Section 1231 gain. However, because the automobile is Section 1245 property, the \$400 gain is recaptured as ordinary income. The \$2,400 loss is a non-deductible personal use loss.

66. Alex purchases a building in 1986 at a cost of \$500,000. ACRS depreciation on the building totals \$320,000, whereas straight-line depreciation would be \$260,000 for the same period. Alex sells the building for \$620,000.

- a. What is Alex's gain on the sale if he deducts the ACRS depreciation on the building?

Amount realized	\$ 620,000
Adjusted basis (\$500,000 - \$320,000)	(180,000)
Gain on sale	<u>\$ 440,000</u>

- b. If the building is an apartment building that Alex rents to individuals, what is the character of the gain? Assume that Alex holds the building as an investment.

**Residential rental property purchased in 1986 is Section 1250 property. An apartment building qualifies as residential rental property. Therefore, only the excess depreciation of \$60,000 (\$320,000 - \$260,000) is recaptured as ordinary income. The \$260,000 (\$320,000 - \$60,000) of depreciation that would have recaptured as ordinary income under Section 1245 is *unrecaptured Section 1250 gain*, which is taxed at maximum rate of 25%. The remaining \$120,000 of gain is a long-term capital gain (i.e., the rental property is held for investment purposes).**

Total gain recognized	\$ 440,000
Ordinary income (\$320,000 - \$260,000)	(60,000)
Remaining gain	<u>\$ 380,000</u>
Unrecaptured Section 1250 gain (\$320,000 - \$60,000)	(260,000)
Long-term capital gain	<u>\$ 120,000</u>

- c. How would your answer to part b change if the building were sold for \$105,000?

**Alex has a realized loss of \$75,000. It is classified as a long-term capital loss because the building is held for investment.**

Amount realized	\$ 105,000
Adjusted basis (\$500,000 - \$320,000)	(180,000)
Long-term capital loss realized on sale	<u>\$ (75,000)</u>



- d. What is Alex's gain on the sale if he deducts the straight-line depreciation on the building?

Amount realized	\$ 620,000
Adjusted basis (\$500,000 - \$260,000)	(240,000)
Gain realized on sale	<u>\$ 380,000</u>

- e. If Alex deducts straight-line depreciation on the building, what is the character of the gain? Assume that Alex holds the building as an investment.

The building is Section 1250 property. Any real property subject to a straight-line election under ACRS is Section 1250 property. Because Section 1250 only recaptures depreciation taken in excess of straight-line as ordinary income, none of the \$380,000 gain on sale is subject to recapture. However, the \$260,000 in depreciation on the building is *unrecaptured Section 1250 gain*, which is taxed at a maximum rate of 25%. The remaining \$120,000 of gain is a long-term capital gain (i.e., the rental property is held for investment purposes).

Total gain recognized	\$ 380,000
Unrecaptured Section 1250 gain	(260,000)
Long-term capital gain	<u>\$ 120,000</u>

67. Manuel is negotiating the sale of two of his rental properties. He has an offer of \$500,000 for each condo. Manuel bought one condo in 1986 for \$400,000 and has deducted depreciation of \$185,000 using ACRS (accelerated depreciation). Straight-line depreciation would have been \$125,000 if he had elected to use it. Manuel paid \$300,000 for the condo he bought in 1993 and he has deducted depreciation of \$81,800 using the MACRS rates for residential real estate. Compare the realized gains or losses and the recognized gains or losses of the two properties, assuming Manuel sells both. Explain the differences.

	<u>1986 Condo</u>	<u>1993 Condo</u>
Amount realized	\$ 500,000	\$ 500,000
Adjusted basis:		
(\$400,000 - \$185,000)	(215,000)	
(\$300,000 - \$ 81,800)		(218,200)
Gain realized on sale	\$ 285,000	\$ 281,800
Section 1250 recapture,		
(\$185,000 - \$125,000)	(60,000)	-0-
Remaining gain	\$ 225,000	\$ 281,800
Unrecaptured Sec. 1250 gain	(125,000)	(81,800)
Long-term capital gain	<u>\$ 100,000</u>	<u>\$ 200,000</u>

Residential rental property purchased in 1986 is Section 1250 property. Therefore, only the excess depreciation of \$60,000 (\$185,000 - \$125,000) is recaptured as ordinary income. The \$125,000 (\$185,000 - \$60,000) of straight-line depreciation is *unrecaptured Section 1250 gain*, which is taxed at a maximum rate of 25%. The remaining \$100,000 of gain is a long-term capital gain (i.e., the rental property is held for investment purposes).

The 1993 property was depreciated using regular MACRS, which uses the straight-line method. Therefore, there is no excess depreciation. However, the \$81,800 in depreciation is *unrecaptured Section 1250 gain*, which is taxed at a maximum rate of 25%. The remaining \$200,000 of gain is a long-term capital gain.

Even though the amount of the gain on the sale of the 1986 condo is only \$3,200 more than the gain on the 1993 condo, the tax effects of the recaptures cause the tax liability to be greater on the 1986 condo. If Manuel is in the 33% rate bracket and he has no other capital gains and losses during the year, his tax on the 1986 condo is \$15,600 (\$66,050 - \$50,450) greater than on the 1993 condo:

	<u>1986 Condo</u>	<u>1993 Condo</u>
Tax on ordinary income - \$60,000 x 33%	\$ 19,800	\$ -0-
Tax on unrecaptured Section 1250 gain		
(\$125,000 x 25%)	31,250	
(\$ 81,800 x 25%)		20,450
Tax on long-term capital gain		
(\$100,000 x 15%)	15,000	
(\$200,000 x 15%)		30,000
Total tax on gain	<u>\$ 69,250</u>	<u>\$ 50,450</u>

68. Anton purchases a building on May 4, 1999, at a cost of \$270,000. The land is properly allocated \$30,000 of the cost. Anton sells the building on October 18, 2016, for \$270,000. What is the character of Anton's gain or loss on the sale if he uses the regular MACRS system and the building is

NOTE: The depreciation calculations for this problem were done for problem 54, Chapter 10.

- a. An apartment building

**From problem 54 in Chapter 10, the depreciation on the apartment building is \$151,993, resulting in an adjusted basis of \$118,007 at the date of sale. MACRS uses straight-line depreciation on real property and there is no Section 1250 recapture. However, the \$151,993 of depreciation is unrecaptured Section 1250 gain, which is taxed at a maximum rate of 25%. The \$151,993 gain on the sale of the building is all unrecaptured Section 1250 gain.**

Amount realized	\$ 270,000
Adjusted basis (\$270,000 - \$151,993)	(118,007)
Gain on sale	<u>\$ 151,993</u>
Section 1250 recapture - no excess depreciation	-0-
Unrecaptured Section 1250 gain	<u>(151,993)</u>
Long-term capital gain	<u><u>\$ -0-</u></u>

- b. An office building

**The depreciation on the office building is \$107,188, resulting in an adjusted basis of \$162,812 at the date of sale. There is no Section 1250 recapture on real property purchased after 1986 for the reasons stated in part a. The \$107,188 of depreciation is unrecaptured Section 1250 gain, which is taxed at a maximum rate of 25%. The gain of \$107,188 is all unrecaptured Section 1250 gain.**

Amount realized	\$ 270,000
Adjusted basis (\$270,000 - \$107,188)	(162,812)
Gain on sale	<u>\$ 107,188</u>
Section 1250 recapture - no excess depreciation	-0-
Unrecaptured Section 1250 gain	<u>(107,188)</u>
Section 1231 gain	<u><u>\$ -0-</u></u>

69. Assume that the building in problem 68 is an apartment building held for investment. In addition to the sale of the building, Anton has the following capital gains and losses during 2016:

Short-term capital loss	\$ 4,000
Collectibles gain	7,000
Long-term capital gain	15,000
Long-term capital loss carryover from 2015	6,000

Anton is married and has a taxable income of \$160,000 without considering his capital gains and losses. What is his taxable income and income tax liability?

**The collectibles gain and the unreaptured Section 1250 gain are long-term capital gains in the capital gain and loss netting procedure. Anton has a \$4,000 net short-term capital loss and a \$167,993 net-long term capital gain. The short-term loss and the long-term gain are netted, resulting in a \$167,993 net long-term capital gain:**

Short-term capital loss		\$ (4,000)
Unrecaptured Section 1250 gain	\$151,993	
Collectibles gain	7,000	
Long-term capital gain	15,000	
Long-term capital loss carryover from 2015	<u>(6,000)</u>	167,993
Net long-term capital gain		<u>\$163,993</u>

The \$163,993 net long-term capital gain is added to taxable income. In calculating the tax, the \$163,993 net long-term capital gain is reduced by the 28% rate gain and the unreaptured Section 1250 gain. The 28% rate gain is a negative \$3,000, which reduces the unreaptured Section 1250 gain to \$148,993 (\$151,993 - \$3,000). The adjusted net capital gain is \$15,000.

28% rate gain	= \$ 7,000 - \$ 4,000 - \$6,000	= \$ (3,000)
Unrecaptured Sec. 1250 gain	= \$151,993 - \$ 3,000	= \$148,993
Adjusted net capital gain	= \$163,993 - \$148,993	= \$ 15,000

The \$15,000 adjusted net capital gain is taxed at 15%. Because Anton is in the 28% marginal tax rate bracket, the \$148,993 unreaptured Section 1250 gain is taxed at 25%. Anton's income tax liability is \$71,284:

Tax on \$160,000 - \$29,517.50 + [28% x (\$160,000 - \$151,900)]	\$ 31,786
Tax on adjusted net capital gain - \$15,000 x 15%	2,250
Tax on unreaptured Section 1250 gain - \$148,993 x 25%	37,248
Income tax liability	<u>\$ 71,284</u>

70. Thuy buys a rental house in 2009 for \$75,000. In 2016, she sells it for \$86,000. Thuy properly deducted \$22,000 in depreciation on the house before its sale.
- a. What is the amount and character of the gain on the sale?

**Thuy realizes a \$33,000 gain on the sale. The rental house is Section 1250 property but there is no depreciation recapture because MACRS uses straight-line depreciation. However, the \$22,000 in depreciation is characterized as unrecaptured Section 1250 gain, leaving an \$11,000 long-term capital gain on the sale:**

Amount realized	\$ 86,000
Adjusted basis - (\$75,000 - \$22,000)	(53,000)
Realized gain	<u>\$ 33,000</u>
Section 1250 recapture	-0-
Unrecaptured Section 1250 gain	22,000
Long-term capital gain	<u><u>\$ 11,000</u></u>

- b. Thuy also sells the following securities:

Security	Purchase Date	Sales Date	Basis	Sales Price
Delphi Corporation	4/13/13	4/08/16	\$ 3,000	\$ 7,000
Mondo, Inc.	6/11/15	7/15/16	12,000	10,000
Horace Company	4/13/16	8/13/16	14,000	19,000

Determine the amount of tax that Thuy will pay on her capital asset transactions. Assume that she is in the 35% marginal tax rate bracket.

**Thuy realizes a \$4,000 (\$7,000 - \$3,000) long-term gain on the 4/08/16 sale, a \$2,000 (\$10,000 - \$12,000) long-term loss on the 7/15/16 sale, and a \$5,000 (\$19,000 - \$14,000) short-term gain on the 8/13/16 sale. The capital gain and loss netting produces a \$5,000 short-term capital gain and a \$35,000 long-term capital gain:**

Short-term capital gain	<u><u>\$ 5,000</u></u>
Unrecaptured Section 1250 gain	\$ 22,000
Long-term capital loss	(2,000)
Long-term gain - stock	4,000
Long-term gain - rental house	<u>11,000</u>
Net long-term capital gain	<u><u>\$35,000</u></u>

**Because the short-term and long-term positions are both gains, no further netting is necessary. In calculating the tax on the capital gains, there is no 28% rate gain. Thuy's adjusted net capital gain is \$13,000 (\$35,000 - \$22,000). The short-term capital gain is taxed at Thuy's 35% marginal tax rate. The adjusted net capital gain is taxed at 15% and the unrecaptured Section 1250 gain is taxed at 25%. The tax on Thuy's capital gains is \$9,200:**

Tax on short-term capital gain - \$5,000 x 35%	\$ 1,750
Tax on unrecaptured Section 1250 gain - \$22,000 x 25%	5,500
Tax on adjusted net capital gain - \$13,000 x 15%	1,950
Tax on capital gains	<u><u>\$ 9,200</u></u>

**ISSUE IDENTIFICATION PROBLEMS**

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

71. Nadia sells land for \$4,000 and the buyer assumes her \$13,000 mortgage. She pays \$1,000 in real estate commissions on the sale.

**The issue is the amount realized from the sale of the land. Nadia receives \$4,000 and \$13,000 in mortgage relief. Therefore, the gross sales price is \$17,000. The \$1,000 in real estate commissions she pays on the sale reduce her amount realized to \$16,000.**

72. Luke trades his baseball card collection for an automobile. The automobile is worth \$11,000, and Luke assumes the \$3,000 loan on the car. Luke has \$3,500 invested in his baseball card collection.

**The issues are the determination of the amount realized from the trade of the baseball card collection and the realized gain on the trade. Because Luke assumes the loan on the car, he receives \$8,000 (\$11,000 - \$3,000) for his baseball card collection. He realizes a \$4,500 (\$8,000 - \$3,500) gain on the trade.**

73. Marino inherits antique pottery from the estate of his grandmother on March 10, 2016. He immediately sells the pottery for \$15,000 to a collector who had made the offer to the executor of the estate several weeks before. The estate valuation of the pottery is \$13,000. Marino's grandmother paid \$20,000 for the pottery during an October 2014 visit to a flea market, convinced it was a valuable investment — that she was getting a "steal" and the pottery would substantially appreciate over time.

**The issues are Marino's basis in the antique pottery, the determination of the realized gain or loss on the sale of the antique pottery and the character of the gain or loss. The basis of inherited property is the value used by the estate. Marino's basis is \$13,000 and he realizes a \$2,000 (\$15,000 - \$13,000) gain on the sale. All inherited property is deemed to be held long-term, so the \$2,000 gain is a long-term capital gain.**

74. Jackie receives 100 shares of stock as a birthday gift from her Uncle Horace. Horace acquired the shares 22 years ago for \$4 each. The stock's value on Jackie's birthday is \$36 per share. She sells half her shares for \$1,500 five months after her birthday and pays a broker \$50 to complete the sale.

**The issues are Jackie's basis in the stock, the determination of the realized gain or loss on the sale of the stock and the character of the realized gain or loss. The general rule for gifts is that the donee's basis is equal to the donor's basis (unless fair market value is less than the donor's basis on the date of the gift) plus the gift tax paid on the appreciation in the value of the property. Because no gift tax is paid on the gift, Jackie's basis is equal to \$4 per share (Uncle Horace's basis). She realizes a \$1,300 [ $\$1,500 - (50 \times \$4)$ ] gain on the sale of the 50 shares. The general rule for holding period is that anytime your basis is made by reference to the basis of another person or the basis of another asset, your holding period includes the holding period of the other person or the other asset. In this case, Jackie uses her Uncle's basis and receives his holding period (22 years). Therefore, the gain is a long-term capital.**

75. While snorkeling on spring break in Cancun, Melody finds a small bag containing several jewels lodged between some rocks about 25 yards offshore. She reports the find to the local authorities. However, no one has reported a loss of jewels, and Melody is allowed to keep them. Upon returning home, she takes the jewels to an appraiser, who sets their value at \$18,000. Because she needs money to pay for her college tuition, dormitory room and board, and books, Melody sells the jewels to a local jewelry store for \$16,000.

**The issue to be resolved is the realized gain on the sale of the jewels. Melody's wealth increases due to the discovery of the jewelry. However, the increase in wealth has not been realized in an arm's-length transaction at the time she finds the jewels. Therefore, Melody has a zero basis in the jewelry and she realizes a \$16,000 capital gain on the sale. Her holding period begins on the date she is allowed to keep the jewels. From the facts, it appears that the sale was made less than a year from that date and the gain is a short-term capital gain.**

76. Carter owns 1,200 shares of Echo Corporation stock. He purchased 400 shares of the stock on December 23, 2014 for \$48,000, and the other 800 shares on October 31, 2015, for \$84,000. On August 14, 2016, he sells 500 shares of the stock for \$15,000 and pays a \$900 commission on the sale.

**The issues are the basis of the 500 shares sold on August 14, 2016, the determination of the realized gain or loss on the sale of the shares, and the character of the realized gain or loss. In the absence of specific identification of shares sold, stock is assumed to be sold on a first-in first-out basis. Under the general rule, Carter is assumed to have sold the 400 shares purchased on December 23, 2014 and 100 of the shares purchased on October 31, 2015. The 400 shares purchased on December 23, 2014, produce a \$36,720 long-term capital loss. The 100 shares purchased on October 31, 2015 produce a \$7,680 short-term capital loss:**

**400 shares purchased on 12/23/14:**

Amount realized $[(\$15,000 - \$900) \times (400 \div 500)]$	\$ 11,280
Adjusted basis	(48,000)
Long-term capital loss	<u><u>\$ (36,720)</u></u>

**100 shares purchased on 10/31/15:**

Amount realized $[(\$15,000 - \$900) \times (100 \div 500)]$	\$ 2,820
Adjusted basis $[(\$84,000 \div 800) \times 100]$	(10,500)
Short-term capital loss	<u><u>\$ (7,680)</u></u>

77. Martina purchases 10,000 shares of Monrovia Corporation stock for \$90,000 on November 14, 2015. On June 18, 2016, Monrovia declares bankruptcy. Because the corporation's assets are less than its liabilities, the stock is determined to be worthless on October 16, 2016.

**The issue is the character of the loss on the worthless securities. Securities are deemed to become worthless on the last day of the tax year the securities become worthless. Therefore, Martina is deemed to have held the shares from November 14, 2015 until December 31, 2016. Her loss on the shares is a \$90,000 long-term capital loss. Note: If the shares are qualified small business stock, Martina can deduct \$50,000 [or \$90,000 (\$100,000 maximum) if she is married] of the loss as an ordinary loss.**

78. Deskjet Corporation sells equipment with an adjusted basis of \$22,000 for \$3,000. The corporation paid \$43,000 for the equipment three years ago.

**The issues are the determination of the realized gain or loss on the sale of the equipment and the character of the gain or loss. Deskjet realizes a \$19,000 (\$3,000 - \$22,000) loss on the sale of the equipment. Equipment is Section 1231 property, so the loss is a Section 1231 loss. Note: Even if the equipment is Section 1245 property, there is no depreciation recapture on sales of depreciable property at a loss.**



79. Bostian Company reports a net Section 1231 gain of \$31,000 during the current year.

**The issue is the character of the \$31,000 net Section 1231 gain. Net Section 1231 gains are long-term capital gains. However, the lookback recapture rule reclassifies any Section 1231 ordinary loss deductions taken during the last 5 years as ordinary income. Therefore, if Bostian Company has deducted any Section 1231 loss in the last 5 years that have not been recaptured, it must recapture the losses as ordinary income before any of the \$31,000 gain is given long-term capital gain treatment.**

80. Jammer, Inc., sells a building for \$180,000. The company paid \$135,000 for the building four years earlier and had taken \$12,000 in depreciation on it up to the date of the sale.

**The issues are the basis of the building, the determination of the gain or loss realized on the sale of the building, and the character of the realized gain or loss. Jammer's basis is \$123,000 (\$135,000 - \$12,000) and it realizes a \$57,000 (\$180,000 - \$123,000) gain on the sale. Buildings used in a trade or business are Section 1231 property. Depreciable real property used in a trade or business is Section 1250 property. However, because the building has been depreciated using the straight-line method under MACRS, there is no Section 1250 recapture and the entire \$57,000 gain is a Section 1231 gain.**

81. Bernadero Corporation sells a construction crane with an adjusted basis of \$32,000 for \$37,000. The corporation paid \$50,000 for the crane.

**The issues are the determination of the gain or loss realized on the sale of the crane, and the character of the realized gain or loss. Bernadero realizes a \$5,000 (\$37,000 - \$32,000) gain on the sale. A construction crane is Section 1231 property. It is also Section 1245 property. Under Section 1245, any gain that is due to the depreciation taken on the property is recaptured as ordinary income. Bernadero has deducted \$18,000 (\$50,000 - \$32,000) in depreciation on the crane. Therefore, the \$5,000 gain on the sale is due to the depreciation deducted and is characterized as ordinary income under Section 1245.**

82. Harry sells the automobile he has used in his job as a salesman for \$2,000. It cost \$15,000 four years earlier. Harry used the automobile 70% of the time in his job and 30% of the time for personal purposes. At the date of sale, Harry had taken \$10,000 in depreciation on the car.

The issues are the determination of the gain or loss realized on the sale of the car, and the character of the realized gain or loss. The auto is a mixed-use asset and the gain or loss must be computed separately on the business portion and the personal use portion to determine the treatment of any gain or loss realized on the sale. Harry realizes a \$900 gain on the sale of the business use portion and a \$3,900 loss on the personal use portion of the automobile:

		70% <u>Business</u>		30% <u>Personal</u>
Sales price		\$ 1,400		\$ 600
Adjusted basis:				
Original basis	\$ 10,500		\$4,500	
Less: depreciation	<u>(10,000)</u>	<u>(500)</u>	<u>-0-</u>	<u>(4,500)</u>
Realized gain (loss)		<u>\$ 900</u>		<u>\$(3,900)</u>

The business use portion is Section 1231 property and Section 1245 property. Under Section 1245, any gain that is due to the depreciation taken on the property is recaptured as ordinary income. Because Harry has deducted \$10,000 in depreciation on the business use portion of the automobile, the \$900 is characterized as ordinary income under Section 1245. Losses on personal use assets are not deductible. Therefore, Harry cannot deduct the \$3,900 personal use loss on the sale of the automobile.

83. Tawana purchased real property in 2014 at a cost of \$200,000. In 2016, she is experiencing cash-flow problems and sells the property for \$220,000. The adjusted basis of the property is \$185,000.

The issues are the determination of the gain or loss realized on the sale of the real property, and the character of the realized gain or loss. Tawana has a \$35,000 (\$220,000 - \$185,000) gain on the sale. The only uncertainty is the treatment of the gain as either a capital gain or a Section 1231 gain. This will depend on whether she holds the rental property for investment purposes (capital asset) or as a trade or business asset (Section 1231 asset). In addition, the gain on the sale that is attributable to the depreciation taken on the property is reclassified as unrecaptured Section 1250 gain. Thus, Tawana has a \$15,000 (\$200,000 - \$185,000) unrecaptured Section 1250 gain on the sale. The remaining \$20,000 of gain is either a long-term capital gain or a Section 1231 gain. In either case, the classification will not likely affect the ultimate tax treatment because a net Section 1231 gain is treated as a long-term capital gain.

84. **Tax Simulation** In 2015, Nuts & Seeds Inc., purchased a new “high-tech” shelling machine from Soft-Core Corporation. Nuts & Seeds paid \$1,000 in cash and gave Soft-Core a \$29,000 note. The note is non-recourse and Soft-Core’s only recourse in the event of default by Nuts & Seeds is to take back the shelling machine. The sales agreement allows Nuts & Seeds to transfer ownership of the machine back to Soft-Core at any time to satisfy payment of the remaining indebtedness on the note. Nuts & Seeds elects to expense the \$30,000 cost of the machine in 2015. The shelling machine doesn’t live up to expectations and in 2016, Nuts & Seeds transfers ownership of the machine back to Soft-Core, thereby satisfying the indebtedness on the note. At the time of the transfer, the fair market value of the shelling machine is \$16,000 and the remaining principal balance on the note is \$28,000.

Required: Determine the income tax treatment of Nuts & Seeds Inc.’s transfer of the ownership of the shelling machine in satisfaction of the outstanding debt on the machine. Use a tax research database and find the relevant authority(ies) that form 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 Gloria’s sale. If there is any uncertainty regarding the tax treatment of the sale, explain what is uncertain and what you need to know to resolve the uncertainty.

**Sec. 1001(a) defines the gain (or loss) from the sale or other disposition of property as the excess of the amount realized over the adjusted basis of the property.**

***SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.***

***1001(a) Computation of Gain or Loss. — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.***

**Sec. 1002(b) defines the amount realized from the sale or other disposition of property as the money received plus the fair market value of any other property received. However, Sec. 1002 does not specifically address the effect of transfers of debt on the amount realized.**

***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 —***

Reg. Sec. 1.1001-2 addresses the effect of discharges of liabilities on the amount realized from a sale or other disposition. Reg. Sec. 1.1001-2(a) generally requires the inclusion of liabilities from which the transferor is discharged in the amount realized from the sale or other disposition.

***§1.1001-2., Discharge of liabilities***

***(a) Inclusion in amount realized (1) In general. — Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.***

Reg. Sec. 1.1001-2(b) states that the fair market value of the security underlying the liability is irrelevant in determining the amount realized from the discharge of the liability. The full amount of the liability is treated as being received from the sale or other disposition of the property. Therefore, Nuts & Seeds Inc., realizes \$28,000 from the transfer of ownership of the shelling machine in settlement of the note.

***(b) Effect of fair market value of security. — The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.***

This result is consistent with Example 7 in Reg. Sec. 1.1001-2(c).

***Example (7). In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is \$20,000 consisting of \$1,000 cash and a \$19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is \$15,000 and the remaining principal balance on the note is \$19,000. At the time E's adjusted basis in the herd is \$16,500 due to a deductible loss incurred when a portion of the herd died as a result of a disease. As a result of the indebtedness being satisfied, E's amount realized is \$19,000 notwithstanding the fact that the fair market value of the herd was less than \$19,000. E's realized gain is \$2,500 (\$19,000 - \$16,500).***

To calculate the gain or loss on the sale, the adjusted basis of the shelling machine must be calculated using Sec. 1011 per Sec. 1001(a).

**SEC. 1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.**

**1011(a) General Rule.** — *The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.*

Sec. 1011(a) uses the basis as defined in Sec. 1012 adjusted per Sec. 1016. The basis in Sec. 1012 is the cost of the property (\$30,000).

**SEC. 1012. BASIS OF PROPERTY—COST.**

*The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.*

Sec. 1016(a) requires adjustments to basis for expenditures for which deductions have been taken in prior years. Nuts & Seeds Inc, expensed the \$30,000 cost of the shelling machine in 2011. Therefore, the adjusted basis of the machine is zero (\$30,000 - \$30,000) at the date of the transfer and Nuts & Seeds realizes a gain of \$28,000 (\$28,000 - \$0) on the transfer.

**SEC. 1016. ADJUSTMENTS TO BASIS.**

**1016(a) General Rule.** — *Proper adjustment in respect of the property shall in all cases be made —*

*1016(a)(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made —*

*1016(a)(1)(A) for taxes or other carrying charges described in section 266, or*

*1016(a)(1)(B) for expenditures described in section 173 (relating to circulation expenditures),*

*for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;*

85. **INTERNET ASSIGNMENT** As discussed in this chapter, planning for capital gains and losses is an important aspect of tax practice. Use the Internet to find information that provides year end tax planning opportunities. Trace the process you used to find the information (search engine or tax directory used and key words). Write a summary of the tax planning information you find on the Internet.

There are many articles on the Internet that discuss capital gains and losses. These can be accessed from one of the tax directory sites listed in Chapter 16 or by using a search engine offered by your browser. When using a search engine, limiting the search to dates after 2006 will help eliminate references prior to prior law. In addition, searches should be as restrictive as possible - use phrase and proximity searches to keep the number of documents to a manageable size. For example, the search "capital gains and losses" produced over 6,670,000 documents and 187,000 in the past year. By limiting the search to those occurring within the last year and containing "planning", the number of documents is reduced to 51,200.

Using the tax directories, the best place to find information on capital gains planning is the web sites of the major CPA firms. Each firm has various write-ups on the capital gains changes and offer varying degrees of advice on how to take advantage of the new rules.

**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 Internal Revenue Service provides various types of help to taxpayers on its World Wide Web site (<http://www.irs.gov/>). Its publication series explains the tax treatment of many different transactions and situations. Find the publication(s) that discuss the treatment of gains on the sale of qualified small business stock. Write a summary of the information that the IRS provides on this topic.

Publication 544 - Sales and Other Dispositions of Assets and Publication 550 - Investment Income and Expenses (Including Capital Gains and Losses) explain the treatment of qualified small business stock. The most extensive discussion of the qualifying requirements, the rollover of gain from the sale of qualified small business stock, and how to report the gain is found in Publication 550. The explanation in Publication 544 is very brief.

**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** On April 3, 2015, Arlene sells land that she holds as an investment to a construction company. The deed conveying the land to the construction company contains a covenant restricting construction on the land to single-family residences. The market for apartment buildings picks up in 2016, and the construction company pays Arlene \$5,000 on August 10, 2016, to release the restrictive covenant so that it can build apartments on the land. Determine the income tax treatment of the \$5,000 payment Arlene receives for the release of the restrictive covenant.

**This problem is based on Revenue Ruling 70-203, 1970-1 CB 171, which held that amounts received for release of a restrictive covenant in a deed to land are proceeds from the sale of a capital asset. Therefore, Arlene has a \$5,000 long-term capital gain (held > 12 months) from the receipt of the \$5,000.**

88. **RESEARCH PROBLEM** Jeremiah owns farm land that he paid \$20,000 for in 2004. In 2015, he planted a winter wheat crop on the land, incurring \$35,000 of expenses. Jeremiah deducted the \$20,000 of planting expenses that he paid in 2015. He pays the remaining \$15,000 of expenses in 2016. Jeremiah sells the land together with the unharvested wheat crop for \$110,000 in 2016. Determine the tax consequences of the sale of the land.

**The issue in this problem is the treatment of the unharvested crops and the expenses related to them upon the sale of the land. Sec. 1231 indicates that unharvested crops are subject to the capital gain-ordinary loss rule. This rule taxes gains on qualifying sales as long-term capital gains and losses as ordinary losses. Sec. 1231(b)(4) states that unharvested crops sold with land are considered property used in the taxpayer's trade or business if 1) the land was used in the taxpayer's trade or business and held for more than the long-term holding period, and 2) the land and crops are sold at the same time and to the same person. For Jeremiah, this means that the gain on the sale of the land (including that attributable to the unharvested crops) is a long-term capital gain.**

**Sec. 268 and Reg. Sec. 1.268-1 indicates that deductions attributable to producing the unharvested crops are not allowed, including any deductions taken in a prior year. Under Sec. 1016(a)(11), the disallowed deductions are added to the basis of the land for computing gain or loss on the sale. If deductions were taken on the unharvested crops in a prior year, an amended return must be filed to reflect the nondeductibility of the costs.**

**Jeremiah's basis in the land is increased to \$55,000 (\$20,000 + \$35,000) for the expenses related to the unharvested crops. An amended return must be filed to eliminate the \$20,000 of expenses he deducted in 2015. His gain on the sale is \$55,000 (\$110,000 - \$55,000), which is a long-term capital gain.**

**INTEGRATIVE PROBLEM**

89. In problem 89 in Chapter 9 and problem 74 in Chapter 10, the initial basis and the adjusted basis of Emelio and Charita's assets were determined as of December 31, 2015. During 2017, they have the following transactions related to the assets:

- a. In June, an electrical connection shorts out and starts a fire in Emelio's building. The cost of repairing the damage caused by the fire is \$11,500. Emelio's insurance policy reimburses him \$5,500 for the fire damage.

**Emelio has a business casualty loss of \$6,000 as a result of the fire:**

<b>Insurance proceeds</b>	<b>\$ 5,500</b>
<b>Cost of repairs</b>	<b>(11,500)</b>
<b>Business casualty loss</b>	<b><u>\$ (6,000)</u></b>

- b. The real estate market begins to deteriorate in 2017. Emelio and Charita decide to sell their rental house before it loses any more value. They sell the house for \$76,000 on October 16, 2017. They pay \$325 to advertise the property for sale. In addition, they pay \$5,200 in brokerage commissions and \$1,045 in legal fees on the sale. Because their renters had a one-year rental agreement, Emelio and Charita have to pay the renters \$900 to vacate the lease.

**The rental property is a depreciable capital asset subject to Section 1250 recapture of excess depreciation. Because MACRS for realty uses straight-line depreciation, no excess depreciation results. However, the \$14,319 in depreciation taken on the property is classified as *unrecaptured Section 1250 gain*. The remaining \$19,430 of gain from the sale of the property is a long-term capital gain.**

<b>Amount realized</b>	<b>(\$76,000 - \$325 - \$5,200 - \$1,045)</b>	<b>\$ 69,430</b>
<b>Adjusted basis</b>	<b>(\$50,000 - \$13,060 - \$1,259)</b>	<b>(35,681)</b>
<b>Gain on sale</b>		<b><u>\$ 33,749</u></b>
<b>Unrecaptured Section 1250 gain</b>	<b>(\$13,060 + \$1,259)</b>	<b>(14,319)</b>
<b>Long-term capital gain</b>		<b><u>\$ 19,430</u></b>

**2017 Depreciation on building:**

$$[\$43,750 \times 3.636\% \times (9.5 \div 12)] = \$1,259$$

**The \$900 payment to the renters is a current period rental expense.**

- c. Emelio's office building is next to a new industrial park development project. The developer needs to run utility lines through Emelio's property. The developer agrees to pay Emelio \$2,000 for an easement to run the utility lines along one side of Emelio's property.

**There is no income effect from the receipt of the \$2,000. A realization has not occurred. The basis of the land is reduced by the \$2,000 (capital recovery).**



- d. While assessing the damage caused by the fire, the contractor Emelio hired to repair the damage finds an antique chair that had been sealed behind one wall. Emelio sells the chair to a local dealer for \$1,200.

**Emelio has a \$1,200 short-term capital gain on the sale of the antique chair. The antique chair is not property used in his trade or business and therefore, is a capital asset.**

- e. Emelio raises the additional cash he needs to complete the building repairs by selling 100 shares of Software Corporation stock for \$24 per share (He pays brokerage commissions of \$140.) He also sells 100 shares of Flex Corporation stock for \$40 per share (Brokerage commissions are \$200.)

**Both stocks have been held for more than 12 months. The sale of the Software stock results in a long-term capital gain of \$1,260. The sale of the Flex stock results in a \$300 long-term capital gain:**

**Software Corporation stock:**

Amount realized (100 x \$24 = \$2,400 - \$140)	\$ 2,260
Adjusted basis (100 x \$10.20)	(1,020)
Long-term gain on sale	<u>\$ 1,260</u>

**Flex Corporation stock:**

Amount realized (100 x \$40 = \$4,000 - \$200)	\$ 3,800
Adjusted basis (100 x \$35)	(3,500)
Long-term gain on sale	<u>\$ 300</u>

- f. Charita decides to upgrade her home office by purchasing new furniture costing \$1,300. She gives the old office furniture to her gardener, who agrees to exchange 8 weeks of gardening services for the furniture. The gardener normally charges \$50 per week.

Amount realized (\$50 x 8)	\$ 400
Adjusted basis (\$800 - \$621 - \$36)	(143)
Gain on sale	<u>\$ 257</u>
Section 1245 recapture	(257)
Section 1231 gain	<u>\$ -0-</u>

**The 2017 depreciation is \$36 (\$800 x 8.92% x 50%). The office furniture is Section 1245 property and the \$257 gain on the sale is recaptured as ordinary income.**

- g. In addition to these transactions, Charita tells you that a company in which she and Emelio had invested went bankrupt in 2015. They had purchased the stock from Charita's father for \$24,000 in 2010. The company was dissolved in 2015, and the shareholders received nothing from the bankruptcy proceeding. Emelio and Charita had no other capital asset transactions in 2015 and 2016.

**The worthless security would have been a long-term capital loss in 2015. Because they had no other capital asset transactions in 2015 and 2016, they would have deducted \$3,000 of the loss each year. This leaves a long-term capital loss carryforward to 2017 of \$18,000:**

Worthless security - Long-term capital loss in 2015	\$ (24,000)
2015 loss deduction	3,000
2016 loss deduction	3,000
Long-term capital loss carryforward to 2017	<u>\$ (18,000)</u>

Do the appropriate year-end netting procedures, and determine the effect of the transactions on Emelio and Charita's 2017 adjusted gross income and their income tax liability. Assume that Emelio and Charita's adjusted gross income before considering these transactions is \$120,000.

### Section 1231 Netting

#### First netting:

Business casualty loss from fire is an ordinary loss	<u>\$ (6,000)</u>
--	-------------------

#### Second netting:

There are no other Section 1231 gains or losses	<u>\$ -0-</u>
---	---------------

### Capital Gain and Loss Netting

#### Long-term gain and loss netting:

Unrecaptured Section 1250 gain	\$ 14,319
Gain on sale of rental house	19,430
Gain on sale of Software stock	1,260
Gain on sale of Flex stock	300
Capital loss carryforward	(18,000)
Net long-term capital gain	<u>\$ 17,309</u>

Short-term capital gain on antique chair	<u>\$ 2,200</u>
--	-----------------

### Income Effect Summary

Business casualty loss	\$ (6,000)
Section 1245 recapture - ordinary income	257
Long-term capital gain	17,309
Short-term capital gain	2,200
Net effect on adjusted gross income	<u>\$ 13,766</u>

The transactions increase Emelio and Charita's adjusted gross income to \$133,766. Their taxable income is \$104,966.

Original adjusted gross income	\$120,000
Additional income effect on adjusted gross income	13,766
Revised adjusted gross income	<u>\$133,766</u>
Less: Standard deduction	(12,600)
Personal exemptions (4 x \$4,050)	(16,200)
Taxable income	<u>\$104,966</u>

In calculating their income tax liability, the net long-term capital gain is taxed at 15%: the \$18,000 capital loss carryforward is used to offset the unrecaptured Section 1250 gain (\$18,000 > \$14,025), leaving an adjusted net capital gain of \$17,309. The remaining income \$87,657 (\$104,966 - \$17,309) of income is taxed at the married, filing jointly tax rates. Their total income tax liability is \$16,053:

Tax on \$87,657 ordinary income	
\$10,367.50 + [25% x (\$87,657 - \$75,300)]	\$13,457
Tax on adjusted net capital gain - \$17,309 x 15%	2,596
Income tax liability	<u>\$16,053</u>

**COMPREHENSIVE PROBLEMS**

90. Duke Plumbing and Wallpaper Company is a corporation that has been in business since 1997. During the current year, it has the following property transactions:

- a. A warehouse purchased in 2007 for \$200,000 is sold for \$180,000. Depreciation taken on the building to date of sale totals \$62,000.

Amount realized	\$ 180,000
Adjusted basis (\$200,000 - \$62,000)	(138,000)
Section 1231 gain realized on sale	<u>\$ 42,000</u>

**A warehouse purchased in 2007 is Section 1250 property. However, no portion of the gain is recaptured as ordinary income because regular MACRS uses straight-line depreciation. Note: The unrecaptured Section 1250 gain provisions do not apply to corporations.**

- b. Wallpaper that cost \$60,000 becomes obsolete when a new type of wallpaper is developed. Duke is unable to sell the wallpaper and ends up throwing it in the trash.

**The wallpaper is an inventory item. The \$60,000 loss from obsolescence is an ordinary loss.**

- c. Two of Duke's service trucks collide in the parking lot, destroying both trucks. The older truck cost \$18,000 and had an adjusted basis of \$5,000. Its fair market value of \$9,000 is reimbursed by Duke's insurance company. The newer truck was purchased 3 months earlier for \$22,000. It has a fair market value of \$18,000, which is reimbursed by Duke's insurance company.

**Old Truck**

Amount realized	\$ 9,000
Adjusted basis (\$18,000 - \$13,000)	(5,000)
Casualty gain	<u>\$ 4,000</u>
Section 1245 recapture – ordinary income	(4,000)
Section 1231 Casualty Gain	<u>\$ -0-</u>

**New Truck**

Amount realized	\$ 18,000
Adjusted basis	(22,000)
Casualty loss	<u>\$ (4,000)</u>

**The gain on the casualty on the old truck is recaptured as ordinary income and is not eligible for Section 1231 treatment. The new truck is not a Section 1231 asset because it has been held less than one year. Therefore, the loss is an ordinary loss.**

- d. Plumbing equipment purchased in January for \$6,000 is sold in November for \$4,000. The equipment was advertised as being the easiest of its kind to use in installing new plumbing fixtures. However, it is so complicated to operate that none of Duke's employees can figure out how to use it, and Duke decides it is easier to do the work the old-fashioned way.

**The \$2,000 (\$4,000 - \$6,000) loss on the plumbing equipment is an ordinary loss. Because the equipment was not held for more than one year, it is not Section 1231 property.**

- e. Duke's computer system becomes obsolete and is sold for \$1,500. Duke paid \$15,000 for the system 4 years earlier and has taken \$11,500 in depreciation on the system as of the date of sale.

<b>Amount realized</b>	<b>\$ 1,500</b>
<b>Adjusted basis (\$15,000 - \$11,500)</b>	<b>(3,500)</b>
<b>Section 1231 loss</b>	<b><u>\$ (2,000)</u></b>

**A computer system is a Section 1231 asset. Losses on depreciable assets are not recaptured. The entire loss is a Section 1231 loss.**

- f. Because the 2 service trucks that were destroyed (in part c) have to be replaced, Duke decides to sell its other service truck and buy 3 new trucks. The third service truck cost \$19,000 two years earlier and has an adjusted basis of \$13,000. Duke receives \$14,000 from the sale of the truck.

<b>Amount realized</b>	<b>\$ 14,000</b>
<b>Adjusted basis (\$19,000 - \$6,000)</b>	<b>(13,000)</b>
<b>Gain on sale</b>	<b>\$ 1,000</b>
<b>Section 1245 recapture – ordinary income</b>	<b>1,000</b>
<b>Section 1231 gain</b>	<b><u>\$ -0-</u></b>

- g. An antique plumbing plunger for which Duke had paid \$4,000 and which was fully depreciated is sold for \$7,000.

<b>Amount realized</b>	<b>\$ 7,000</b>
<b>Adjusted basis (\$4,000 - \$4,000)</b>	<b>-0-</b>
<b>Gain on sale</b>	<b>\$ 7,000</b>
<b>Section 1245 recapture – ordinary income</b>	<b>4,000</b>
<b>Section 1231 gain</b>	<b><u>\$ 3,000</u></b>

- h. Duke decides not to replace the warehouse it sold in part a. The office building it erected in 2007 at a cost of \$140,000 to service the warehouse is no longer of any use and is sold for \$162,000. The office building has an adjusted basis of \$122,000.

Amount realized	\$ 162,000
Adjusted basis (\$140,000 - \$18,000)	(122,000)
Gain on sale	\$ 40,000
Section 1250 recapture	-0-
Section 1231 gain	<u>\$ 40,000</u>

Real property purchased in 2007 is Section 1250 property. Because the property is depreciated straight-line under MACRS, there is no excess depreciation to recapture.

Determine the effect of all of the transactions on Duke's taxable income for the year.

**Section 1231 Netting:**

**Step 1 Netting - There were no Section 1231 Casualty Gains or Losses**

**Step 2 Netting -**

Warehouse	\$ 42,000
Antique plumbing plunger	3,000
Office building	40,000
Computer system	(2,000)
Net Section 1231 gain	<u>\$ 83,000</u>

**Effect on Taxable Income:**

**Ordinary income from depreciation recapture**

Casualty on old truck	\$ 4,000
Sale of third truck	1,000
Antique plumbing plunger	4,000

**Ordinary losses**

Inventory obsolescence	(60,000)
Casualty on new truck	(4,000)
Plumbing equipment	(2,000)

**Long-term capital gain - net Section 1231 gain**

**Net increase in taxable income**

83,000
<u>\$ 26,000</u>

**Because Duke is a corporation, the \$26,000 increase is the actual effect on taxable income.**

91. Barney is a farmer who has the following transactions during 2016:

- a. A barn that had cost \$36,000 in 2008 with an adjusted basis of \$16,000 is destroyed by a tornado. Barney's insurance pays him \$26,000 for the casualty.

<b>Amount realized</b>	<b>\$ 26,000</b>
<b>Adjusted basis</b>	<b>(16,000)</b>
<b>Casualty gain</b>	<b><u>\$ 10,000</u></b>

**None of the gain is recaptured. All real property purchased after 1986 uses straight-line depreciation, resulting in no Section 1250 recapture at disposition. The gain is a casualty gain used in the Section 1231 netting. The \$10,000 gain is also unrecaptured Section 1250 gain.**

- b. Barney's prize bull, for which he paid \$22,000 and which has an adjusted basis of \$14,000, is in the barn when the tornado hits. Although the bull is not killed, he is injured severely enough that he can no longer breed. The bull is worth only \$2,000 after the casualty (at stud he was valued at more than \$30,000), but he is such a favorite of Barney's that Barney keeps him and puts him out to pasture. Barney's insurance company refuses to pay anything for the bull's injuries.

**The loss on business property partially destroyed as a result of a casualty is the lower of the adjusted basis (\$14,000) or the decline in market value (\$28,000). Therefore, the casualty loss on the bull is \$14,000. The casualty loss is included in the Section 1231 netting.**

- c. Breeding cattle that had cost \$19,500 in 2013 with an adjusted basis of \$7,200 were sold for \$21,000.

<b>Amount realized</b>	<b>\$ 21,000</b>
<b>Adjusted basis</b>	<b>( 7,200)</b>
<b>Gain on sale</b>	<b><u>\$ 13,800</u></b>
<b>Section 1245 recapture (\$19,500 - \$7,200)</b>	<b><u>(12,300)</u></b>
<b>Section 1231 gain</b>	<b><u>\$ 1,500</u></b>

**The breeding cattle are Section 1231 property. However, as tangible personal property, they are subject to recapture under Section 1245. The \$12,300 of depreciation taken on the cattle is ordinary income, with the remaining \$1,500 gain included in the Section 1231 netting.**

- d. A tractor that cost \$20,000 and has an adjusted basis of \$12,000 is sold for \$7,000.

Amount realized	\$ 7,000
Adjusted basis	(12,000)
Section 1231 loss	<u>\$ (5,000)</u>

**A tractor is Section 1231 property. Because the tractor is sold at a loss, there is no depreciation recapture (recapture applies only to gains).**

- e. Stock in Old Mill Company that Barney purchased on November 13, 2015, for \$20,000 becomes worthless when Old Mill goes out of business on April 1, 2016.

**Securities are deemed to be worthless on the last day of the year in which they become worthless. Therefore, the loss on the Old Mill Company stock is a \$20,000 long-term capital loss (11/13/15 – 12/31/16 > 12 months).**

- f. A horse Barney purchased in February for \$8,000 as a gift for his daughter comes up lame and has to be sold for \$2,000.

**The sale of the horse results in a \$6,000 loss (\$2,000 - \$8,000). However, because the horse is a personal use asset, the loss is not deductible.**

- g. Barney sells 80 acres of farmland for \$42,000. He had received the land as a gift from his uncle when he first went into farming. Barney's uncle paid \$8,000 for the land, which was worth \$30,000 at the time of the gift.

Amount realized	\$ 42,000
Adjusted basis	(8,000)
Section 1231 gain	<u>\$ 34,000</u>

**Farmland is a Section 1231 property. The basis of the land received as a gift is his Uncle's basis.**



What is the effect of these transactions on Barney's taxable income for 2016? In solving this problem, first determine the amount and character of gain or loss on each of the transactions. Then, perform the appropriate netting procedures. Your answer should summarize the gains and losses as they would appear on Barney's tax return. Write a letter to Barney explaining the tax results of his transactions.

### **Section 1231 Netting**

#### **1st Netting - Business Casualty Gains and Losses**

Gain on barn	\$ 10,000
Loss on bull	(14,000)
Net casualty loss	<u>\$ (4,000)</u>

Because there is a net casualty loss for the year, the loss is ordinary.

#### **2nd Netting - All other Section 1231 Gains and Losses**

Gain on breeding cattle	\$ 1,500
Gain on farmland	34,000
Loss on Tractor	(5,000)
Net Section 1231 gain	<u>\$ 30,500</u>

Assuming that Barney has no net Section 1231 losses deducted in the last 5 years, the \$30,500 net Section 1231 gain is a long-term capital gain.

### **Capital Gain and Loss Netting**

Long-term capital gain from Section 1231 netting	\$ 30,500
Long-term capital loss on Old Mill stock	(20,000)
Net long-term capital gain	<u>\$ 10,500</u>

### **Summarizing the Results**

Net business casualty loss	\$ (4,000)
Recapture on breeding cattle	12,300
Net long-term capital gain	10,500
Net increase in Barney's income	<u>\$ 18,800</u>

**NOTE:** The \$10,500 long-term capital gain is taxed at 15%.

**DISCUSSION CASES**

92. As a gift for her granddaughter Ella's 13th birthday, Melanie bought 500 shares of Soft'n Sales Corporation stock on September 25, 2010. Melanie bought the stock directly from the underwriter for \$20,000. Soft'n Sales had just gone public, and Melanie believes the stock will be a good investment for Ella's college education. Melanie tells Ella that she will receive control of the stock on her 18th birthday so long as Ella maintains an A average in high school.

Soft'n Sales is a software development enterprise in San Diego. At the date of the public offering, its gross assets total \$10 million. These assets include mostly intangibles, equipment, and raw materials for product development. The company owns no real estate and holds no investment securities. All capital is reinvested in the enterprise.

When Ellen begins college in September 2016, the Soft'n Sales stock is worth \$50,000. Explain Melanie's options for transferring the stock to Ella to use for college expenses. What are the tax implications of each option?

**The stock probably qualifies as small business stock. Therefore, Melanie may exclude 75% of the realized gain on disposition if she holds the stock for at least 5 years and the company's gross assets do not exceed \$50 million. Therefore, if Melanie waits until after September 25, 2015 to sell the stock, she can exclude 75% of her \$30,000 (\$50,000 - \$20,000) realized gain. The remaining gain of \$7,500 is taxed at a maximum rate of 28%, resulting in a tax of \$2,100. The effective tax rate on the gain is 7% ( $\$2,100 \div \$30,000$ ).**

**Another option is to give the stock shares directly to Ella. Then Ella can sell them as she needs funds for college. Since Ella isn't the original purchaser of the shares, she will not be afforded the tax benefits of small business stock and will be taxed under the rules for sales of capital assets. As a student, Ella's marginal tax rate is probably not greater than 15%. Thus, any gain on the sale of the stock would be taxed at 0% (the gain is long-term because Ella's basis is equal to Melanie's basis and she retains Melanie's holding period).**

**The 0% capital gains rate for a taxpayer in the 10% or 15% marginal tax rate bracket favors (0% rate versus 7% effective rate) gifting the stock and having Ella sell it. Note: The gift might cause Melanie to pay a gift tax or reduce her lifetime estate and gift tax credit. Any gift tax paid by Melanie on the transfer reduces the overall benefit of this option. This can be partially avoided by only gifting the amount of stock necessary to pay Ella's education expenses for the current year.**

93. Christoffe sells 1,000 shares of HoTech Corporation preferred stock for \$37 per share on August 3 of the current year. Sales commissions total \$300. The stock's price has been falling since after HoTech's management was sued for patent infringement four months ago. The price is expected to keep falling at least until the law suit is settled. Christoffe received the stock as a Christmas gift from his wife last year. She paid \$48 per share plus a \$400 commission for the stock. Christoffe is wondering what to do. The year-end is approaching, and he wants to optimize his tax position. Christoffe's current portfolio contains the following corporate stock:

Stock	Number of Shares	Date Acquired	Adjusted Basis Per Share	FMV
MURF Corp.	1,000	1/12/13	\$11	\$30
Tellics, Inc.	2,000	8/4/15	15	18
HIGG Corp.	600	2/9/16	41	48

Make recommendations to Christoffe.

**Christoffe realizes a loss of \$11,700 on sale of the HoTech shares:**

<b>Selling price - 1,000 x \$37</b>	<b>\$ 37,000</b>
<b>Less: Commissions</b>	<b>(300)</b>
<b>Amount realized</b>	<b>\$ 36,700</b>
<b>Adjusted basis [(1,000 x \$48) + \$400]</b>	<b>(48,400)</b>
<b>Realized loss</b>	<b><u><u>\$(11,700)</u></u></b>

Because an individual taxpayer can deduct only \$3,000 in net capital losses annually, a taxpayer in a net capital loss position can use the situation to his advantage by selling other stock that will produce capital gains. The capital gain income is not subject to tax since it is netted against the capital loss. Christoffe could sell some of his other shares at a gain to offset the realized loss. The optimal gain to take is \$8,700, resulting in a net \$3,000 capital loss.

**The amount and character of gain from the sale of each security is:**

<b>MURF Corp. - [1,000 x (\$30 - \$11)]</b>	<b>\$ 19,000</b>	<b>long-term</b>
<b>Tellics, Inc. - [2,000 x (\$18 - \$15)]</b>	<b>6,000</b>	<b>long-term</b>
<b>HIGG Corp. - [ 600 x (\$48 - \$41)]</b>	<b>4,200</b>	<b>short-term</b>

Although Christoffe can sell any stock or combination thereof to produce the desired \$8,700 loss, he should sell the Higg Corp. stock because it will produce a short-term capital gain. This will eliminate tax at Christoffe's marginal tax. The Tellics and the MURF Corp. stock would both be taxed at the 15%, so either of the shares could be sold to generate the additional \$4,500 (\$8,700 - \$4,200 gain from Higg Corp.) optimal gain.

The choice of which stock to sell can be a difficult decision. Shares should not be sold solely for tax purposes. For example, if Christoffe believes that the Tellics, Inc., shares will continue to appreciate in value, he may choose not to sell the shares this year and wait until they have reached their peak market value.

**TAX-PLANNING CASES**

94. At the beginning of 2016, Heather owns the following stocks:

Stock	Date Purchased	Number of Shares	Per Share Purchase Price	Commissions
Clutch Common	11/30/15	250	\$ 40	\$ 500
Pauley Preferred	4/13/15	100	10	100
Leines Common	10/14/15	1,000	35	2,000

In addition to these stocks, Heather received 400 shares of Poor Boy preferred stock from her grandfather as a gift on December 25, 2015. The shares were selling for \$25 per share on December 24, 2015. No gift tax was paid on the transfer of the stock. Her grandfather had purchased the shares for \$5 per share in 2000.

During 2016, Heather has the following stock transactions:

Stock	Transaction	Date	Total Price	Commissions Paid
Poor Boy	Sold 100 shares	3/12	\$ 2,200	\$ 200
Leines	Sold 400 shares	6/8	5,300	300
Clutch	Sold 200 shares	10/18	4,700	270
Ragtop Common	Purchased 2,000	12/18	20,000	600
Leines	Purchased 200	12/25	3,550	450

a. What is Heather's net capital gain or loss for 2016?

**Heather's 2016 position is a short-term capital loss of \$13,770 and a long-term capital gain of \$1,500:**

Security	Amount Realized	Adjusted Basis	Gain or (Loss)	Holding Period
Poor Boy	\$ 2,000	\$ 500 (100 x \$5)	\$ 1,500	long-term
Leines	5,000	14,800 (400 x \$37)	(9,800)	short-term
Clutch	4,430	8,400 (200 x \$42)	(3,970)	short-term

**Capital Gain and Loss Netting**

Short-term capital loss (\$9,800 + \$3,970)	\$ (13,770)
Long-term capital gain	1,500
Net short-term capital loss	<u>\$ (12,270)</u>

Of the total capital loss of \$12,270, only \$3,000 can be deducted in 2016, leaving a carryforward to 2017 of \$9,270 if no further transactions are undertaken.

- b. On December 28, 2016, Heather's stocks have the following fair market value:

Pauley	\$ 13 per share
Clutch	28 per share
Leines	23 per share
Poor Boy	37 per share
Ragtop	4 per share

Assuming that the commission paid on any sale is equal to 5% of the selling price, what action(s) would you recommend to Heather to minimize her 2016 tax? Discuss the potential tax effects of selling each of the stocks Heather owns at the end of the year.

**The optimal strategy for Heather would be to take gains up to \$9,270 before the end of the year. These gains will be canceled out by the \$9,270 of extra capital loss already incurred in 2016 with no tax being paid on the gain. To determine which stock(s) to sell the following chart is useful:**

Stock	FMV	Adjusted Basis	Gain or (Loss)	# of Shares
Pauley	\$ 13.00	\$ 11.00	\$ 2.00	100
Clutch	28.00	42.00	(14.00)	50
Leines	23.00	37.00	(14.00)	600
Leines	23.00	20.00	3.00	200
Poor Boy	37.00	5.00	32.00	300
Ragtop	4.00	10.30	(6.30)	2,000

From an analysis of this table, only the Pauley, Leines (2nd Purchase) and the Poor Boy shares can be sold for a gain. A sale of the Poor Boy shares would result in a gain of \$9,045:

Amount realized	$[(300 \times \$37) - (5\% \times \$11,100)]$	\$ 10,545
Adjusted basis	$(300 \times \$5)$	(1,500)
Gain on sale		<u>\$ 9,045</u>

This would reduce the capital loss carryover to \$225 (\$9,270 - \$9,045). A sale of the Pauley stock would result in a gain of \$135, reducing the carryover to \$90. Alternatively, selling the recently purchased Leines shares results in a gain of \$370. This would eliminate the capital loss carryover and reduce the capital loss deduction by \$145. Whether these two additional sales should be made is questionable as they provide a very small tax savings.

- c. Assume that in addition to the stock sales, Heather sells some land she inherited from her father. Her father paid \$5,000 for the land in 2001. He died on April 14, 2011, when the land was worth \$12,000. Heather sells the land on May 21, 2016, for \$50,000. Legal fees and commissions of \$5,500 are paid on the sale. What is Heather's net capital gain or loss for 2016?

**The sale of the land results in a long-term capital gain of \$32,500:**

Amount realized	$(\$50,000 - \$5,500)$	\$ 44,500
Adjusted basis - FMV at date of death		12,000
Gain on sale		<u>\$ 32,500</u>

Combining this gain with the previous results yields a net long-term capital gain of \$20,230:

Long-term capital gain - Poor Boy stock	\$ 1,500
Long-term capital gain - Land	32,500
Net long-term capital gain	<u>\$ 34,000</u>
Short-term capital loss	(13,770)
Net long-term capital gain	<u>\$ 20,230</u>

- d. Given the fair market values, what action would you recommend Heather take to minimize her 2016 tax? Explain.

The optimal tax strategy would be to sell securities to create a loss of \$23,230. This would completely net out the \$20,230 long-term capital gain and result in a \$3,000 capital loss, all of which would be deductible. In looking at the table in part b above, candidates for sale in this situation are the 2,000 shares of Ragtop, the 600 shares of Leines stock and the 50 shares of Clutch stock. If Heather decides to sell all of these stocks, she will have a loss of \$19,830 (\$13,000 + \$6,060 + \$770). Netting these losses with her long-term capital gain of \$20,230 will give her a net gain of \$400.

A sale of the Ragtop shares will result in a loss of \$13,000:

Amount realized [(2,000 x \$4) - (5% x \$8,000)]	\$ 7,600
Adjusted basis (2,000 x \$10.30)	(20,600)
Loss on sale	<u>\$ (13,000)</u>

If the Leines shares are sold, the loss on 200 shares will be disallowed due to the wash sale rules (200 shares of Leines were purchased on 12/25, which is within 30 days of the date of the sale). This would result in a deductible loss of only \$6,060:

Amount realized [(600 x \$23) - (5% x 13,800)]	\$ 13,110
Adjusted basis (600 x \$37)	(22,200)
Loss on sale	\$ (9,090)
Disallowed loss [\$9,090 x (200 ÷ 600)]	3,030
Deductible loss	<u>\$ (6,060)</u>

The \$3,030 of disallowed loss is added to the basis of the Leines shares purchased on 12/25.

A sale of the Clutch shares will result in a loss of \$770:

Amount realized [(50 x \$28) - (5% x \$1,400)]	\$ 1,330
Adjusted basis (50 x \$42)	(2,100)
Loss on sale	<u>\$ (770)</u>

95. Rosie has owned a successful luncheonette for several years. Tired of the long hours and eager to try another way of life, she decides to buy a fishing boat and start a charter service near Key West. The only obstacle is the sale of the following assets of the luncheonette to fund her fishing boat endeavor:

<u>Asset</u>	<u>Date Acquired</u>	<u>Adjusted Basis</u>	<u>Original Cost</u>
Building	1/12/86	\$ 5,000*	\$50,000
Land	1/12/86	\$10,000	\$10,000
Equipment	2/9/11	\$ 7,800	\$25,000
Supplies	Current Year	\$ 5,000	\$ 5,000

\* The adjusted basis is \$6,600 if the straight-line method is used

Hank, Rosie's part-time cook, offers her \$175,000 for the luncheonette, which Rosie believes is a fair price. However, she is concerned about the tax consequences of the sale. For example, she wonders how to allocate the sales price among the assets to receive the most advantageous tax results. Make reasonable recommendations to Rosie, and explain the tax effects of structuring the sale according to your recommendations.

**The main problem with allocating the sale price among the assets is the character of the resulting gain. Ordinary income items like the supplies and the recapture portion of the gain on the depreciable assets are taxed at the taxpayer's marginal tax rate, while capital gain assets (through Section 1231) are generally taxed at 15%.**

**Three alternatives exist for establishing the sale price of the assets: assessed value, appraisal values, and by arms-length contractual agreement with the purchaser. In the present case, values should be set by agreement with the purchaser. The IRS generally accepts these agreements because of their arms-length nature. Buyers generally want higher allocations to depreciable property, whereas, sellers generally want the opposite. That is, they want higher allocations to nondepreciable, capital gain and Section 1231 property that will not be subject to recapture at ordinary income rates.**

**In the present case, Rosie needs cash to acquire her new boat. Therefore, structuring the sale as an installment sale will not benefit her.**

**Several different approaches can be taken to the specific allocation of values to the four assets. The approach presented below assumes the total purchase price is allocated to the specific assets and no goodwill exists, minimizing the recognition of ordinary income for the amount allocated to goodwill. The approach minimizes the amount of ordinary income relative to Section 1231 income.**

**The supplies were recently purchased and are valued at their cost, \$5,000. Therefore, no gain (loss) results.**

The equipment is valued at its adjusted basis, \$7,800. Therefore, no gain (loss) results. The equipment shows wear and tear which is represented by the amount depreciated, and the resale of restaurant equipment is difficult. By allocating a sale price equal to adjusted basis, no gain is recognized as ordinary income. The equipment is Section 1245 property, and the recapture potential is \$17,200 (\$25,000 - \$7,800).

The building is valued at \$110,000 and the land valued at \$52,200. The realized gain on the building is \$105,000 (\$110,000 - \$5,000), and the realized gain on the land is \$42,200 (\$52,200 - \$10,000). The building is Section 1245 property (purchased in 1986 and accelerated depreciation used). Note: The amount allocated to land will vary depending on local market conditions.

	<u>Building</u>	<u>Land</u>
Sale price	\$110,000	\$ 52,200
Adjusted basis	( 5,000)	(10,000)
Realized gain	\$105,000	\$ 42,200
Ordinary income	(45,000)	-0-
Section 1231 income	<u>\$ 60,000</u>	<u>\$ 42,200</u>

**Summary Table:**

Asset	Adjusted Sales Price	Basis	Ordinary Income	Sec. 1231
Building	\$ 110,000	\$ 5,000	\$ 45,000	\$ 60,000
Land	52,200	10,000	-0-	42,200
Equipment	7,800	7,800	-0-	-0-
Supplies	5,000	5,000	-0-	-0-
Total	<u>\$ 175,000</u>	<u>\$27,800</u>	<u>\$ 45,000</u>	<u>\$ 102,200</u>

**Note:** This is merely one of many different approaches to allocating the purchase price. Students may develop several valid ways to minimize the seller's tax consequences. The important aspect of the case is that they understand that the goal in the allocation is to minimize the amount of ordinary income recognized from the sale of the assets and convert as much of the gain as possible into Section 1231 income. The long-term capital gain is taxed at 15%. Note: Because the building is Section 1245 property and subject to Section 1245 recapture, there is no unrecaptured Section 1250 gain.



96. Twenty years ago, Consuela Guerro invented and patented a high-speed burrito-stuffing machine. Through the years, she has jealously guarded her invention, allowing its use only in El Consuela's, a chain of restaurants in which she owns 60% of the stock. (Her basis in the stock is \$200,000.) On the advice of her accountant, the patent is owned and manufacturing of the burrito stuffer is done exclusively by Consuela's wholly owned corporation, Stuff, Inc. (Consuela's basis in the Stuff, Inc., stock is \$250,000).

Consuela has been approached by the Frijoles Company about acquiring her burrito-stuffing operation. Specifically, Frijoles would like to acquire Stuff, Inc.'s patent and burrito-stuffer manufacturing operation. Consuela is tired after spending so many years fighting off the competition, and she agrees to sell to Frijoles. Consuela feels that the patent and manufacturing equipment are worth at least \$2,000,000, although they are carried on Stuff, Inc.'s books at their adjusted basis of \$100,000. Consuela wants your advice on how best to structure her exit from the burrito-stuffing business. She intends to retain her ownership interest in El Consuela's.

- a. From Consuela's point of view, should she sell the burrito-stuffer assets owned by Stuff, Inc., directly to Frijoles, or should she sell her stock in Stuff, Inc.? Consider not only the tax aspects of the alternatives but also how each alternative could influence the proposed \$2,000,000 purchase price.

**Consuela will be better off by selling her stock in Stuff Inc. because she has a higher basis in the stock. That is, if she sells the stock at the proposed selling price, she will have a capital gain of \$1,750,000 (\$2,000,000 - \$250,000). Assuming that Consuela is in the 39.6% tax rate bracket, the capital gain would be taxed at 20%, resulting in a tax liability of \$350,000 on the sale of the stock. If the assets are sold directly, the corporation will have a gain of \$1,900,000 on the sale of the assets. Because the assets bases are so low, it is likely that most, if not all, of the gain would be ordinary income due to depreciation recapture. Any Section 1231 gain would be taxed at the corporations marginal tax rate [most likely 34%, resulting in a tax of \$646,000 (\$1,900,000 x 34%)]. In addition, if the assets are sold, when the corporation distributes the remaining cash to Consuela, any amounts received in excess of Consuela's \$250,000 basis in the stock will be taxed to her as a dividend.**

**The widely different tax effects for the two sales methods could influence the purchase price. If Frijoles does not wish to purchase the stock, Consuela could negotiate a higher price for a sale of the assets to offset the additional taxes she will have to pay under this approach.**

- b. Consider question a from Frijoles' point of view.

**Frijoles would prefer to purchase the assets to have the purchase price reflected in the basis of the assets. If Frijoles purchases the stock of Stuff Inc., its \$2,000,000 purchase price will become the basis of the stock. Thus, Frijoles would not get any tax benefit from the purchase price until it disposes of the stock. By purchasing the assets, Frijoles will be able to deduct the purchase price through depreciation and amortization as it uses the assets.**

**Because of the negative tax effects of purchasing the stock, Frijoles probably would not be willing to pay the \$2 million proposed purchase price for the stock. Therefore, it would want to negotiate the purchase price down for the estimated loss of tax savings if it is to purchase the stock.**

**Given the opposite optimal positions of the two parties, what is the best method? The answer is that there is not one best method. Assuming that both parties want to consummate a transaction, they will negotiate the purchase price up or down for each option until they reach agreement on a purchase price under one of the options.**

**This case illustrates how the income tax effects of the two different methods of acquiring a business ultimately affects how the transaction is done and at what price. As such, it illustrates the importance of understanding the basic tax effects of the two methods on the seller and the buyer so that an agreement can be reached which does not harm one party versus the other party from an income tax perspective.**

**ETHICS DISCUSSION CASE**

97. You are a CPA who works for a local accounting firm. While having lunch at Willie's Diner last Thursday, you overheard Beth Murray describe how Bart (her spouse) was able to get a \$2,000 business loss, free car maintenance for 2 years, and \$4,000 cash to spend on their vacation in exchange for an old truck. You didn't think too much about the conversation until you returned to your office. While you were at lunch, Bart Murray dropped off the tax information for his business, Bart's Mobile Glass Service, for the past year. Your curiosity gets the best of you. You open the packet of information and immediately look for the truck sale information. The only documentation you find is a hand-written memo stating, "2010 Dodge truck sold for \$4,000 and loss on sale = \$2,000." The memo is initialed by Bart Murray. Attached to it is a photocopy of a check from Haroldene Harvey's Auto Castle, Inc., for \$4,000. Haroldene Harvey is also your client. You know that Haroldene and Bart are neighbors and good friends. Your review of Bart Murray's asset and depreciation schedules confirms that the truck had an adjusted basis of \$6,000 as of the sale date. What are your obligations under the Statements on Standards for Tax Services (which can be found at [www.cengagebrain.com](http://www.cengagebrain.com))? Write a memorandum to the managing partner explaining what should be done about the situation involving Bart Murray.

**Bart Murray apparently did not include the value of the car maintenance in his calculation. Although the CPA overheard the interesting information about the car maintenance, the information has not been confirmed by the client. Bart determined his realized loss of \$2,000 (\$4,000 - \$6,000) using only the cash received.**

**It may be difficult to ascertain whether car maintenance was part of the sale. Haroldene and Bart are neighbors and friends. Also, the CPA has only overheard a conversation. No substantive documentation apparently exists. SSTS No. 1 recommends that the CPA should not prepare or sign a return unless the CPA has knowledge of all material facts. SSTS No. 3 allows the CPA to rely in good faith on information provided by clients. However, if the information is incomplete or incorrect, the CPA should request the client to provide supporting information. The CPA in this case needs to talk to Bart. Then, the CPA must decide whether the additional facts are sufficient.**

## Chapter 11

### Check Figures

22. a. Amount realized - \$25,100  
c. Amount realized - \$46,000
- b. Amount realized - \$199,000  
d. Amount realized - \$102,000
23. a. Amount realized - \$4,420  
c. Amount realized - \$610,000
- b. Amount realized - \$170,000  
d. Amount realized - \$250,000; \$300,000
24. Amount realized- \$139,950
25. a. Recognized loss \$3,250  
c. Recognized loss \$0
- b. Carrie recognized loss \$0  
d. Realized gain \$20,000
26. a. Recognized gain \$300  
c. Recognized gain \$0
- b. Recognized loss \$0  
d. Recognized gain \$0
27. James: Recognized gain \$1,800  
DeWayne: Recognized gain \$5,900
28. a. Jared Partnership pays Elvira \$40,000  
Elvira's gross selling price - \$220,000
- b. Jared's gross selling price - \$250,000
29. \$2,000 gain
30. \$800 gain
31. Loss on sale \$1,650; Gain on sale \$1,750
32. Sell 2/15/15 shares and 100 5/12/14 shares
33. a. Ordinary  
c. Capital asset  
e. Capital asset
- b. Ordinary  
d. Mixed use - Section 1231 (75%)  
f. Capital asset
34. a. Ordinary  
c. Ordinary  
e. Section 1231
- b. Capital asset  
d. Ordinary income  
f. Personal use asset
35. a. \$375 realized loss
- b. \$1,275
36. 12/28/15 - STCG \$80; 02/15/16 - STCG \$50; 03/01/16 – Wash sale \$0  
08/13/16 - LTCG \$65; 12/04/16 - STCG \$500; 12/19/16 - LTCG \$1,300; STCG \$423
37. a. LTCG - \$2,300  
c. Leroy -0-; Son STCG - \$3,000
- b. LTCG - \$4,780  
d. LTCL - \$7,400; STCG - \$400
38. a. LTCL - \$3,000  
c. LTCG - \$5,500
- b. STCL - \$200  
d. LTCG - \$100

- 39. STCL deduction \$3,000; STCL carry forward \$5,400
- 40. Capital loss deduction \$0
- 41. Capital loss deduction \$3,000; Capital loss carry forward \$100
- 42. Net STCG \$3,600 and Net LTCG \$3,200
- 43. Net LTCG \$2,100
- 44. Net STCG \$3,000 and Net LTCG \$9,000; Tax on capital gains - \$2,710
- 45. Net STCL \$4,000 and Net LTCG \$12,000; Tax on capital gains - \$2,320
- 46. Tax Savings \$750; Taxable income - \$116,000
- 47. Net STCL \$2,000 and Net LTCG \$14,000; Tax on capital gains - \$2,300
- 48. a. Recognized LTCG - \$175,000                      b. 14%
- 49. Tax on LTCG - \$26,600
- 50. a. Recognized LTCG - \$87,500                      b. 7%
- 51. 100% exclusion no tax on gain
- 52. 12/12 sale – tax of \$120,000
- 53. a. LTCG - \$144,000                                      b. LTCG \$24,000 (at 28%)  
c. LTCG \$24,000 (at 28%)                              d. Net capital gain \$28,000
- 54. LTCG - \$60,000; \$35,000 (at 28%) and \$25,000 (at 15%)
- 55. Generate \$8,000 of capital losses
- 56. Sell 500 shares of Header stock
- 57. \$15,000 LTCL
- 58. Section 1231 gain of \$6,400; ordinary loss of \$3,200
- 59. Section 1231 loss of \$9,000 (ordinary loss)
- 60. Ordinary income \$8,000
- 61. Section 1231 gain of \$1,000

