

## CHAPTER 12

### NONRECOGNITION TRANSACTIONS

2017 Edition	Topic	Status
<b>Questions</b>		
1	The role of the wherewithal-to-pay concept in gain recognition	Unchanged
2	Contrast the tax treatment of deferrals and exclusions	Unchanged
3	The use of the capital recovery concept on deferrals	Unchanged
4	The effect of depreciation recapture on like-kind exchanges.	Unchanged
5	Discuss boot and its affect on like-kind exchanges	Unchanged
6	What is an exchange?	Unchanged
7	Does an exchange have to occur simultaneously?	Unchanged
8	What is like-kind property?	Unchanged
9	Explain why the assumption of a mortgage is boot	Unchanged
10	Restrictions on like-kind exchanges between related parties	Unchanged
11	What is meant by the term recapture potential?	Unchanged
12	Compare involuntary conversions with like-kind exchanges	Unchanged
13	Time period(s) for replacement of involuntarily converted property	Unchanged
14	What is a principal residence?	Unchanged
15	Compare the treatment of losses on exchanges with involuntary conversions and sales of personal use assets	Unchanged
16	Rules for excluding gain on a principal residence	Unchanged
17	Explain the conditions under which the rules for excluding the gain on a principal residence are modified	Unchanged
<b>Problems</b>		
18	Nonrecognition transactions	Unchanged
19	Exchange requirement - five scenarios	Unchanged
20	Identify like-kind exchanges - five scenarios	Unchanged
21	Identify like-kind exchanges - five scenarios	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
22-CT	Like-kind exchange with boot	Unchanged
23	Exchange with boot - relates to #22	Unchanged
24	Like-kind exchange and realized loss	Unchanged
25	Like-kind exchange with boot and recapture potential	Unchanged
26	Like-kind exchange of realty with boot	Unchanged
27	Like-kind exchange with boot	Unchanged
28	Like-kind exchange with boot and recapture potential	Unchanged
29	Like-kind exchange of realty with mortgage assumption and realized loss	Unchanged
30	Like kind exchange of foreign with U.S. real property	Unchanged
31	Like-kind exchange with boot and realized loss	Unchanged
<b>32-COMM</b>	Tax planning with like-kind exchange when old property has a realized loss	Unchanged
33	Like kind exchange versus sale and purchase	Unchanged
34	Like-kind exchange with paid boot and recapture potential	Unchanged
35	Subsequent sale of like-kind exchange property and recapture - related to #34	Unchanged
36	Like-kind exchange with cash boot received and assumption of mortgage	Unchanged
37	Like-kind exchange with loan assumption - both sides of the exchange	Unchanged
38	Like-kind exchange of realty with mortgage assumption and cash balance paid	Unchanged
39	Like-kind exchange between related parties	Unchanged
40	Like-kind exchange - attribute carryover	Unchanged
41	Determine whether replacement property qualifies for involuntary conversion treatment - five scenarios	Unchanged
42	Determine whether replacement property qualifies for involuntary conversion treatment - four scenarios	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
43	Involuntary conversion by fire and realized loss	Unchanged
44	Involuntary conversion via condemnation	Unchanged
<b>45-COMM</b>	Election to recognize total gain on involuntary conversion - relates to #44	Unchanged
46	Involuntary conversion of factory by tornado	Unchanged
47	Involuntary conversion of manufacturing plant caused by a fire	Unchanged
48	Involuntary conversion of boats destroyed in a tidal wave	Unchanged
<b>49-COMM</b>	Involuntary conversion of auto dealership in hurricane and net operating loss	Unchanged
50	Determine the realized and recognized gain or loss on the sale of personal residence - four scenarios	Unchanged
51	Determine the realized and recognized gain or loss on the sale of personal residence - four scenarios	Unchanged
52	Determine the realized and recognized gain or loss on the sale of personal residence (single taxpayer) - two scenarios	Unchanged
53	Determine the realized and recognized gain or loss on the sale of personal residence (married taxpayer) - two scenarios	Unchanged
54	Determine the realized and recognized gain or loss on the sale of personal residence (married taxpayer) - three scenarios	Unchanged
55	Sale of principle residence after death of spouse	Unchanged
56-IID	Requirements for deferred exchange	Unchanged
57-IID	Are assets like-kind	Unchanged
58-IID	Like-kind exchange - loss	Unchanged
59-IID	Like-kind exchange – mortgage assumption	Unchanged
60-IID	Like-kind exchange – payment of boot	Unchanged
61-IID	Like-kind exchange – property boot	Unchanged
62-IID	Involuntary conversion – qualified replacement property	Unchanged
63-IID	Personal casualty gain	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
64-IID	Condemnation – replacement property requirements	Unchanged
65-IID	Sale of principal residence	Unchanged
66-IID	Sale of principal residence at a loss	Unchanged
67-IID	Sale of principal residence after divorce	Unchanged
68	TAX SIMULATION	Unchanged
69	INTERNET	Unchanged
70	INTERNET	Unchanged
71	Research Problem	Unchanged
72	Research Problem	Unchanged
73	Comprehensive problem - five parts	Unchanged
<i>74-DC-CT</i>	Assumption of debt on sale of principal residence - bad debt recognition	Unchanged
<i>75- DC-CT</i>	Involuntary conversion - condemnation of a principal residence	Unchanged
<b>76-TPC-COMM</b>	Involuntary conversion - fire in principal residence	Unchanged
<b>77-TPC-</b>	Evaluating the tax consequences of making a like-kind exchange	Unchanged
<b>78-EDC-CT</b>	Third-party like-kind exchange - SSTS # 1 and #3	Unchanged

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## CHAPTER 12

### NONRECOGNITION TRANSACTIONS

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#### DISCUSSION QUESTIONS

1. How does the wherewithal-to-pay concept affect the recognition of gains on asset dispositions? What else is necessary for nonrecognition of a gain upon disposition of an asset?

**Under the wherewithal-to-pay concept, gains are not taxed when the transaction creating the gain does not provide the means to pay the tax. Therefore, in the nonrecognition transactions, gain is not recognized when there is no wherewithal-to-pay from the transaction. However, when there are proceeds remaining after the nonrecognition transaction requirements have been fulfilled, gain is taxed to the extent any proceeds remain that are available to pay tax.**

**The second criteria for nonrecognition is that the disposition be part of a continuing investment in an asset. In each of the nonrecognition transactions, a qualified replacement asset must be acquired to defer gain on the disposition.**

2. How is the tax treatment of a deferred gain similar to and different from the treatment of an excluded gain?

**The two types of gains are similar in that there is no tax paid on the gain in period of realization. However, an excluded gain is never subject to tax. A deferred gain will be taxed in a future period. Therefore, the tax savings on a deferred gain is the time value of money savings of deferring payment of the tax.**

3. When a gain on a property disposition is deferred, the basis of the replacement property is reduced by the amount of gain deferred. Which concept supports this treatment? Explain.

**The capital recovery concept allows the recovery of capital investment before any income is recognized. A taxpayer cannot recover more than what they have invested in the property. A gain is a recovery of capital in excess of the capital investment. By reducing the basis of the replacement asset, the amount of capital investment that can be recovered is reduced, insuring that the taxpayer does not recover more than they have invested in the two properties.**

4. When a gain on a depreciable property is deferred through a nonrecognition transaction, the tax attributes of the first property carry over to the second property. Why is this important, particularly with respect to like-kind exchanges of property?

**The carryover of tax attributes eliminates the use of like-kind exchanges to avoid depreciation recapture. By requiring that the recapture potential of the exchanged asset be attributed to the replacement asset, taxpayers cannot avoid depreciation recapture by exchanging assets that would result in ordinary income from depreciation recapture and then selling the replacement asset to obtain Section 1231 gain treatment.**

5. What is boot? How does boot affect the recognition of gains or losses on like-kind exchanges?

**Boot is the equalizer in the value of the assets being exchanged. Boot can be paid in cash, other assets, services, or by assuming debt. Because the receipt of boot indicates a wherewithal-to-pay from the transaction, any gain realized on a like-kind exchange is recognized to the extent of any boot received in the exchange. However, losses are never recognized on like-kind exchanges, even when boot is received.**

6. What constitutes an exchange of assets?

**To qualify as an exchange, a direct exchange of assets must occur. That is, the sale of one asset and the purchase of a replacement asset from another party would not constitute an exchange.**

7. Does an exchange have to occur simultaneously to qualify for nonrecognition? Explain.

**An exchange of assets does not have to occur simultaneously. To qualify for like-kind exchange treatment. In so called third party or deferred exchanges, the assets to be exchanged must be identified within 45 days of the first asset transfer and the like-kind exchange must be completed within 180 days of the first transfer. This allows taxpayers to make like-kind exchanges when both parties would like to exchange the property they own, but not for the other party's property.**

8. Define *like-kind property* as it applies to like-kind exchanges, and give examples of like-kind properties and properties that are not of like kind.

**To qualify as a like-kind exchange, the properties must be either used in a trade or business or held for the production of income. The general requirement for two properties to be like-kind is that they must be of the same class of property. The quality or grade of the properties being exchanged is not relevant. Under this general definition, any real property can be exchanged for any other real property.**

**Personal property is subject to a stricter requirement: The properties being exchanged must be of like-class. Like-class is defined as being in the same general asset class as defined for cost recovery purposes. If neither property is classified in a general asset class, then the properties must be in the same product class, as defined by the North American Industry Classification System (NAICS).**

9. Why does the assumption of a mortgage when exchanging related assets constitute boot?

**The assumption of a mortgage in an exchange is considered to be boot received because the taxpayer is relieved from the obligation to pay the mortgage. That is, if the mortgage is not assumed, the amount received in the exchange will increase by the amount of the mortgage. This amount would then be used to pay off the mortgage. Therefore, the party whose mortgage is assumed in the exchange is deemed to be in receipt of cash from the assumption.**

10. Discuss the restrictions placed on like-kind exchanges between related parties. Include the reasoning behind the restriction in your discussion.

**Related parties may make like-kind exchanges of assets and receive the same treatment as other taxpayers. Both parties must hold the assets received in the exchange for 2 years. If either party disposes of the property before the 2-year holding period, then both parties must recognize the gain (loss) on the initial exchange. The purpose of the related party holding period rule is to prevent related parties from taking advantage of the deferral of gain on an exchange to pass a gain from one related party to the other. That is, if one party with a high marginal tax rate has a property they could sell at a substantial gain, the like-kind exchange of the property to a related party with a lower marginal tax rate would allow the gain to be taxed at the lower marginal tax rate. This assumes that the parties could sell the properties immediately following the exchange. However, the holding period rule eliminates the passing of the gain through use of an exchange.**

11. What is the recapture potential of an asset?

**The recapture potential of an asset is the maximum amount of gain that could be recaptured on the property at the point of disposition. For a Section 1245 property, the recapture potential is the amount of depreciation deducted to the date of disposition. The recapture potential of a Section 1250 property is the excess depreciation (actual depreciation - straight-line depreciation) on the property at the date of the disposition.**

12. The rules for loss recognition on involuntary conversions are more liberal than those for exchanges. What features of an involuntary conversion contribute to the difference in treatments for the two types of transactions?

**The major difference between the two transactions is that exchanges of assets are planned by the taxpayer, while involuntary conversions (by definition) are not planned dispositions. Although a taxpayer subject to an involuntary conversion may be compensated for the loss of property by insurance, the taxpayers business will suffer during the time it takes to replace the property. Thus, the tax law allows the maximum possible relief to taxpayers suffering involuntary conversions. Losses on the involuntarily converted property are deductible and gains may be deferred if a qualified replacement property is purchased.**

13. How long does a taxpayer who suffers an involuntary conversion of an asset have to replace the asset to qualify for nonrecognition? Explain.

**In general, the replacement period for an involuntary conversion is 2 years from the end of the tax year in which the conversion takes place. However, if the property involuntarily converted is condemned business or investment real estate, the replacement period is 3 years from the end of the tax year of the condemnation. If property is sold under a threat of condemnation, the replacement period begins in the year in which the threat of condemnation occurs.**

14. What is a principal residence of a taxpayer?

**A principal residence is the place where a taxpayer lives most of the time. Thus, a taxpayer can only have one principal residence at a time. The residence can be a house, mobile home, cooperative apartment, condominium, or a houseboat. A principal residence cannot be a vacation home or a rental property.**

15. Losses on exchanges must be deferred. A loss on an involuntary conversion is never deferred. In contrast, a loss on the sale of a principal residence is never recognized. Explain why losses on the sale of a principal residence are treated differently from losses on exchanges and involuntary conversions.

**The requirements for like-kind exchanges and involuntary conversions require that the assets either be used in a trade or business or held for the production of income. Thus, these assets have a business purpose and full capital recovery is allowed on the amount invested in the property. Deferring and deducting losses allows the taxpayer to recover the lost capital investment. In contrast, a principal residence is by definition a personal use asset. Thus, it does not have a business purpose and losses on the sale of a principal residence are disallowed. Because the loss on sale is disallowed it cannot be deferred into the basis of a replacement residence. If the loss were deferred into the basis of the replacement residence, the taxpayer would effectively be allowed to recover the personal use loss on the sale of the second residence, violating the business purpose concept.**



16. What are the requirements for excluding gain on the sale of a principal residence?

**A single taxpayer can exclude a maximum of \$250,000 of the realized gain from the sale of principal residence. The amount is increased to \$500,000 for married taxpayers if they both meet the ownership test and the use test. If only one spouse meets these tests, then the exclusion is limited to \$250,000. The ownership test requires that the taxpayer own the house for at least two of the five years preceding the sale. The use test requires that the taxpayer use the house as her/his principal residence for two of the preceding five years.**

**However, a taxpayer can still qualify for a pro rata portion of the exclusion if she/he fails to meet these tests due to a change in employment, health, or unforeseen circumstances. The amount a taxpayer can exclude is the ratio of the number of months the taxpayer met the ownership and use tests to 24 months, multiplied by the \$250,000 exclusion amount. The following formula can be used to calculate the amount that can be excluded from tax.**

$$\text{Amount to exclude} = \frac{\text{months ownership and use test met}}{24 \text{ months}} \times \$250,000$$

**The exclusion can only be used once every two years unless the taxpayer fails to meet the ownership or use test due to a change in employment, health, or unforeseen circumstances.**

17. In general, a taxpayer can exclude up to \$250,000 of gain on the sale of a principal residence. However, this exclusion is only available every two years. Explain the circumstances under which the two-year restriction is modified and the tax treatment to the taxpayer when the restriction is modified.

**A taxpayer can still qualify for a pro rata portion of the \$250,000 exclusion if she/he fails to meet the ownership or use test due to a change in employment, health, or unforeseen circumstances. If the taxpayer meets one of these exceptions, the amount that can be excluded is the ratio of the number of months the taxpayer met the ownership and use tests to 24 months multiplied by the \$250,000 exclusion amount. The following formula can be used to calculate the amount that can be excluded from tax.**

$$\text{Amount to exclude} = \frac{\text{months ownership and use test met}}{24 \text{ months}} \times \$250,000$$

**PROBLEMS**

18. Honre Corporation's warehouse and Filip Company's office building were located side by side until a fire raced through both structures, completely destroying them. The warehouse has an adjusted basis of \$250,000 and a fair market value (FMV) before the fire of \$500,000. Honre Corporation's fire insurance policy covers the FMV and pays \$500,000. Honre decides not to replace the warehouse because it already has adequate storage space. Filip Company's office building has an adjusted basis of \$400,000 and a FMV before the fire of \$750,000. Filip's fire insurance covers a maximum structural loss of only \$650,000 and pays that amount. Filip uses the \$650,000 to build a new office building on its old site.

Honre Corporation has a taxable transaction. Filip Company does not. Compare these tax results using only the attributes and commonalities of nonrecognition transactions. (Do not use the specific rules of involuntary conversions.)

**Honre Corporation received \$500,000 from its insurance company. It has the wherewithal to pay tax on the realized gain of \$250,000 (\$500,000 - \$250,000) because it did not reinvest the funds. Honre no longer has a continuing investment in the building destroyed by the fire. Because Filip Corporation used the \$650,000 received from its insurance company to build a new office building, it does not have the wherewithal to pay tax on the gain. Filip's new office building is effectively a continuing investment in the old building.**

19. Which of the following transfers meet the exchange requirement for deferral under like-kind exchange provisions?

**To qualify for nonrecognition, a direct exchange of like-kind property must occur. Thus, a sale of property and a purchase of like-kind property from another would not be considered an exchange, unless the two transactions are interdependent. If the sale and purchase transactions are interdependent, the transactions are treated as an exchange under the substance-over-form doctrine.**

- a. Bonita sells her rental condominium in Park City and uses the proceeds as a down payment to buy a rental condominium in Breckenridge.

**Both properties have an investment purpose, and they are both properties of the same class (real property). However, the sale and subsequent purchase are not interdependent (i.e., no direct exchange of property). Bonita could have taken the proceeds from the sale and used it in any way. She has the wherewithal to pay. The only way Bonita's transaction could have been an exchange is if a third party was involved to hold Bonita's funds and help locate the property for the exchange (deferred or 3<sup>rd</sup> party exchange).**

- b. Enrique Corporation sells its old pasta machine to Angelo Distributing Company and after shopping around for a few days, purchases a new Angelo Model 5 Pasta Machine from Angelo Distributing Company.

**The pasta machines are like-kind properties used in a trade or business. However, a direct exchange exists. Enrique's sale and purchase were with the same dealer. The transactions are collapsed into one and treated as a direct exchange of pasta machines. The substance of the transaction is an exchange between Enrique and Angelo Distributing Co.**

- c. Habit Partnership trades 3 of its delivery vans to Cal's Cars and Trucks for 2 new delivery vans.

**The vans are like-kind properties used in a trade or business. A direct exchange of vans occurred. A continuation of investment exists. The number of vans exchanged does not change the substance of the transaction.**

- d. Louise owns an apartment building in Milwaukee, which Rebecca offers to purchase. Louise is willing to part with the property but does not want to recognize the substantial gain on the sale. She is willing to exchange the apartment for a lakefront resort lodge in Minnesota. Rebecca finds such a property and buys it from Ole. Then Rebecca exchanges the lodge for Louise's apartment building.

**Louise and Rebecca exchange like-kind property (real estate) held as an investment or used in a trade or business. Their exchange qualifies for like-kind exchange deferral treatment. The sale and purchase between Rebecca and Ole does not qualify as a like-kind exchange.**

- e. Phong sells his drill press to Cower Company and purchases a new drill press from Tomzack Manufacturing Corporation with the proceeds from the sale.

**The drill presses are like-kind property used in a trade or business. Because Phong's sale and purchase are not with the same dealer (i.e., no direct exchange), the transaction does not qualify as a like-kind exchange.**

20. Which of the following exchanges of property are like-kind exchanges?

**To qualify as a like-kind exchange, both properties must be business or investment property. In addition, both properties must be of the same general class of property and both assets exchanged must be located within the United States. For real property, this means that any real property can be exchanged for any other real property. For personal property, the assets must either be of the same general asset class, or if neither asset belongs to a general asset class, they must be of the same SIC product class.**

- a. Land traded for an airplane.

**The exchange is not a like-kind because the assets being exchanged are not like-kind. Real property (land) is being exchanged for personal property (airplane).**

- b. A warehouse used in a trade or business exchanged for land to be used as a personal residence.

**The exchange is not a like-kind because trade or business property (warehouse) is being exchanged for personal-use property (principal residence).**

- c. Land in Greece held as an investment for a hotel in Rome.

**The exchange is not a like-kind. Although investment property (land) is being exchanged for trade or business property (hotel), the exchange is not a like-kind because both assets exchanged are not located in United States.**

- d. A personal use computer for a business computer.

**Although the same type of asset (computer) is being exchanged, the transaction does not qualify as a like-kind exchange because trade or business property is being exchanged for personal-use property.**

- e. Business machines traded by Marcus and Travis. Marcus will use his new machine in his business. Travis uses his old machine and the new machine from Marcus for personal use.

**For Travis, the exchange does not qualify as like-kind because both the assets received and given are personal-use property. For Marcus, assuming that the business machines given and received are like class or in the same product class, all requirements for a like-kind exchange are met.**

21. Which of the following exchanges of property are like-kind exchanges?

**To qualify as a like-kind exchange, both properties must be business or investment property. In addition, both properties must be of the same general class of property and both assets exchanged must be located within the United States. For real property, this means that any real property can be exchanged for any other real property. For personal property, the assets must either be of the same general asset class, or if neither asset belongs to a general asset class, they must be of the same SIC product class.**

- a. Horace trades his personal use auto for another personal use auto.

**The exchange of a personal use auto is not a like-kind exchange because the properties are not business or investment property.**

- b. Lian trades an office building she rents out for a warehouse to use in her business.

**Both properties are real properties. Because both properties have either a business or an investment use, the exchange qualifies as a like-kind exchange.**

- c. Arthur owns a hardware store. He trades some nails for storage bins.

**For Arthur, the nails are inventory. Inventory cannot be exchanged in a like-kind exchange.**

- d. Wenona trades in an automobile she uses 80% of the time for business purposes. She expects to use the new automobile for business about 80% of the time.

**The business use portion of the automobile is eligible for like-kind exchange treatment. However, the personal use portion of the automobile does not qualify as a like-kind exchange.**

- e. Ace Construction Company trades a used pile driving hammer for a rock crusher.

**The exchange qualifies as a like-kind exchange. Because neither a rock crusher nor a pile driving hammer are classified in any general asset class, to qualify as a like-kind exchange the rock crusher and the pile driving hammer must be in the same NAICS product class. Both the rock crusher and the piling driving hammer are in NAICS product class 333120 - construction machinery manufacturing. Therefore, the exchange qualifies as a like-kind.**

22. Mayfair Corporation exchanges a machine with a fair market value of \$15,000 and an adjusted basis of \$10,000 for land in Nevada with a fair market value \$15,000. Does Mayfair have a recognized gain on the exchange? Explain.

**To qualify as a like-kind exchange, both properties must be business or investment property. In addition, both properties must be of the same general class of property and both assets exchanged must be located within the United States. For real property, this means that any real property can be exchanged for any other real property. For personal property, the assets must either be of the same general asset class, or if neither asset belongs to a general asset class, they must be in the same NAICS product class.**

**In this example, real property and personal property are being exchanged. They are not like-kind property. Because Mayfair Corporation does not qualify for like-kind exchange treatment, it is treated as having sold the machine for an amount equal to the value of the land \$15,000. As a result, Mayfair Corporation must recognize a \$5,000 gain on the exchange.**

23. Return to the facts of problem 22. Assume that Mayfair Corporation exchanges its machine for another machine worth \$18,000.

- a. How much boot must be paid to make the exchange, and who must pay the boot?

**Mayfair Corporation is giving property worth \$15,000. It is unlikely that an unrelated party would trade property worth \$18,000 for property worth only \$15,000. Thus, Mayfair Corporation must pay \$3,000 in boot to complete the exchange.**

- b. Does the corporation have a recognized gain on the exchange?

**Giving boot does not cause the transferor to recognize gain on the exchange itself. The transferor, however, may recognize gain or loss on the transfer of boot other than cash. The giving of boot constitutes a sale of the boot and a gain or loss on that sale will be recognized if the boot has a basis that is different from its fair market value.**

Amount realized (\$18,000 - \$3,000)	\$ 15,000
Adjusted basis	(10,000)
Realized gain	<u>\$ 5,000</u>
Recognized gain	<u>\$ -0-</u>

24. Jalapeno Company trades in its old delivery van for a new delivery van. The old van cost \$22,000 and has an adjusted basis of \$15,000. Jalapeno is given a \$13,000 trade-in allowance on the new van and pays the remaining \$14,000 of the \$27,000 purchase price in cash.
- What is Jalapeno's realized gain or loss on the exchange?
  - How much of the realized gain or loss is recognized on the exchange?
  - How much of the realized gain or loss is deferred?
  - What is the basis of the new delivery van?

**The delivery vans are like-kind property business property. Jalapeno realizes a \$2,000 loss on the exchange. Because the exchange is a like-kind exchange, the loss is not recognized and the \$2,000 loss is added to the basis of the new delivery van. The basis in the new delivery van is \$29,000 (\$27,000 + \$2,000).**

Amount realized (trade-in value)	\$ 13,000
Adjusted basis	(15,000)
Realized loss	<u>\$ (2,000)</u>
Recognized loss	<u>\$ -0-</u>
Deferred loss	<u>\$ 2,000</u>
<b><u>Basis of new delivery van:</u></b>	
Fair market of new van	\$ 27,000
Add: Deferred loss	2,000
Basis of new van	<u>\$ 29,000</u>



25. Pauline's Pastry Shop decides to remodel its offices this year. As part of the remodeling, Pauline's trades furniture with a cost of \$12,000 that had been expensed in the year of purchase (Section 179 expense election) for new furniture costing \$22,000. Pauline's receives a \$5,000 credit for the old furniture and borrows the remaining \$17,000 from Easy Finance Company.
- What is Pauline's realized gain or loss on the old furniture?
  - How much of the realized gain or loss is recognized on the exchange?
  - How much of the realized gain or loss is deferred?
  - What is the basis of the new furniture?

**Pauline's realizes a gain of \$5,000 on the exchange (\$5,000 trade-in value less \$-0- adjusted basis). Because Pauline's has paid boot on the exchange, none of the gain is recognized in the current period. The \$5,000 of gain is deferred into the basis of the new furniture. This leaves the new furniture with a basis of \$17,000 (\$22,000 - \$5,000). In addition, the \$12,000 of depreciation that was deducted on the old furniture is attributed to the new furniture for purposes of determining depreciation recapture upon its disposition.**

Amount realized (trade-in value)	\$ 5,000
Adjusted basis	-0-
Realized gain	<u>\$ 5,000</u>
Recognized gain	<u>\$ -0-</u>
Deferred gain	<u>\$ 5,000</u>
<b><u>Basis of new furniture:</u></b>	
Fair market of new furniture	\$ 22,000
Less: Deferred gain	<u>(5,000)</u>
Basis of new furniture	<u>\$ 17,000</u>

26. Beaver Corporation owns a parcel of land with a fair market value (FMV) of \$75,000 and a basis of \$40,000. Beaver exchanges the land for a building with a FMV of \$65,000. The corporation also receives \$10,000 in cash. Both properties are investment properties for Beaver.

- a. What is Beaver's amount realized on the exchange?

**Beaver's amount realized is \$75,000. It consists of the FMV of the building (\$65,000) and the cash or (boot) received (\$10,000). The realized gain is \$35,000. Because Beaver received cash of \$10,000, that amount is recognized in the current year. The deferred gain of \$25,000 reduces the basis of the new building to \$40,000 (\$65,000 - \$25,000).**

- b. What is Beaver's realized gain or loss on the exchange?

<b>Amount realized (\$65,000 + \$10,000)</b>	<b>\$75,000</b>
<b>Adjusted basis</b>	<b>40,000</b>
<b>Realized gain</b>	<b><u>\$35,000</u></b>

- c. How much of the realized gain or loss must Beaver recognize?

**The exchange of land for a building qualifies as a like-kind exchange because both assets are real property. The term like-kind has been broadly defined so that real estate includes both improved and unimproved property.**

<b>Recognized gain (cash received)</b>	<b><u>\$10,000</u></b>
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- d. What is the character of the recognized gain or loss?

**The land is investment property. Accordingly, the recognized gain (\$10,000) is a capital gain.**

- e. What is Beaver's basis in the building it acquired?

**The basis of the building is \$40,000 (\$65,000 - \$25,000). The deferred gain (\$25,000) reduces the basis (FMV = \$65,000) of the building to \$40,000.**

27. Tinh exchanges business equipment with an adjusted basis of \$55,000 (initial basis was \$105,000) for business equipment worth \$42,000 and \$20,000 in cash.

a. What is Tinh's realized gain or loss on the old equipment?

<b>Amount realized (\$42,000 + \$20,000)</b>	<b>\$ 62,000</b>
<b>Adjusted basis</b>	<b>(55,000)</b>
<b>Realized gain</b>	<b><u>\$ 7,000</u></b>

b. How much of the realized gain or loss is recognized on the exchange?

**The exchange is like-kind. Trinh has a recognized gain of \$7,000. The gain is recognized to the extent of the boot received (\$20,000), but cannot exceed the amount of the realized gain.**

c. What is the character of the recognized gain or loss?

**The equipment is business use. Accordingly, the gain is Section 1231 gain. However, the portion of the gain that is attributable to depreciation, is recaptured as ordinary income. Since depreciation deducted on the business equipment was \$50,000 (\$105,000 - \$55,000), all of the \$7,000 gain is recaptured as ordinary income.**

d. What is the basis of Tinh's new business equipment?

**The basis of the business equipment is \$42,000, the fair market value of the property. There is no gain deferral due to the boot received. The basis of the new property takes the FMV of the property received.**

<b>Fair market value of new equipment</b>	<b>\$ 42,000</b>
<b>Less: Gain deferral</b>	<b>-0-</b>
<b>Basis of new equipment</b>	<b><u>\$ 42,000</u></b>

28. Armando owns a pizza parlor. Because his business is declining, he trades his old pizza oven in on a smaller oven that is worth \$12,000. The old oven cost \$30,000 and has an adjusted basis of \$18,000. Because Armando's oven is worth \$15,000, he agrees to take the \$3,000 difference in olive oil and pepperoni.

a. What is Armando's realized gain or loss on the old oven?

**Armando receives \$15,000 for his old oven (\$12,000 value of new oven + \$3,000 value of olive oil and pepperoni received) resulting in a \$3,000 realized loss:**

<b>Amount realized (\$12,000 + \$3,000)</b>	<b>\$ 15,000</b>
<b>Adjusted basis</b>	<b>(18,000)</b>
<b>Realized loss</b>	<b><u>\$ (3,000)</u></b>

b. How much of the realized gain or loss is recognized on the exchange?

**Although the \$3,000 of olive oil and pepperoni is considered boot, a loss in a like-kind exchange is never recognized -- even if boot is received. Therefore, the \$3,000 loss is deferred.**

c. What is the character of the recognized gain or loss?

**Because the oven is used in Armando's trade or business, if the \$3,000 loss was recognized it would be a Section 1231 loss.**

d. How much of the realized gain or loss is deferred?

**The \$3,000 loss is deferred. Because the loss is not recognized, it does not have to be characterized.**

e. What is the basis of the new oven?

**The \$12,000 cost of the new oven is increased by the \$3,000 deferred loss, resulting in a basis of \$15,000 (\$12,000 + \$3,000).**

<b>Fair market value of new oven</b>	<b>\$12,000</b>
<b>Add: Deferred loss</b>	<b>3,000</b>
<b>Basis of new oven</b>	<b><u>\$15,000</u></b>

29. Leon exchanges an office building which he held as investment property for a bowling alley. His office building has a basis of \$175,000, a fair market value of \$160,000, and is subject to a mortgage of \$40,000. The fair market value of the bowling alley is \$120,000. The owner of the bowling alley will assume Leon's debt on the office building.

**To qualify as a like-kind exchange, both properties must be business or investment property. In addition, both properties must be of the same general class of property and both assets exchanged must be located within the United States. For real property, this means that any real property can be exchanged for any other real property.**

- a. Is this a like kind exchange? Explain.

**Leon is exchanging investment property for trade or business property. The real estate portion of the office building and the real estate portion of the bowling alley constitute like-kind property.**

- b. What is Leon's realized gain or loss on the office building?

**Leon has a \$15,000 realized loss on the office building, because he has traded an asset with a basis of \$175,000 for property worth \$160,000 (the bowling alley worth \$120,000 plus the debt relief of \$40,000).**

Amount realized (\$120,000 + \$40,000)	\$ 160,000
Adjusted basis	(175,000)
Realized loss	<u>\$ (15,000)</u>

- c. How much of the realized gain or loss is recognized on the exchange?

**The assumption of the mortgage debt by the owner of the bowling alley constitutes boot, but losses on like-kind exchanges are never recognized.**

- d. What is the character of the recognized gain or loss?

**Because the loss is not recognized, it does not have to be characterized. However, because the office building is rental property held for investment, the \$15,000 loss if recognized would be a capital loss.**

- e. How much of the realized gain or loss is deferred?

**All of the \$15,000 loss is deferred.**

- f. What is the basis of the bowling alley acquired in the exchange?

**The basis of the bowling alley is \$135,000. By assigning the bowling alley a basis that is \$15,000 more than its fair market value, the bowling alley maintains the potential \$15,000 loss.**

Fair market value of bowling alley	\$ 120,000
Add: Deferred loss	15,000
Basis of bowling alley	<u>\$ 135,000</u>

30. Jose owns a warehouse in Mexico City with a basis of \$430,000 and a fair market value of \$700,000. Lucien owns a warehouse in Boulder, Colorado with a basis of \$200,000 and a fair market value of \$700,000. Jose and Lucien agree to exchange the warehouses.

a. Does this transaction qualify as a like-kind exchange?

**No. Exchanges of real property located in the United States for real property located outside of the United States do not qualify for like-kind exchange treatment.**

b. Will Lucien recognize a gain or loss? How much?

**Because the transaction does not qualify as a like-kind exchange the realized gain cannot be deferred and the \$500,000 gain must be recognized:**

Amount realized (FMV of Jose's warehouse)	\$ 700,000
Adjusted basis	<u>(200,000)</u>
Realized gain on sale	<u>\$ 500,000</u>
 Recognized gain	 <u>\$ 500,000</u>
 Deferred gain	 <u>\$ -0-</u>

c. What is Lucien's basis in his Mexico City warehouse?

**Lucien's basis in the Mexico City property is its purchase price of \$700,000. Because the transaction does not qualify as a like-kind exchange, the holding period begins on the date of the exchange.**

31. Fremont Corporation and Dement Corporation exchange equipment with the following particulars.

	Fremont	Dement
Fair Market Value	\$44,000	\$54,000
Adjusted basis	20,000	60,000
Cash Paid	10,000	

What are Fremont's and Dement's realized and recognized gains or losses on the exchange and the bases in the equipment they acquire in the exchange?

**Fremont:**

Amount realized (\$54,000 - \$10,000)	\$ 44,000
Adjusted basis	(20,000)
Realized gain	\$ 24,000
Recognized gain (no boot received)	-0-
Deferred gain	<u>\$ 24,000</u>

$$\text{Basis in equipment} = \$54,000 - \$24,000 = \$30,000$$

**Dement:**

Amount realized (\$44,000 + \$10,000)	\$ 54,000
Adjusted basis	(60,000)
Realized loss	\$ (6,000)
Recognized loss (losses never recognized)	-0-
Deferred loss	<u>\$ (6,000)</u>

$$\text{Basis in equipment} = \$44,000 + \$6,000 = \$50,000$$

32. Shirley has an old tractor that has an adjusted basis of \$9,000 and a fair market value of \$5,000. She wants to trade it in on a new tractor that costs \$25,000. Write a memorandum to Shirley advising her about how to structure the transaction to optimize her tax situation.

**Shirley should structure the transaction as a sale of the old tractor and a separate purchase of the new tractor. This will allow her to recognize the \$4,000 (\$5,000 - \$9,000) loss on the tractor. If Shirley structures the transaction as an exchange, she will not be able to deduct the loss on the exchange. Instead, the loss is deferred and added to the basis of the new tractor. A sale and purchase with the same dealer in property is usually collapsed as an exchange. Therefore, she should not buy the new tractor from the same individual or entity to which she sells the old tractor.**

33. Jerry sells his delivery truck which has a basis of \$25,000 to Tom's Truck Company for \$10,000. On the same day, he purchases a new truck from Tom's Truck Company at a cost of \$40,000.

- a. Does Jerry recognize any gain or loss on the old truck?

**This transaction has been structured as a sale and a purchase. The IRS, however, has successfully collapsed sales and purchases, involving essentially the same parties, into one exchange. Because Tom's Truck Company is involved in both the sale and purchase, it is likely that the IRS would be successful in treating the transaction as an exchange. As an exchange, Jerry will not be able to recognize a loss on the old truck.**

- b. What is Jerry's basis in the new truck?

**If the transaction is treated as an exchange, Jerry's basis in the new truck is \$55,000. The \$15,000 loss cannot be recognized and is deferred until Jerry sells the truck.**

Fair market value of the truck	\$40,000
Add: Deferred loss	15,000
Basis in new truck	<u>\$55,000</u>

**If the transaction is treated as a sale, Jerry's basis in the new truck is \$40,000. Jerry has a realized and recognized loss of \$15,000.**

Amount realized	\$ 10,000
Adjusted basis	(25,000)
Realized and recognized loss	<u>\$ 15,000</u>



34. Olga trades in a computer she had used in her trade or business for a new computer. The old computer cost Olga \$5,300 and has an adjusted basis of \$800. The computer dealer gives her a \$1,200 trade-in allowance on the old computer, and Olga pays the remaining \$5,000 price of the new computer in cash.
- a. What are Olga's realized and recognized gains on the trade-in of her old computer?

**The exchange of computers is a qualifying like-kind exchange. Olga must defer gain on the exchange under the like-kind exchange rules. Because Olga paid \$5,000 of boot to make the trade, none of the \$400 realized gain is recognized.**

Amount realized (trade-in value)	\$ 1,200
Adjusted basis	(800)
Realized gain	<u>\$ 400</u>
Recognized gain (no boot received)	-0-
Deferred gain	<u><u>\$ 400</u></u>

- b. What is the basis of the new computer?

$$\text{Basis of new computer} = \$6,200 - \$400 = \$5,800$$

**The \$5,800 basis is the fair market value of the computer \$6,200 less the deferred gain of \$400. In addition, the \$4,500 (\$5,300 - \$800) of depreciation taken on the first computer is attributed to the new computer for purposes of computing depreciation recapture on a future taxable disposition of the new computer.**

35. Return to the facts of problem 34. Two years after acquiring the new computer, Olga sells it for \$6,000. The adjusted basis of the computer is \$3,800. What is the character of the recognized gain on the sale of the computer?

**Olga has a recognized gain on the sale of \$2,200 (\$6,000 - \$3,800). The computer is Section 1245 property and any gain due to depreciation is recaptured as ordinary income. The depreciation taken on the second computer is \$2,000 (\$5,800 - \$3,800). Because \$4,500 of the depreciation on the first computer was not recaptured due to the like-kind exchange, it is carried over and recaptured on the sale of the second computer. Therefore, the entire \$2,200 gain is ordinary income.**

Depreciation not recaptured in like-kind exchange	\$4,500
Depreciation recapture from sale	<u>2,000</u>
Potential recapture on sale	<u><u>\$6,500</u></u>
Gain on sale (two years later)	<u><u>\$2,200</u></u>
Amount of gain recaptured as ordinary income	<u><u>\$2,200</u></u>

36. Maya exchanges an office building with a fair market value of \$200,000 and a basis of \$110,000 for \$20,000 cash and a warehouse with a fair market value of \$300,000. In the exchange, she assumes the \$120,000 mortgage on the warehouse.

- a. Has Maya given or received boot? Explain.

**Maya has received \$20,000 of boot (cash received). The debt assumed by Maya cannot offset the cash boot received.**

- b. Does Maya recognize any gain or loss on this exchange?

<b>FMV of warehouse received in exchange</b>	<b>\$ 300,000</b>
<b>Cash boot received</b>	<b>20,000</b>
<b>Less: Mortgage assumed by Maya</b>	<b>(120,000)</b>
<b>Amount realized</b>	<b>\$ 200,000</b>
<b>Less: Adjusted basis</b>	<b>110,000</b>
<b>Realized gain</b>	<b><u>\$ 90,000</u></b>
 <b>Recognized gain (Boot received)</b>	 <b><u>\$ 20,000</u></b>
 <b>Deferred gain</b>	 <b><u>\$ 70,000</u></b>

**Maya's recognized gain is the lessor of boot received or realized gain.**

- c. What is Maya's basis in the warehouse that she acquires in the exchange.

<b>Fair market value of warehouse received</b>	<b>\$ 300,000</b>
<b>Less: Deferred gain</b>	<b>(70,000)</b>
<b>Adjusted basis of warehouse</b>	<b><u>\$ 230,000</u></b>

37. Evelyn's Excavating Service traded an excavator for a new backhoe. The excavator has a fair market value of \$37,000 and an adjusted basis of \$24,000. The backhoe is worth \$34,000. The owner of the backhoe, Susan, agrees to assume Evelyn's \$8,000 loan on the excavator, and Evelyn's pays \$5,000 in cash in the exchange. Susan's adjusted basis in the backhoe is \$18,000.
- a. What are Evelyn's Excavating Service's realized and recognized gains or losses on the exchange and its basis in the backhoe?

**The exchange of an excavator for a backhoe is a like-kind exchange. Neither asset is in a general asset class. Because both assets are in NAICS product class 333120 - construction machinery and manufacturing, they are like-kind property. Evelyn's realizes a gain of \$13,000 on the exchange and must recognize the gain to the extent she is in receipt of boot. Evelyn's has \$8,000 of boot received from the assumption of her loan on the excavator. However, because she had to pay cash boot in the exchange, she is allowed to offset the \$8,000 of mortgage boot received by the \$5,000 of cash boot paid. This results in a \$3,000 recognized gain, and a \$10,000 deferred gain. Her basis in the backhoe is \$24,000:**

Amount realized (\$34,000 + \$8,000 - \$5,000)	\$ 37,000
Adjusted basis	<u>(24,000)</u>
Realized gain	\$ 13,000
Recognized gain (boot received)	
Loan assumed	\$ (8,000)
Cash boot paid	<u>5,000</u>
Deferred gain	<u><u>\$ 10,000</u></u>

**Basis of backhoe = \$34,000 - \$10,000 = \$24,000**

**The \$24,000 basis of the backhoe consists of the fair market value of the excavator (\$34,000) less the \$10,000 deferred gain.**

- b. How much of the realized gain must Susan recognize on the exchange? What is her basis in the excavator?

**Susan realizes a gain of \$16,000 on the exchange. The \$5,000 of cash boot received must be recognized. Cash boot received cannot be offset by mortgage (debt) boot assumed.**

Amount realized (\$37,000 + \$5,000 - \$8,000)	\$ 34,000
Adjusted basis	<u>(18,000)</u>
Realized gain	\$ 16,000
Recognized gain (Cash boot received)	<u>(5,000)</u>
Deferred gain	<u><u>\$ 11,000</u></u>

**Basis in excavator = \$37,000 - \$11,000 = \$26,000**

**The \$26,000 basis of the backhoe consists of the fair market value of the excavator (\$37,000) less the \$11,000 deferred gain.**

38. Oscar and Harriet agree to exchange apartment buildings and the mortgages on the buildings, with any difference in value to be paid in cash. Particulars of their respective buildings are as follows:

	<u>Oscar</u>	<u>Harriet</u>
Fair market value	\$120,000	\$112,000
Mortgage	70,000	52,000
Adjusted basis	40,000	55,000

- a. How much cash must be paid, and who must pay the cash to equalize the exchange?

**Oscar must pay Harriet \$10,000 (\$60,000 - \$50,000). Oscar's net of mortgage value is \$50,000 (\$120,000 - \$70,000) and Harriet's net of mortgage value is \$60,000 (\$112,000 - \$52,000).**

- b. What are Oscar's realized and recognized gains on the exchange and his basis in the apartment building acquired in the exchange?

**Oscar recognizes the \$18,000 of net mortgage boot received on the exchange. However, he is allowed to offset the net mortgage boot by the \$10,000 of cash boot he paid in the exchange. Oscar's net boot received is \$8,000.**

Amount realized (\$112,000 - \$10,000 + \$70,000 - \$52,000)	\$ 120,000
Adjusted basis	(40,000)
Realized gain	\$ 80,000
Recognized gain	
Debt relief (Mortgage assumed by Harriet)	\$ 70,000
Less: Mortgage assumed by Oscar	(52,000)
Net mortgage boot	\$ 18,000
Less: Cash paid to Harriet	(10,000)
Deferred gain	<u>\$ 72,000</u>

**Basis in new apartment building = \$112,000 - \$72,000 = \$40,000**

- c. What are Harriet's realized and recognized gains on the exchange and her basis in the apartment building acquired in the exchange?

**Harriet recognizes the \$10,000 cash boot received on the exchange. Although Harriet is a net payer of mortgage boot, she cannot offset cash boot received by mortgage boot paid.**

Amount realized (\$120,000 + \$10,000 - \$70,000 + \$52,000)	\$112,000
Adjusted basis	(55,000)
Realized gain	\$ 57,000
Recognized gain (cash boot received by Harriet)	(10,000)
Deferred gain	<u>\$ 47,000</u>

**Basis in new apartment building = \$120,000 - \$47,000 = \$73,000**

**The \$73,000 basis consists of the old building's basis of \$55,000, plus the \$18,000 net mortgage assumed (\$70,000 - \$52,000).**

39. On July 8, 2016, Cynthia and her daughter Constance agree to exchange land they held for investment. Both tracts are worth \$18,000. Cynthia acquired her land 4 years earlier for \$9,000. Constance paid \$16,000 for her land the previous year.

a. What are the tax effects of the exchange for Cynthia and Constance?

**No gain is recognized. A like-kind exchange between related parties is allowed. Because no boot is received by either party, neither Cynthia nor Constance recognizes any gain on the exchange. However, if either party disposes of the property acquired in the exchange within two years of the date of the exchange, all gain on the initial exchange is immediately recognized.**

b. On February 15, 2018, Constance sells the land acquired in the exchange for \$21,000. What are the tax effects of the sale? Explain.

**Because Constance sold the land she acquired from Cynthia before the two year holding period had expired, both Cynthia and Constance must recognize the gains they realized on the initial exchange. Cynthia must recognize her \$9,000 gain (\$18,000 - \$9,000) and Constance recognizes her \$2,000 gain (\$18,000 - \$16,000) from the July 8, 2016 exchange. After the recognition of the gains, Cynthia and Constance each have a basis of \$18,000 in their land. Constance has a \$3,000 gain (\$21,000 - \$18,000) on the February 15, 2018 sale of the land.**

40. Walker Corporation acquires a business automobile with a fair market value of \$20,000 by trading in an old automobile and giving \$14,000. Walker paid \$12,000 for the old automobile, which has an adjusted basis of \$1,000 at the date of the trade. Two years after acquiring the new automobile, Walker sells it for \$15,000. Depreciation taken on the automobile is \$7,000. How much gain or loss should Walker recognize on the sale, and how should it be characterized?

**Walker recognizes no gain on the exchange of the automobiles. It received no boot to complete the transfer.**

Amount realized (\$20,000 - \$14,000)	\$ 6,000
Less: Adjusted basis	<u>(1,000)</u>
Realized gain	\$ 5,000
Recognized gain (no boot received)	- 0-
Deferred gain	<u>\$ 5,000</u>

**Basis in new automobile = \$20,000 - \$5,000 = \$15,000**

**The \$15,000 basis consists of the old automobile's basis of \$1,000, plus the \$14,000 cash paid.**

**When Walker Corporation sells the replacement automobile for \$15,000, it realizes and recognizes a gain of \$7,000 (\$15,000 - \$8,000). Because tax attributes, like depreciation recapture potential, carry over to replacement property, the realized gain is ordinary income (1245 recapture).**

Amount realized	\$ 15,000
Adjusted basis (\$15,000 - \$7,000)	<u>(8,000)</u>
Realized/Recognized gain	<u>\$ 7,000</u>
Ordinary income (1245 recapture)	<u>\$ (7,000)</u>

41. Which of the following are qualified replacement properties for properties involuntarily converted? Explain.

**The general requirement for qualified replacement property on an involuntary conversion is that the property has the same *functional use* as the property converted. An exception to this general requirement is granted for condemned business or investment real property, which only requires the property acquired be like-kind property (as defined for like-kind exchanges).**

- a. The insurance proceeds from a warehouse destroyed by a fire are used to purchase a manufacturing plant. The warehouse and the plant are both used in the taxpayer's manufacturing business.

**A manufacturing plant does not perform the same function in the taxpayer's business as the warehouse. Therefore, it is not a qualified replacement property.**

- b. Assume the same facts as in part a, except that the warehouse is held as an investment and rented out to businesses. The plant will also be rented out to a manufacturing business.

**The warehouse was held for the production of rental income. The functional use test requires that the replacement property also produce rental income. In this case, the manufacturing plant will produce rental income and therefore, it is a qualifying replacement property.**

- c. An office building used in a trade or business was condemned. The proceeds are used to buy an apartment complex that will be used as an investment activity.

**Condemned real property must be replaced by like-kind property. In this case, both the office building and the apartment complex are real property and the like-kind replacement requirement has been met.**

- d. The insurance proceeds from the destruction of a construction crane are used to buy a fleet of fork lifts. The crane and the fork lifts are used in the taxpayer's construction business.

**The fleet of fork lifts does not perform the same function in the taxpayer's business as the construction crane. Therefore, the fork lifts are not a qualified replacement property for the crane.**

- e. An antique vase was stolen from the lobby of a business. The insurance proceeds are used to buy a painting which is hung in the same lobby.

**Both the vase and the painting are used as office furniture. The painting performs the same functional use as the vase and is a qualifying replacement property.**

42. Which of the following are qualified replacement properties for properties involuntarily converted? Explain.

**The general requirement for an involuntary conversion is that the replacement property have the same functional use as the property converted. An exception to this general requirement is granted for condemned business or investment real property that only requires the property acquired be like-kind property (as defined for like-kind exchanges).**

- a. The city of Marble River announces plans to condemn Heima's rental apartment complex on July 2, 2016. On August 7, 2016, Heima purchases a warehouse to use as a rental. The city pays Heima \$890,000 on November 1, 2016, as the condemnation proceedings come to a close.

**Condemned real property must be replaced by like-kind property. In this case, both the rental apartment complex and the rental warehouse are real estate. The like-kind replacement requirement has been met.**

- b. The city of Marble River also announces plans to condemn Heima's principal residence on July 2, 2016. He receives a check for \$350,000 on the November 1, 2016, condemnation closing date. On March 29, 2017, Heima purchases a new residence for \$375,000. His basis in the residence is \$60,000.

**The involuntary conversion of a principal residence is treated as a sale of the principal residence. Heima has a realized gain on the condemnation (i.e., sale) of \$290,000 (\$350,000 - \$60,000). Because he is allowed to exclude \$250,000 of the realized gain, Heima's recognized gain is \$40,000 (\$290,000 - \$250,000). Note: If Heima is married, he could exclude \$500,000 of the realized gain and his recognized gain would be \$0.**

- c. Lila uses the insurance proceeds from the destruction of her commercial fishing boat by Hurricane Fredd to buy new fishing equipment and nets for her other fishing boat.

**The fishing equipment and nets do not perform the same function in the taxpayer's business as the boat. Therefore, the equipment and nets are not qualified replacement property.**

- d. Milo uses the insurance proceeds from a fire that totally destroys his warehouse to buy 100% of the common stock of Storage Space Corporation, a company that owns and operates 3 warehouses.

**The warehouse does not have the same functional use as the common stock. Therefore, the common stock is not qualified replacement property.**



43. A fire in the factory of Franny's Famous Frankfurters destroys several stuffing machines. The machines have an adjusted basis of \$125,000 and a fair market value of \$225,000. Franny's insurance company reimburses Franny's \$100,000 for the destruction of the machines. Franny's uses the insurance proceeds to buy secondhand stuffers costing \$175,000. What are Franny's realized and recognized gains or losses on the fire and the basis in the replacement stuffers?

**Franny's has realized a loss of \$25,000 (\$100,000 insurance proceeds less \$125,000 adjusted basis) on the fire. A fire loss is an involuntary conversion. All losses realized on involuntary conversions are recognized. They are never deferred. The basis of the replacement stuffers is the cost of the stuffers, \$175,000.**

44. Grant Industries' warehouse is condemned by the city on August 18, 2016. Because of widespread publicity leading up to the condemnation, Grant anticipates it and purchases a replacement warehouse on April 15, 2016, for \$670,000. The city pays Grant \$430,000 for the condemned property, which has an adjusted basis to Grant of \$220,000.

- a. What is Grant's realized gain or loss on the condemnation?

**Grant has realized a gain of \$210,000 on the condemnation.**

Amount realized (condemnation proceeds)	\$ 430,000
Adjusted basis	(220,000)
Realized gain	<u>\$ 210,000</u>

- b. What is the minimum amount of gain Grant must recognize on the condemnation?

**Grant does not have to recognize any of the \$210,000 realized gain because the entire \$430,000 of condemnation proceeds were reinvested in the purchase of the warehouse for \$670,000. At Grant's election, the \$210,000 of realized gain is deferred.**

- c. If Grant elects to recognize the minimum amount of gain on the condemnation, what is the basis in the new warehouse?

**The basis of the new warehouse is its cost less the gain deferred on the condemnation. This gives Grant a basis of \$460,000 (\$670,000 - \$210,000). The \$460,000 is the \$220,000 of basis in the old warehouse plus the additional \$240,000 (\$670,000 - \$430,000) Grant invested in purchasing the replacement warehouse.**

45. Refer to the facts of problem 44. Write a letter to Grant Industries explaining why it might want to recognize the entire gain on the condemnation.

**Grant will elect to recognize the gain if it can pay no tax on the gain. Thus, if Grant has either an unused net operating loss or a net capital loss that it could use against the gain, it may be advantageous to recognize the gain. This allows the gain to go untaxed (through the offset against the loss) and gives Grant a basis in the replacement warehouse of the full \$670,000 purchase price. The larger basis will result in larger cost recovery deductions in the future.**

46. One of Reddy's Fancy Dog Food factories is destroyed by a tornado. The factory has an adjusted basis of \$375,000. Reddy's receives \$540,000 from its insurance company to cover the loss. What is the minimum amount of gain that must be recognized in each of the following situations and the basis of any property purchased with the insurance proceeds?

**Reddy's has realized a gain of \$165,000 on the casualty. To defer all of the gain, Reddy's will have to buy a qualified replacement factory costing at least \$540,000. To the extent that a replacement property costing less than \$540,000 is purchased, gain will have to be recognized.**

Amount realized (Insurance proceeds)	\$ 540,000
Adjusted basis	(375,000)
Realized gain	<u>\$ 165,000</u>

- a. Reddy's decides that the lost production could be made up by its other factories and uses the proceeds to pay a cash dividend to its shareholders.

**Because a qualified replacement factory was not purchased, Reddy's must recognize the entire gain of \$165,000.**

- b. Reddy's purchases another factory for \$590,000.

**The replacement factory costs \$50,000 more than the proceeds received. Therefore, Reddy's may defer all of the realized gain. If Reddy's elects to defer the gain, the basis of the new factory is reduced by the amount of gain deferred. Reddy's basis is \$425,000 (\$590,000 - \$165,000).**

- c. Reddy's purchases another factory for \$480,000.

**Reddy's has not reinvested all of the proceeds in the replacement factory. The \$60,000 (\$540,000 - \$480,000) of proceeds not reinvested must be recognized. The remaining \$105,000 (\$165,000 - \$60,000) of realized gain may be deferred, resulting in a basis in the new factory of \$375,000 (\$480,000 - \$105,000).**

- d. Reddy's purchases another factory for \$350,000.

**Reddy's has not reinvested all of the proceeds in the replacement factory. The excess proceeds are \$190,000 (\$540,000 - \$350,000). However, Reddy's will not have to recognize more gain than was realized on the casualty. Reddy's recognized gain will be the \$165,000 realized gain. The basis in the new factory will be the \$350,000 purchase price.**

**47.** A fire totally destroys a manufacturing plant owned by Ansel Corporation. The plant, located in Louisiana, has been used for more than 30 years and is fully depreciated. Ansel's insurance pays \$500,000 for the destruction. In analyzing qualified replacement properties, Ansel can buy a qualified replacement plant in Oklahoma for \$460,000.

- a. What is the minimum amount of gain Ansel must recognize on the insurance proceeds? Explain.

**Ansel has realized a gain of \$500,000 on the plant. If Ansel buys the Oklahoma plant, \$40,000 of the proceeds will not be reinvested in acquiring the replacement plant. Therefore, \$40,000 of the gain is recognized. The remaining \$460,000 gain can be deferred. The basis in the Oklahoma plant is \$-0-.**

Amount realized		\$ 500,000
Adjusted basis		<u>-0-</u>
Realized gain		\$ 500,000
Recognized gain:		
Insurance proceeds	\$ 500,000	
Cost of replacement	<u>(460,000)</u>	
Recognized gain		<u>(40,000)</u>
Deferred gain		<u>\$ 460,000</u>

- b. What is the basis of the Oklahoma plant?

**Basis of replacement plant = \$460,000 - \$460,000 = \$ -0-**

**Note that the replacement requirement only requires that the taxpayer meet the functional use test. There is no location requirement. The replacement property does not have to be located in the same area as the property subject to the conversion. This allows companies flexibility in planning the replacement of properties that are involuntarily converted.**

48. MacKenzie owns a boat rental business. During the current year, a tidal wave sweeps through the harbor where she keeps her boats anchored. Four boats are totally destroyed, but the rest of the rental fleet escapes serious damage. MacKenzie replaces the 4 boats within 6 months of the tidal wave. Details on each boat destroyed and the cost of its replacement are as follows:

Boat	Insurance Proceeds	Adjusted Basis	Replacement Cost
Sailboat	\$ 50,000	\$ 18,000	\$ 48,000
Yacht	\$ 136,000	\$ 75,000	\$ 150,000
Speedboat	\$ 82,000	\$ 102,000	\$ 95,000
Fishing Boat	\$ 142,000	\$ 112,000	\$ 80,000

- What is the realized gain or loss on each of the boats?
- What is the minimum amount of gain or loss that must be recognized on each of the boats?
- Assuming that MacKenzie elects to recognize the minimum amount of gain or loss on each boat, what is the basis of each replacement boat?

	<u>Sailboat</u>	<u>Yacht</u>	<u>Speedboat</u>	<u>Fishing Boat</u>
Amount realized	\$ 50,000	\$ 136,000	\$ 82,000	\$ 142,000
Adjusted basis	(18,000)	(75,000)	(102,000)	(112,000)
Realized gain (loss)	<u>\$ 32,000</u>	<u>\$ 61,000</u>	<u>\$ (20,000)</u>	<u>\$ 30,000</u>
<b>Recognized Gain:</b>				
Insurance proceeds	\$ 50,000	\$ 136,000		\$ 142,000
Replacement cost	<u>48,000</u>	<u>150,000</u>		<u>80,000</u>
Excess	\$ 2,000	\$ -0-		\$ 62,000
Recognized gain (loss)	<u>\$ 2,000</u>	<u>\$ -0-</u>	<u>\$ (20,000)</u>	<u>\$ 30,000</u>
Deferred gain	\$ 30,000	\$ 61,000	\$ -0-	\$ -0-
Replacement cost	\$ 48,000	\$ 150,000	\$ 95,000	\$ 80,000
Less: Deferred gain	<u>30,000</u>	<u>61,000</u>	<u>-0-</u>	<u>-0-</u>
New basis	<u>\$ 18,000</u>	<u>\$ 89,000</u>	<u>\$ 95,000</u>	<u>\$ 80,000</u>

MacKenzie must recognize \$2,000 of the gain on the sailboat since she did not invest the entire amount of the insurance proceeds in a new sailboat. The entire amount of the gain on the yacht is deferred because MacKenzie reinvested more than the insurance proceeds in a new Yacht. The loss on the speedboat must be recognized in the period of realization. Losses on involuntary conversions are never deferred. The full \$30,000 gain on the fishing boat is recognized. The \$142,000 of insurance proceeds on the boat exceeds the replacement cost of (\$80,000) by \$62,000. However, the maximum gain which can be recognized is the \$30,000 realized gain.

49. Alley's automobile dealership, which has an adjusted basis of \$400,000, is destroyed by a hurricane in the current year. Alley's receives \$600,000 from its insurance company to cover the loss. Alley's has begun to rebuild the dealership at an estimated cost of \$750,000. Assume that the rebuilding costs at least \$750,000.

- a. What is the minimum gain Alley's must recognize on the hurricane damage?

**Alley's has two years to complete the replacement of the dealership. Assuming that the replacement period requirement is met and Alley's rebuilding costs are \$750,000, Alley's will not have to recognize any gain on the hurricane. Alley's will have fully reinvested the \$600,000 of insurance proceeds in the dealership. The basis of the new dealership will be reduced by the \$200,000 of deferred gain.**

Amount realized		\$ 600,000
Adjusted basis		<u>(400,000)</u>
Realized gain		\$ 200,000
Recognized gain:		
Insurance proceeds	\$ 600,000	
Rebuilding cost	<u>750,000</u>	
Recognized gain		<u>-0-</u>
Deferred gain		<u>\$ 200,000</u>

**Basis of new dealership = \$750,000 - \$200,000 = \$550,000**

- b. Alley's is organized as a corporation. Because of a slump in the automobile industry, Alley's has net operating losses totaling \$400,000 that it is carrying forward from the previous 5 years. Alley's expects to have another operating loss in the current year. Write a letter to Alley's explaining how to account for the involuntary conversion results and why you advise taking those measures.

**Because Alley's has a large unused net operating loss carryover and faces current year (and possibly future year) operating losses, Alley's can recognize the entire \$200,000 gain on the involuntary conversion and pay no tax on the gain. The current year loss and the NOL carryover will offset the \$200,000 gain. By electing to recognize the gain in the current year, Alley's will pay no tax on the gain and will have a basis in the new dealership equal to its cost (no reduction in cost for a deferred gain). In addition, by recognizing the gain, Alley's uses up some of its NOL carryforward. Given the projections in the problem, it is possible that some of the carryforward may be lost if Alley's does not return to profitability in the near future.**

50. In each of the following cases, determine the amount of realized gain or loss and the recognized gain or loss:

- a. Cheryl sells her house for \$73,000 and she pays \$4,000 in commissions on the sale. She paid \$83,000 for the house 4 years earlier.

**Cheryl has realized a loss of \$14,000 [(\$73,000 - \$4,000) - \$83,000] on the sale. The loss on the sale of a principal residence is a personal loss and is not deductible.**

- b. In July 2016, Alexandra, who is single, is transferred to San Diego. She had purchased a new home the previous month for \$50,000, and had contracted to make \$25,000 of improvements to the house. After the improvements are completed in November, Alexandra sells the house for \$97,000 and pays a commission of \$3,000 on the sale.

**Alexandra has a realized gain of \$19,000 on the sale of her residence. She can exclude the entire amount of the gain (\$250,000 maximum for a single taxpayer) only if she meets both the ownership test and the use test. The ownership test requires that she own the house for at least two of the five years preceding the sale. The use test requires that the house be used as her principal residence for two of the five preceding years. However, she still qualifies for a pro rata portion of the exclusion if she fails to meet these tests due to a change in employment, health, or unforeseen circumstances. Although Alexandra does not meet the tests, she is entitled to a pro rata share of the exclusion because she fails to meet the tests due to a change in employment.**

**The amount she can exclude is the ratio of the number of months she met the ownership and use tests (1 month - June) to 24 months multiplied by the \$250,000 exclusion amount. Therefore, Alexandra can exclude \$10,417 of the gain.**

$$\text{\$10,417} = \frac{1 \text{ month}}{24 \text{ months}} \times \$250,000$$

**Alexandra must recognize a gain of \$8,533 on the sale.**

Amount realized (\$97,000 - \$3,000)	\$ 94,000
Adjusted basis (\$50,000 + \$25,000)	<u>(75,000)</u>
Realized gain	\$ 19,000
Exclusion amount	<u>(10,417)</u>
Recognized gain	<u><u>\$ 8,533</u></u>

- c. Oswald is single and sells his principal residence for \$340,000. He pays selling expenses of \$20,000. Oswald purchased the house for \$75,000. He purchased the house for \$75,000 in 2001.

**Oswald has a realized gain of \$245,000. Oswald can exclude up to \$250,000 of the gain if he meets both the ownership test and the use test. The ownership test requires that Oswald own the house for at least two of the five years preceding the sale. The use test requires that the house was his principal residence for two of the preceding five years. Because Oswald meets both of these tests he can exclude the \$245,000 gain he realized on the sale.**

Amount realized (\$320,000 - \$20,000)	\$ 320,000
Adjusted basis	(75,000)
Realized gain	\$ 245,000
Exclusion amount	(245,000)
Recognized gain	<u>\$ -0-</u>

- d. Ushi is transferred to North Carolina in September 2013 and was unable to sell her home in Texas before moving. She acquired the home in December 2011 for \$110,000. She rents out the Texas house on a 6-month lease. In March 2015, Ushi purchases a new residence in North Carolina at a cost of \$150,000. She continues to rent out the Texas property on a 6-month lease. The Texas house finally sells in December 2016 for \$130,000. Ushi pays \$10,000 in commissions on the sale.

**Ushi has a realized gain of \$10,000. Ushi can exclude up to \$250,000 of the gain if she meets both the ownership test and the use test. The ownership test requires that Ushi own the house for at least two of the five years preceding the sale. She meets this test. The use test requires that she has used the house as her principal residence for two of the preceding five years. Ushi fails to meet this test. Her house was only her principal residence for 22 months (December 2011 to September 2013) during the previous five year period. (December 2011 to December 2016).**

**However, she still qualifies for a pro rata portion of the exclusion if she fails to meet these tests due to a change in employment, health, or unforeseen circumstances. Because Ushi meets the tests due to a change in employment, she is entitled to a pro rata share of the exclusion. The amount she can exclude is the ratio of the number of months she met the ownership and use tests (22 months) to 24 months multiplied by the \$250,000 exclusion amount. Therefore, Ushi can exclude the \$10,000 realized gain.**

$$\$229,167 = \frac{22 \text{ months}}{24 \text{ months}} \times \$250,000$$

Amount realized (\$130,000 - \$10,000)	\$ 120,000
Adjusted basis	(110,000)
Realized gain	\$ 10,000
Exclusion amount	10,000
Recognized gain	<u>\$ -0-</u>



51. Aretha sells her house on June 9, 2016, for \$220,000 and pays commissions of \$10,000 on the sale. She had purchased the house for \$60,000 and made capital improvements costing \$15,000. What are Aretha's realized and recognized gain in each of the following cases?

- a. Aretha is single and acquired the house on September 15, 2008.

**Aretha has a realized gain of \$135,000. She can exclude the entire amount of the gain (\$250,000 maximum for a single taxpayer) if she meets both the ownership test and the use test. The ownership test requires that she own the house for at least two of the five years preceding the sale. The use test requires that the house was her principal residence for two of the preceding five years.**

**Because Aretha meets both of these tests, she can exclude the \$135,000 gain.**

Amount realized (\$220,000 - \$10,000)	\$ 210,000
Adjusted basis (\$60,000 + \$15,000)	(75,000)
Realized gain	\$ 135,000
Exclusion amount	(135,000)
Recognized gain	<u><u>\$ -0-</u></u>

- b. Assume the same facts as in part a, except that Aretha sold the house for \$375,000 and pays commissions of \$30,000 on the sale.

**Aretha has a realized gain of \$270,000 and a recognized gain of \$20,000.**

Amount realized (\$375,000 - \$30,000)	\$ 345,000
Adjusted basis (\$60,000 + \$15,000)	(75,000)
Realized gain	\$ 270,000
Exclusion amount	(250,000)
Recognized gain	<u><u>\$ 20,000</u></u>

- c. Aretha is single and acquired the house on September 1, 2015. She sold the house because her company transferred her to Phoenix.

**Arthea fails to meet the ownership and use tests. Although she has not met these tests, she still qualifies for a pro rata portion of the exclusion because her failure to meet these tests is due to a change in employment, health, or unforeseen circumstances.**

The amount she can exclude is the ratio of the number of months she met the ownership and use tests (9 months) to the total number of months in the exclusion period (24 months) multiplied by the exclusion amount of \$250,000. The amount Arthea can exclude is \$93,750.

$$\$93,750 = \frac{9 \text{ months}}{24 \text{ months}} \times \$250,000$$

**Aretha has a realized gain of \$135,000, of which \$41,250 is excluded:**

Amount realized (\$220,000 - \$10,000)	\$ 210,000
Adjusted basis (\$60,000 + \$15,000)	(75,000)
Realized gain	\$ 135,000
Exclusion amount	( 93,750)
Recognized gain	<u>\$ 41,250</u>

- d. Assume the same facts as in part c, except that she moved to Phoenix to enter medical school.

**Aretha fails to meet the ownership and use tests. Because her reason for failing these tests is not due to a change in employment, health, or due to unforeseen circumstances, she does not qualify for a pro rata share of the \$250,000 exclusion. Aretha has a recognized and realized gain of \$135,000.**

**Aretha has a realized gain of \$135,000 and a recognized gain of \$135,000:**

Amount realized (\$220,000 - \$10,000)	\$ 210,000
Adjusted basis (\$60,000 + \$15,000)	(75,000)
Realized gain	\$ 135,000
Exclusion amount	-0-
Recognized gain	<u>\$ 135,000</u>

52. Mai, a single taxpayer, sells her residence in the suburbs for \$300,000. She bought the house twelve years ago for \$60,000 and made \$30,000 of improvements to it. Mai buys a new downtown condominium for \$155,000 a few weeks after she sells her suburban residence.
- a. What is Mai's realized gain and recognized gain on the sale? What is her basis in the condominium?

**Mai has a realized gain of \$210,000. She can exclude up to \$250,000 of gain if she meets both the ownership test and the use test. The ownership test requires that she own the house for at least two of the five years preceding the sale. The use test requires that the house was her principal residence for two of the preceding five years.**

**Because Mai meets both of these tests, she can exclude the \$210,000 gain:**

Amount realized	\$ 300,000
Adjusted basis (\$60,000 + \$30,000)	<u>(90,000)</u>
Realized gain	\$ 210,000
Exclusion amount	<u>(210,000)</u>
Recognized gain	<u><u>\$ -0-</u></u>

**Her basis in the condominium is the \$155,000 purchase price. The exclusion has no impact on the basis of the new home.**

- b. Assume that Mai sells the property for \$350,000. What is her realized gain and recognized gain on the sale? What is her basis in the condominium?

**Mai has a realized gain of \$260,000 and a recognized gain of \$10,000:**

Amount realized	\$ 350,000
Adjusted basis (\$60,000 + \$30,000)	<u>(90,000)</u>
Realized gain	\$ 260,000
Exclusion amount	<u>(250,000)</u>
Recognized gain	<u><u>\$ 10,000</u></u>

**Her basis in the condominium is the \$155,000 purchase price. The exclusion has no impact on the basis of the new home.**

53. Manuel and Rita sell their home in Minneapolis for \$495,000, incurring selling expenses of \$25,000. They had purchased the residence for \$85,000 and made capital improvements totaling \$20,000 during the 20 years they lived there. They buy a new residence in Tampa for \$225,000.

- a. What is Manuel and Rita's realized gain and recognized gain on the sale? What is their basis in the Tampa house?

**Manuel and Rita have a realized gain of \$365,000. They can exclude the entire amount of the gain (\$500,000 maximum for a married taxpayer) if either of them meets the ownership test and both of them meet the use test. The ownership test requires that either of them own the house for at least two of the five years preceding the sale. The use test requires that the house was the principal residence for both of them in two of the preceding five years.**

**Because they meet both of these tests, they can exclude the \$365,000 gain:**

Amount realized (\$495,000 - \$25,000)	\$ 470,000
Adjusted basis (\$85,000 + \$20,000)	(105,000)
Realized gain	\$ 365,000
Exclusion amount	(365,000)
Recognized gain	<u>\$ -0-</u>

**Manuel and Rita's basis in the house is the \$225,000 purchase price. The exclusion has no impact on the basis of the new home.**

- b. Assume that Manuel and Rita sell the Minneapolis home for \$675,000. What is their realized gain and recognized gain on the sale? What is their basis in the Tampa house?

**Manuel and Rita have a realized gain of \$545,000 and a recognized gain of \$45,000:**

Amount realized (\$675,000 - \$25,000)	\$ 650,000
Adjusted basis (\$85,000 + \$20,000)	(105,000)
Realized gain	\$ 545,000
Exclusion amount	(500,000)
Recognized gain	<u>\$ 45,000</u>

**Manuel and Rita's basis in the house is the \$225,000 purchase price. The exclusion has no impact on the basis of the new home.**

54. Kerri and John are married. On May 12, 2016, they sell their home for \$190,000 and purchase another residence costing \$225,000. What is Kerri and John's realized and recognized gain in each of the following cases?
- a. They purchased the residence for \$85,000 on February 8, 2014.

**Kerri and John have a realized gain of \$105,000. They can exclude the entire amount of the gain (\$500,000 maximum for a married taxpayer - \$250,000 each) if either of them meets the ownership test and both of them meet the use test. The ownership test requires that either of them own the house for at least two of the five years preceding the sale. The use test requires that the house was the principal residence for both of them in two of the preceding five years. If only one spouse meets both requirements, that spouse is eligible to use their \$250,000 exclusion.**

**Because they meet both of these tests, they can exclude the \$105,000 gain.**

Amount realized	\$ 190,000
Adjusted basis	(85,000)
Realized gain	\$ 105,000
Exclusion amount	(105,000)
Recognized gain	<u>\$ -0-</u>

- b. Kerri purchased the residence for \$85,000 on June 13, 2013. They are married on June 13, 2014, and use Kerri's house for their principal residence.

**Kerri meets both the ownership and use test. However, John fails to meet the use test because the home has not been his principal residence for two years. In addition, his failure to meet these tests is not due to a change in employment, health, or a result of unforeseen circumstances. Although John fails to meet the tests, this does not preclude Kerri from using her \$250,000 exclusion. Therefore, Kerri and John have a realized gain of \$105,000 and a recognized gain of \$0:**

Amount realized	\$ 190,000
Adjusted basis	(85,000)
Realized gain	\$ 105,000
Exclusion amount	(105,000)
Recognized gain	<u>\$ -0-</u>

- c. Assume the same facts as in part b, except that they sell the house for \$390,000.

**Because John cannot use his \$250,000 exclusion, the maximum amount of the realized gain they can exclude is \$250,000. Therefore, Kerri and John have a realized gain of \$305,000 and a recognized gain of \$55,000.**

Amount realized	\$ 390,000
Adjusted basis	(85,000)
Realized gain	\$ 305,000
Exclusion amount	(250,000)
Recognized gain	<u>\$ 55,000</u>

55. Gary and Gertrude are married on April 8, 2015. They use Gertrude's home as their residence. Gertrude purchased the home on November 14, 2013, for \$60,000. On February 19, 2016, Gertrude is killed in an automobile accident. Gary is distraught and sells their residence on May 14, 2016 for \$110,000 and moves to Portugal. How much of the gain on the sale of the residence is taxable?

**Gary realizes a \$50,000 (\$110,000 - \$60,000) gain on the sale of the residence. Gary has not met the 2-year ownership and use test (April 8, 2015 - May 14, 2016 < 2 years). However, the tax law provides that a taxpayer's period of ownership includes the period during which the taxpayer's deceased spouse owned the residence. Under this rule, Gary is deemed to have owned and used the residence since November 14, 2013, and he is eligible to exclude the \$50,000 gain.**

**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.

56. Bonnie wants to trade her Snow Bird, Utah, condominium, which she has held for investment, for investment property in Steamboat Springs or Crested Butte, Colo. On April 20, 2016, she transfers title to the Snow Bird property to Thanh/Hao Partnership, which transfers \$300,000 cash to a real estate broker to hold in escrow until Bonnie finds a replacement property. The broker is commissioned to find suitable property for Bonnie.

**The issue is whether the transaction will qualify as a like-kind exchange. The transaction may qualify for like-kind exchange treatment as a deferred (third-party) exchange. To accomplish this result, the property to be exchanged to Bonnie must be identified within 45 days of the date of the first property transfer. That is, the property must be identified no later than June 4, 2016. Then, the actual exchange must be completed within 180 days of the first transfer, or not later than October 17, 2016.**

57. Erica owns A-1 Landscaping Services. She trades a lawn tractor with a basis of \$200 for a powered post hole digger worth \$300.

**The issue is whether the lawn tractor and the powered post hole digger are like-kind property, making the transaction a like-kind exchange. To qualify as a like-kind exchange, both properties must be business or investment property. In addition, both properties must be of the same general class of property and both assets exchanged must be located within the United States. For personal property, the assets must either be of the same general asset class, or if neither asset belongs to a general asset class, they must be of the same NAICS product class. In this case, neither of the assets are in a general asset class. A lawn tractor is in NAICS product class 333112 (Lawn and Garden Tractor and Home Lawn and Garden Equipment Manufacturing) and a powered post hole digger is in NAICS product class 333120 (Construction Machinery Manufacturing). Because they are not in the same NAICS product class, a lawn tractor and the powered post hole digger are not like-kind property and the exchange is not subject to the like-kind exchange rules.**

58. Rollie exchanges a parking lot used in his business for a tract of land worth \$20,000 and \$4,000 in cash. He plans to subdivide and sell the land as residential lots. The adjusted basis of the parking lot is \$30,000.

The issues are whether this is a like-kind exchange and if so, how much of the gain or loss realized on the exchange is recognized, and the basis of the parking lot. To qualify as a like-kind exchange, both properties must be business or investment property. In addition, both properties must be of the same general class of property and both assets exchanged must be located within the United States. For real property, this means that any real property can be exchanged for any other real property. Therefore, the exchange is a like-kind exchange.

Rollie realizes a \$6,000  $[(\$20,000 + \$4,000) - \$30,000]$  loss on the exchange. Losses on like-kind exchanges are never recognized. Even though Rollie is in receipt of cash on the exchange, he cannot recognize the loss. His basis in the land is \$26,000 (\$20,000 fair market value of the land + \$6,000 deferred loss).

59. Johann exchanges an apartment building for an office building worth \$100,000. The apartment building has an adjusted basis of \$80,000 and is encumbered by a \$30,000 mortgage, which the owner of the office building assumes in the exchange.

The issues are the amount realized on the exchange, the realized and recognized gain or loss on the exchange, and the basis in the office building. Johann's amount realized is \$130,000 (\$100,000 fair market value of the office building + \$30,000 mortgage assumed), and she has a \$50,000  $(\$130,000 - \$80,000)$  realized gain on the exchange. The mortgage assumption is boot received and she must recognize a \$30,000 gain. The remaining \$20,000 of gain is deferred into the basis of the office building, resulting in a basis of \$80,000  $(\$100,000 - \$20,000)$ :

FMV of the office building received	\$ 100,000
Mortgage assumption	<u>30,000</u>
Amount realized	\$ 130,000
Less: Adjusted basis	<u>(80,000)</u>
Realized gain	\$ 50,000
Recognized gain (mortgage assumed)	<u>\$ 30,000</u>
Deferred gain	<u>\$ 20,000</u>

**Basis of office building = \$100,000 - \$20,000 = \$80,000**



60. Lorraine is an avid baseball card collector. She gives a card dealer \$50 and a Roger Maris card for a Sammy Sosa card.

**The issue is whether Lorraine recognizes any gain or loss on the exchange. The baseball cards are like-kind property. Because Lorraine is the giver of boot (\$50) in the exchange, she will recognize no gain or loss on the exchange.**

**Note: This is not a like-kind exchange for the card dealer. The baseball cards are inventories for a dealer. Inventories are not allowed like-kind exchange treatment. Therefore, the dealer treats this as a sale of the Sammy Sosa card for \$50 plus the fair market value of the Roger Maris card.**

61. Stephanie owns 75% of the Gould Corporation. She exchanges land that she owns as an investment for an office building owned by Gould that has a fair market value of \$130,000. In the exchange, Stephanie gives Gould Corporation stock with a fair market value of \$20,000. Stephanie's basis in the land is \$60,000, and her basis in the stock is \$28,000. Gould's basis in the office building is \$90,000.

The issues are the amount of gain or loss that is recognized by Stephanie and Gould Corporation on the like-kind exchange and the basis of the property each receives in the exchange. Stephanie realizes \$110,000 for her land, resulting in a \$50,000 gain on the exchange. Because she is a payer of boot, she does not recognize any of the gain. Her basis in the office building is \$80,000. However, the stock boot she gives in the exchange is not like-kind property and she realizes an \$8,000 (\$20,000 - \$28,000) loss on its disposition. She cannot deduct the loss since it is related party transaction (i.e., she owns 75% of Gould Corporation).

FMV of the office building received	\$ 130,000
Less: Boot paid (FMV of stock)	<u>(20,000)</u>
Amount realized	\$ 110,000
Less: Adjusted basis	<u>(60,000)</u>
Realized gain	\$ 50,000

Recognized gain - no boot received	<u>-0-</u>
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Deferred gain	<u>\$ 50,000</u>
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Basis of office building = \$130,000 - \$50,000 = \$80,000

Gould Corporation realizes a \$40,000 gain. It must recognize \$20,000 of the gain (boot received). Its basis in the land is \$90,000 and it has a \$20,000 basis in the stock.

FMV of land received	\$ 110,000
FMV of stock received	<u>20,000</u>
Amount realized	\$ 130,000
Less: Adjusted basis	<u>(90,000)</u>
Realized gain	\$ 40,000

Recognized gain (FMV of stock received)	<u>20,000</u>
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Deferred gain	<u>\$ 20,000</u>
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Basis of land = \$110,000 - \$20,000 = \$90,000

62. Festus Farmers Cooperative truck barn, which has a \$50,000 adjusted basis, is destroyed by a fire. Festus receives \$80,000 from its insurance company for the barn and uses the proceeds as a down payment on a new grain silo costing \$160,000.

**The issue is whether Festus can use the involuntary conversion rules to defer recognition of the \$30,000 (\$80,000 - \$50,000) gain on the destruction of the truck barn. The general requirement for an involuntary conversion is that the replacement property have the same functional use as the property converted. Because the grain silo does not have the same functional use in Festus' business as the truck barn, the grain silo is not a qualified replacement property and it cannot defer recognition of the gain.**

63. Raylene's personal automobile is destroyed by a tornado. Her insurance company paid her \$5,000, which she used to purchase a new automobile costing \$10,000. Raylene received the automobile that was destroyed as a graduation present from her uncle Earl. Earl's basis in the automobile was \$2,000. The automobile was worth \$8,000 when Raylene received it.

**The issue is whether Raylene can defer the \$3,000 (\$5,000 - \$2,000) realized gain on the casualty. The involuntary conversion rules apply to gains realized on business and investment property. They do not apply to gains on personal use property. Therefore, Raylene cannot defer recognition of the casualty gain on her personal use automobile.**

64. Inez is a freelance artist. She purchased 10 acres of land in 2011 for \$5,000. On July 15, 2016, the land is condemned by the county government to build a new courthouse and jail facility. The county awards Inez \$35,000 for the condemnation of the land. Inez uses the proceeds to purchase a building that she will use as a production studio for her artwork.

**The issue is whether the purchase of the building is a qualified replacement property for application of the involuntary conversion rules. The general requirement for an involuntary conversion is that the replacement property has the same functional use as the property converted. An exception to this general requirement is granted for condemned business or investment real property that only requires the property acquired be like-kind property (as defined for like-kind exchanges). The land appears to be investment property and the like-kind exception applies. Under the like-kind exchange rules, any real property can be exchanged for any other real property. Therefore, the purchase of the building qualifies the condemnation for involuntary conversion treatment.**

65. Laurie bought a home in 2013 for \$65,000. On November 2, 2016, she sells it for \$114,000. Laurie uses the proceeds to purchase a duplex costing \$200,000. She uses one unit in the duplex as her principal residence.

**The issue is the amount of gain recognized on the sale of the residence. Laurie realizes a \$49,000 (\$114,000 - \$65,000) gain on the sale. Because she has owned and used the property as a residence for more than two years, she can exclude the entire gain. The use of the proceeds from the sale is irrelevant to the taxation of the gain.**

66. Harvey sells his personal residence on March 18, 2016, for \$78,000. He paid \$86,000 for it on April 22, 2014.

**The issue is the treatment of the gain or loss realized on the sale of the residence. Harvey realizes an \$8,000 (\$78,000 - \$86,000) loss on the sale. A personal residence is a personal use asset. Losses on the sale of personal use assets are not recognized. Therefore, Harvey cannot deduct any of the loss on the sale.**

67. Eva and Mario are married on June 14, 2015. They use Eva's home as their principal residence. Eva purchased the home for \$97,000 in 2012. On January 13, 2016, Eva and Mario are divorced. As part of the settlement, Mario receives the home. He sells it on March 30, 2016, for \$119,000.

**The issue is whether Mario can exclude any of the \$22,000 (\$119,000 - \$97,000) gain realized on the sale of the principal residence. He can exclude up to \$250,000 of gain if he meets both the ownership test and the use test. The ownership test requires that he own the house for at least two of the five years preceding the sale. The use test requires that the house was his principal residence for two of the preceding five years. Mario has only used the house as a principal residence from June 14, 2015 to March 30, 2016 (less than 2 years). However, the tax law provides that a taxpayer who receives a residence in a divorce is deemed to have used it during the time the taxpayer's spouse owned the property and used it as a residence. Therefore, because Mario is deemed to have owned and used the residence since Eva purchased it in 2012, he can exclude the \$22,000 gain realized on the sale.**

68. **Tax Simulation** Othello trades a concrete ready mix truck and a general purpose truck used in his landscape business to Sonja for an ore truck and a general purpose truck and \$1,000 cash. The adjusted basis and fair market value of the animals traded are as follows:

	Adjusted Basis	Fair Market Value
Concrete ready mix truck	\$30,000	\$36,000
General purpose truck	19,000	18,000
Ore truck		32,000
General purpose truck		21,000
Cash		1,000

Required: Determine the income tax treatment of Othello's trade of his concrete truck and general purpose truck for Sonja's ore truck and general purpose truck. 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 Othello's trade. 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. 1031(a)(1) requires deferral of gains and losses on exchanges of like-kind business assets.**

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

**Sec. 1031(b) requires recognition of gains on like-kind exchanges to the extent of any money and other property received in the exchange.**

***Sec. 1031(b) GAIN FROM EXCHANGES NOT SOLELY IN KIND. —If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.***

The general rule of Sec. 1031 contemplates a property by property comparison in determining the gain recognized on a like-kind exchange and does not address multiple exchanges of property. Reg. Sec. 1.1031(j)-1 addresses multiple exchanges of property. Reg. Sec. 1.1031(j)-1(a)(1) defines a multiple exchange as one in which more than one exchange group is created in the exchange.

## Exchanges of multiple properties (a) Introduction

**(1) Overview.** —As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

Reg. Sec. 1.1031(j)-1(b)(2) requires the properties transferred and the properties exchanged be separated into exchange groups and a residual group. Each exchange group consists of only like-kind properties in the exchange.

### **(b) Computation of gain recognized**

**(1) In general.** —In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

**(2) Exchange groups and residual group.** —The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

**(i) Exchange groups.** —Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in §1.1031(a)-2(b)). Each exchange group must

***consist of at least one property transferred and at least one property received in the exchange.***

The concrete truck and the ore truck will constitute one exchange group and the general purpose trucks will constitute a second exchange group. The residual group is defined in Reg. Sec. 1.1031(j)-1(b)(2)(iii) as the difference in the aggregate fair market value of the properties in the exchange groups transferred and the aggregate fair market values of the properties in the exchange groups received. In this case, the \$1,000 of cash received in the exchange is the residual group.

***(iii) Residual group. —If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both.***

For each exchange group, the exchange group surplus or exchange group deficiency is then determined. These are defined in Reg. Sec. 1.1031(j)-1(b)(iv) as the difference in the aggregate fair market value of the property received and the aggregate fair market value of the property transferred. The cement/ore truck exchange group has a \$4,000 (\$32,000 - \$36,000) exchange group deficiency and the general purpose truck exchange group has a \$3,000 (\$21,000 - \$18,000) exchange group surplus.

***(iv) Exchange group surplus and deficiency. —For each of the exchange groups described in this section, an “exchange group surplus” or “exchange group deficiency,” if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.***

The amount of gain (loss) realized is calculated by comparing the aggregate fair market value of the properties transferred in each exchange group with the aggregate basis of the properties transferred. A \$6,000 (\$36,000 - \$30,000) gain is realized on the concrete truck and a \$1,000 (\$18,000 - \$19,000) loss is realized on the general purpose truck. Reg. Sec. 1.1031(j)-1(b)(3) requires recognition of the lesser of the gain

realized on each exchange group and the exchange group deficiency. Realized losses are not recognized. Othello must recognize a \$4,000 (exchange group deficiency less than realized gain) gain on the cement truck and cannot recognize the \$1,000 loss on the general purpose truck.

***(3) Amount of gain recognized***

***(i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031(a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.***

Under Reg. Sec. 1.1031-1(c), the aggregate basis of the properties received in the exchange group is the adjusted basis of the property transferred, increased by the gain recognized and the exchange group surplus and decreased by the exchange group deficiency. The adjusted basis of the ore truck is \$30,000 (\$30,000 adjusted basis of cement truck + \$4,000 gain recognized - \$4,000 exchange group deficiency). The adjusted basis of the general purpose truck is \$22,000 (\$19,000 adjusted basis of general purpose truck + \$3,000 exchange group surplus).



69. **INTERNET ASSIGNMENT** The Internal Revenue Service provides information on a variety of tax issues in its publication series. These publications can be found on the IRS world wide web site (<http://www.irs.gov/>). Go to the IRS world wide web site and find any publications that contain information on the sale of a principal residence. Describe the process you used to obtain this information and provide the title(s) of the publication(s) that contain relevant information.

**At the IRS homepage you should click on More Forms and Publications. Under the heading "Download forms and publications by:", click on "Publication Number". At the next screen you will be given a choice of which IRS publications you would like to download. Scroll down to Publication 523 "Selling Your Home". At this point, you need to select the file type Publication 523 will be saved as. The most versatile file type is PDF. After selecting the file type, hit "download" and the file will be loaded into the Adobe Acrobat reader. Note: You will need Adobe Acrobat to read the PDF file "Publication 523". If you do not have Adobe Acrobat, you can also download it from the IRS website.**

**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.

70. **INTERNET ASSIGNMENT** Taxpayers can structure transactions through third parties that qualify as like-kind exchanges if certain time requirements for identifying the properties and closing the transaction are met. This type of exchange is referred to as a deferred or third-party exchange. Use the Internet to find information about deferred (third-party) exchanges. Trace the process you used to find the information (search engine or tax directory used and key words). Write a summary of the information you find on deferred (third-party) exchanges.

**The best method of finding information on deferred (third-party) exchanges is to use a search engine with the phrase "like-kind exchange" or "deferred exchange". This will lead to web pages that explain the like-kind exchange rules and offer advice about such exchanges. One web site that provides an excellent discussion of like-kind exchanges (including deferred exchanges) is found at <http://1031it.com>.**

**NSTRUCTOR'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.

71. **RESEARCH PROBLEM** Will owns residential rental property that is destroyed by a tornado in March 2015. He files a claim with his insurance company and receives \$90,000 for the property. The building is fully depreciated, and the adjusted basis of the land is \$3,000. The area around the property is being developed into a high-priced residential subdivision, and Will does not have the cash to build a replacement unit consistent with the quality of the new homes being built. In April 2016, Will sells the land for \$75,000, and in December 2016, he finds a suitable replacement property for \$170,000. Before Will acquires the replacement property he would like you to determine whether the sale of the land will be considered part of the involuntary conversion and eligible for gain deferral.

**In LTR 9334007, the taxpayer couldn't afford to invest the additional funds it would take to build a house comparable to the ones around it because of the taxpayer's age and limited financial resources. The IRS ruled that the house and land constituted an economic unit.**

**The facts of this case are based on this private letter ruling. Because a private letter ruling is applicable only to the taxpayer requesting it, Will is not assured that the IRS will reach a similar conclusion in his case. However, the rationale for the IRS's decision in the private letter ruling can be used by Will to justify his position that the sale of the land will be considered as part of the involuntary conversion and eligible for gain deferral.**

72. **RESEARCH PROBLEM** Orley, Goutam, and Serena each own undivided one-third interests as tenants in common in three parcels of land held as an investment. One of the parcels is mortgaged for \$60,000, for which each is personally liable. They would like to rearrange their interests in the properties so that each becomes a 100 percent owner of one property. Orley has agreed to take the mortgaged parcel and assume the \$60,000 liability. Goutam and Serena will each issue Orley a \$20,000 note to compensate him for taking the mortgaged parcel. Each parcel is worth \$75,000 and has a basis of \$30,000. Determine the tax consequences of the proposed transaction.

There are several issues to resolve in this problem. The first issue is whether the transaction qualifies as a like-kind exchange. The second issue is the treatment of the assumption of the \$60,000 loan by Orley and his receipt of the \$20,000 notes from Goutam and Serena. Finally, the basis in each owner's property must be determined.

Rev. Rul. 73-476, 1973-2 CB 300 held that undivided interests in real property held by tenants in common qualify as like-exchanges. Reg. Sec. 1.1031(d)-(2) states that gain on the division of property is based on the excess of the mortgage assumed by the transferee over the mortgage assumed by the transferor. Rev. Rul. 79-44, 1979-1 CB 265 explains that when some of the parcels are mortgaged and some are not, a division-exchange resulting in separate ownership can result in taxable gain to one of the parties. This occurs because the amount of cash or other boot received in a like-kind exchange cannot be offset by the assumption of liabilities by another party to the exchange. In this case, Orley is receiving \$40,000 of boot from the receipt of the notes that cannot be offset by his assumption of the \$60,000 mortgage.

Each party in the exchange realizes a \$45,000 ( $\$75,000 - \$30,000$ ) gain on the exchange. Orley receives \$40,000 in boot from the notes received from Goutam and Serena that cannot be offset by the extra \$40,000 of debt he assumed in the transaction. Therefore, he must recognize \$40,000 of gain. His basis in the parcel he receives is \$70,000 ( $\$75,000 - \$5,000 = \$30,000 + \$40,000$ ). Serena and Goutam can offset their \$20,000 share of the mortgage that Orley assumed by the \$20,000 of boot they paid in the exchange. They recognize no gain and each has a basis of \$30,000 ( $\$75,000 - \$45,000 = \$30,000$  original basis in property) in their parcel.

**COMPREHENSIVE PROBLEM**

73. During the current year, the Harlow Corporation, which specializes in commercial construction had the following property transactions. Determine the realized and recognized gain or loss on each of Harlow's property transactions and the basis of any property acquired in each transaction.

- a. In April, a tornado damages a crane and a dump truck at one of its construction sites. The crane was acquired in 2013 for \$120,000 and has an adjusted basis \$39,650. The dump truck was acquired in 2011 for \$70,000 and has an adjusted basis of \$33,880. The insurance company reimburses Harlow \$35,000 for the crane and \$42,000 for the dump truck. The company decides not to replace the dump truck and uses the insurance proceeds to purchase a new crane for \$110,000.

**The purchase of the new crane is a qualified replacement. However, the reinvestment of the dump truck proceeds into a new crane does not qualify because they do not have the same functional use in the business. Therefore, Harlow must recognize a gain of \$8,120 on the dump truck and must recognize the \$4,650 loss on the crane. Losses on an involuntary conversion must be recognized.**

**Dump truck:**

Amount realized	\$ 42,000
Adjusted basis	(33,880)
Realized gain	\$ 8,120
Recognized gain	(8,120)
Deferred gain	<u>\$ -0-</u>

**Crane:**

Amount realized	\$ 35,000
Adjusted basis	(39,650)
Realized loss	\$ (4,650)
Recognized loss	4,650
Deferred loss	<u>\$ -0-</u>

**Basis of crane = \$110,000**

- b. The company trades a road grader with a fair market value of \$72,000 for a bulldozer worth \$60,000. Harlow receives \$12,000 in the exchange. The road grader originally cost \$90,000 and has an adjusted basis of \$50,000. The bulldozer cost \$85,000, and its adjusted basis is \$37,000.

**The exchange qualifies as a like-kind exchange. Because neither a road grader nor a bulldozer are classified in any general asset class, to qualify as a like-kind exchange both the road grader and bulldozer must be in the same SIC product class. Both are in NAICS product class 333120 - Construction Machinery and Manufacturing and the exchange is like-kind. Harlow realizes a gain of \$22,000 on the exchange. The \$12,000 of cash boot received must be recognized.**

**Harlow's recognized gain is \$12,000 and its deferred gain is \$10,000.**

Amount realized (\$60,000 + \$12,000)	\$ 72,000
Adjusted basis	(50,000)
Realized gain	<u>\$ 22,000</u>
Recognized gain (Cash boot received)	<u>(12,000)</u>
Deferred gain	<u><u>\$ 10,000</u></u>

**Basis of bulldozer = \$50,000 (\$60,000 - \$10,000)**

- c. A fire destroys the company's supply warehouse. The warehouse originally cost \$300,000 and has an adjusted basis of \$200,000. Its fair market value before the fire is \$250,000. The insurance company pays Harlow \$230,000, which it uses to acquire a warehouse costing \$280,000.

**Harlow has realized a gain of \$30,000 (\$230,000 insurance proceeds less \$200,000 adjusted basis) from the fire. Because Harlow acquired a replacement warehouse costing more than the insurance proceeds (\$280,000 > \$230,000), it can defer the \$30,000 gain. The basis of the new warehouse is \$250,000 (\$280,000 - \$30,000).**

Amount realized (Insurance proceeds)	\$ 230,000
Adjusted basis	(200,000)
Realized gain	<u>\$ 30,000</u>
Recognized gain	<u>\$ -0-</u>
Deferred gain	<u><u>\$ 30,000</u></u>

**Basis of warehouse = \$250,000 (\$280,000 - \$30,000)**

- d. The city of PeaceDale condemns land that Harlow had acquired in 1982 for \$22,000 and held as an investment. The city pays Harlow the \$195,000 fair market value of the land. Harlow uses the proceeds to acquire a commercial office park for \$350,000.

**The general requirement for qualified replacement property on an involuntary conversion is that the property have the same *functional use* as the property converted. An exception to this general requirement is granted for condemned business or investment real property, which only requires the property acquired be like-kind property (as defined for like-kind exchanges). The replacement of the land with the commercial office park would qualify as like-kind property. Therefore, Harbor can elect to defer the gain it realizes on the condemnation.**

**Harlow has realized a gain of \$173,000 on the condemnation.**

Amount realized (condemnation proceeds)	\$ 195,000
Adjusted basis	(22,000)
Realized gain	<u>\$ 173,000</u>
Recognized gain	<u><u>\$ -0-</u></u>

Harlow does not have to recognize any of the \$173,000 realized gain because the entire \$195,000 of condemnation proceeds are reinvested in the purchase of the office park. At Harlow's election, the \$173,000 of realized gain is deferred.

Deferred gain	<u>\$ 173,000</u>
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**Basis of office park = \$177,000 (\$350,000 - \$173,000)**

- e. Harlow sells an automobile used by its president for business purposes for \$10,000 to a local car dealership. The car originally cost \$32,000, and its adjusted basis is \$15,000. The company had an agreement to replace the automobile with a customized four-wheel-drive vehicle from a company that specializes in custom cars. However, the day the company sells the automobile, it is informed that the custom car company will not be able to deliver the vehicle for at least 10 weeks. Harlow terminates its contract with the custom car company and buys a new automobile from the local car dealership for \$55,000.

This transaction has been structured as a sale and a purchase. The IRS, however, has successfully collapsed sales and purchases, involving essentially the same parties, into one exchange. Because the local car dealership is involved in both the sale and purchase, it is likely that the IRS would be successful in treating the transaction as an exchange. As an exchange, Harlow will not be able to recognize a loss on the old automobile.

If the transaction is treated as an exchange, the \$5,000 loss cannot be recognized and is deferred until Harlow sells the new automobile.

Amount realized	\$ 10,000
Adjusted basis	<u>(15,000)</u>
Realized loss	<u>\$ (5,000)</u>
Recognized loss	<u>\$ -0-</u>
Deferred loss	<u>\$ (5,000)</u>

The basis of the automobile is \$60,000.

Fair market value of new automobile	\$55,000
Add: Deferred loss	<u>5,000</u>
Basis in new automobile	<u>\$60,000</u>

**DISCUSSION CASES**

74. On July 8, 2014, Joe and Jill sell their principal residence for \$650,000. Their adjusted basis in the property is \$275,000. To complete the sale, Joe and Jill have to take back a second mortgage for \$120,000. The buyers borrow \$465,000 from a local bank and put down \$65,000 in cash.

In December 2016, Joe and Jill are notified that the buyers have defaulted on the second mortgage and filed for bankruptcy. A large manufacturing plant near the house has closed, and the housing market is overstocked; the value of the house has dropped significantly -- below the amount remaining on the bank's mortgage. Joe and Jill want to deduct the loss on the second mortgage. The IRS Hot Line adviser tells them the loss is not recognizable because there is no basis in the mortgage debt. Joe and Jill never reported as income the payments they received on the second mortgage. Advise Joe and Jill on the deductibility of the defaulted mortgage.

**Joe and Jill have a realized gain of \$375,000 on the sale of their principal residence. Because married taxpayers can exclude up to \$500,000 of the gain on the sale of a principal residence (assuming they meet the ownership and use tests), Joe and Jill will not recognize any gain on the sale of their home.**

Amount realized	\$ 650,000
Adjusted basis	(275,000)
Realized gain	\$ 375,000
Exclusion	(375,000)
Recognized gain	<u>\$ -0-</u>

**The question does not have a definitive answer. The IRS will take the position that as cash basis taxpayers, they do not have a basis in the debt until recognition occurs. However, Joe and Jill will take the position that they will never have a basis in the debt, because they were allowed to exclude their entire gain under a special provision in the tax law. Not allowing Joe and Jill a bad debt deduction is inconsistent with the legislative intent of the exclusion which allows a taxpayer to deduct their unrecovered investment (i.e., capital recovery concept).**

75. The city of Stillcreek decides to expand the runway at the local airport. To get the land for the expansion, it condemns the property it needs and pays the owners the current appraised value. Buster's house is condemned, and he is paid \$340,000 for his property. Buster, who is single, had purchased the property for \$70,000 and had made \$30,000 in improvements to it. He plans to use the proceeds to purchase a new residence but is unsure how much he should reinvest in the new home. In addition to the condemnation, 1,000 shares of stock that Buster owns in Cantmis Corporation becomes worthless during the year. His loss on the stock is \$22,000, and he does not anticipate any large capital gains in the next few years. Buster has heard that there have been some changes in the tax law concerning principal residences, and seeks your advice. Discuss Buster's options concerning the condemnation of his property.

**Buster has a realized gain of \$240,000 on the condemnation. The involuntary conversion of a principal residence is treated as a sale of the principal residence. Buster can exclude the entire amount of the gain (\$250,000 maximum for a single taxpayer) since he meets both the ownership test and the use test. The ownership test requires that Buster own the house for at least two of the five years preceding the sale. The use test requires that the house was his principal residence for two of the preceding five years.**

**Because Buster meets both of these tests he can exclude the \$240,000 gain.**

Amount realized	\$ 340,000
Adjusted basis (\$70,000 + \$30,000)	(100,000)
Realized gain	<u>\$ 240,000</u>
Exclusion amount	(240,000)
Recognized gain	<u><u>\$ -0-</u></u>

**Buster does not have the option of recognizing a portion of the gain and excluding a portion of it. Therefore, the \$22,000 loss on the worthless stock is a long-term capital loss. He will only be able to deduct \$3,000 of the loss in the current year.**



**TAX PLANNING CASES**

76. In October 2016, fire completely destroys the principal residence of Olaf, who is 63 and single, and lives in Bemidji, Minnesota. He owned the home for 16 years; his adjusted basis is \$58,000. Olaf receives insurance proceeds of \$200,000.

Olaf plans to move to Scottsdale, Arizona to be near his daughter no later than 2018, when she plans to return there after finishing a five-year tour of duty with the U.S. Foreign Service. Olaf also owns a condominium in Hilton Head, South Carolina, which he paid \$120,000 for in February 2015. Write a letter to Olaf advising him on his options and their tax consequences.

**Olaf has a realized gain of \$142,000 on the condemnation. The involuntary conversion of a principal residence is treated as a sale of the principal residence. Olaf can exclude the entire amount of the gain (\$250,000 maximum for a single taxpayer) since he meets both the ownership test and the use test. The ownership test requires that Olaf own the house for at least two of the five years preceding the sale. The use test requires that the house was his principal residence for two of the preceding five years.**

**Because Olaf meets both of these tests he can exclude the \$142,000 gain.**

Amount realized	\$ 200,000
Adjusted basis	(58,000)
Realized gain	<u>\$ 142,000</u>
Exclusion amount	<u>(142,000)</u>
Recognized gain	<u><u>\$ -0-</u></u>

**Olaf should then move to his condominium in Hilton Head. By converting the Hilton Head condominium to his principal residence, he will be able to exclude any gain on the sale if he meets the two tests previously discussed. Since Olaf will not move to Scottsdale until the year 2018, he should meet both of these tests. Because Olaf used his \$250,000 exclusion on his Bemidji home, he is not eligible to use the \$250,000 exclusion for two years. Therefore, assuming Olaf moves to Hilton Head on November 1, 2016, he could not exclude any portion of the gain on the condominium if he sells it before November 2, 2018.**

77. Ken and Helen own a bed and breakfast in Vermont. They acquired the property in 2001 for \$190,000, and their adjusted basis in it is \$95,000. The property is worth \$260,000, and they have a mortgage of \$100,000. Both are tired of the cold winters and eventually would like to retire in the Southwestern United States. However, Ken and Helen feel that they need to work another 7 or 8 years first. A friend has suggested that they could move now if they can find another bed and breakfast or a small motel in the Southwest and do a like-kind exchange. However their friend warns them: "If you do a like-kind exchange, you better get some tax help and don't make the same mistake I made." After consulting with a regional real estate firm, they find three properties that they are interested in pursuing. Before they go to the expense of visiting the properties, Ken and Helen have come to you for tax advice. They tell you that any cash needed to acquire the new property would come from the sale of stock. The long-term capital gain on the sale would be approximately 70% of the sale proceeds. They are in the 28% marginal tax bracket. Using the information on the three properties below, and determine which property will minimize the tax consequences of the exchange.

Type of Property	Fair Market Value	Mortgage	Cash Received (Paid)
Bed and Breakfast	\$300,000	\$150,000	\$ 10,000
Motel	\$320,000	\$140,000	\$ (20,000)
Bed and Breakfast	\$250,000	\$125,000	\$ 35,000

In some like-kind exchanges, the parties not only exchange properties but also mortgages. In this case, the mortgage debt assumed and relieved is offset to determine whether boot is received or paid. If more debt is assumed than relieved, the result is boot paid from mortgage debt. (The net mortgage assumed is treated as boot paid). If more debt is relieved than assumed, the result is boot received from mortgage debt. (net mortgage relieved is treated as boot received). Cash or boot paid can be used to offset net mortgage relieved. However, a net payer of mortgage boot cannot offset cash boot received by mortgage boot paid. In a like-kind exchange where boot is received, gain is recognized. The amount of gain recognized is the lesser of the boot received or the realized gain. The realized and recognized gain for each of the properties is presented below.

**Realized gain on Bed and Breakfast #1:**

FMV of Bed and Breakfast #1	\$ 300,000
Cash boot received	10,000
Mortgage assumed by Bed and Breakfast #1	100,000
Less: Mortgage assumed by Ken and Helen	<u>(150,000)</u>
Amount realized	\$ 260,000
Less: Adjusted basis	<u>(95,000)</u>
Realized gain	<u>\$ 165,000</u>
Boot received - cash	<u>\$ 10,000</u>
Recognized gain	<u>\$ 10,000</u>
Deferred gain	<u>\$ 155,000</u>

Even though Ken and Helen are a net mortgage payer (\$150,000 assumed - \$100,000 relieved) they must recognize the \$10,000 cash received as gain.

**Motel:**

FMV of Motel	\$ 320,000
Mortgage assumed by motel	100,000
Less: Cash boot paid	(20,000)
Less: Mortgage assumed by Ken and Helen	(140,000)
Amount realized	\$ 260,000
Less: Adjusted basis	(95,000)
Realized gain	<u>\$ 165,000</u>

Recognized gain – no boot received	<u>\$ -0-</u>
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Deferred gain	<u>\$ 165,000</u>
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**Bed and Breakfast #2:**

FMV of Bed and Breakfast #2	\$ 250,000
Cash boot received	35,000
Mortgage assumed by Bed and Breakfast #1	100,000
Less: Mortgage assumed by Ken and Helen	(125,000)
Amount realized	\$ 260,000
Less: Adjusted basis	(95,000)
Realized gain	<u>\$ 165,000</u>

Boot received - cash	<u>\$ 35,000</u>
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Recognized gain	<u>\$ 35,000</u>
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Deferred gain	<u>\$ 130,000</u>
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Even though Ken and Helen are a net mortgage payer (\$125,000 assumed - \$100,000 relieved) they must recognize the \$35,000 cash received as gain.

Assuming they used straight-line depreciation to depreciate the bed and breakfast, Ken and Helen will recognize a \$10,000 gain on the exchange of their property for bed and breakfast #1. The gain will be a Section 1231 gain and will be taxed at a maximum rate of 25% (unrecaptured Section 1250 gain). Assuming they have no other gains and losses during the year, this exchange will increase their tax liability by \$2,500 (\$10,000 x 25%).

Ken and Helen will not recognize any gain on the exchange of their property for the motel. However, they will need to sell stock to pay the \$20,000 necessary for the exchange. Based on the facts of the problem, 70% of the \$20,000 sale proceeds will be treated as a long-term capital gain. Because Ken and Helen will have to pay tax on the sale of the stock (i.e., long-term capital gains rate is 15%), the sales proceeds from the stock sale must be greater than \$20,000 and can be determined using the following formula:

$$\$20,000 = Y - (Y \times 70\% \times 15\%)$$

$$\$20,000 = Y - .105Y$$

$$\frac{\$20,000}{.895} = \frac{.895Y}{.895Y}$$

$$\$22,346 = Y$$

As a result, this exchange will increase their tax liability by \$2,346 [(\$22,346 x 70%) x 15%].

Assuming they used straight-line depreciation to depreciate the bed and breakfast, Ken and Helen will recognize a \$35,000 gain on the exchange of their property for bed and breakfast #2. The gain will be a Section 1231 gain and will be taxed at a maximum rate of 25%. Assuming they have no other gains and losses during the year, this exchange will increase their tax liability by \$8,750 (\$35,000 x 25%).

If Ken and Helen decide to exchange their Vermont property, they would minimize their tax liability by exchanging their property for bed and breakfast #1.

**ETHICS DISCUSSION CASE**

78. Claude is a CPA and a partner with SKH and Associates, a regional public accounting firm. In September 2014, Brokaw Technologies approached one of his clients, Walter Fenner, about acquiring 100 acres of land that Walter owned next to the company's headquarters. To minimize its tax liability, Brokaw was interested in doing a like-kind exchange to obtain the property. Walter was not interested in a like-kind exchange because he wanted to recognize the capital gain from the sale of the land to offset losses he had incurred in the stock market. In November 2014, Brokaw Technology was approached by Simmons Corporation about buying land that Brokaw owned in a neighboring town. Brokaw informed Simmons that it would be interested in doing a like-kind exchange if the corporation could acquire the Walter Fenner's property. Because Fenner was anxious to recognize the capital gain in 2014, Simmons Corporation bought the property from him on December 15, 2014, with the intention of making the exchange with Brokaw Technology. However, because of a legal problem with the title on the Brokaw property, the exchange did not take place until July 1, 2015.

In June 2016, Brokaw Technology becomes a client of SKH and Associates, and Claude is named the partner-in-charge on the engagement. While reviewing the prior year audit workpapers and tax return, he notices that Brokaw acquired the land for its new warehouse in a like-kind exchange. Because the address and description of the property is familiar, Claude obtains the supporting documentation on the transaction from the previous auditors. The documentation confirms that Claude's client, Walter Fenner, did previously own the land acquired in the like-kind exchange. Since Brokaw did not acquire the property within 180 days of Walter's sale of the property, Claude is unsure of Brokaw's treatment of the transaction as a like-kind exchange. A closer look at the supporting documentation shows the date Simmons acquired the property from Walter as January 15, 2015. The chief financial officer of Brokaw tells him "I remember it took a little longer than we expected because of some legal issues concerning title to the property we owned. As to when Simmons acquired the property, that is documentation Simmons provided to us." Claude is sure that the CFO is not telling him the whole story. However, he is unsure how to proceed. What is Claude's obligation under the Statements on Standards for Tax Services (which can be found at [www.cengagebrain.com](http://www.cengagebrain.com)) concerning Brokaw's 2015 return and the preparation of its 2016 return?

**Simmons Corporation, Brokaw Corporation, and Walter Fenner are attempting to engage in a deferred (i.e., third party) like-kind exchange. Therefore, even though Brokaw and Simmons do not originally own the property that eventually will be exchanged, it will be treated as a like-kind exchange if the following requirements are met.**

**To qualify as a deferred exchange, the exchange of the assets does not have to occur simultaneously. However, to qualify for like-kind treatment, the assets to be exchanged must be identified within 45 days of the first asset transfer and the exchange must be completed within 180 days of the first transfer.**

**Brokaw and Simmons meet the first requirement since the property to be exchanged was identified in the first 45 days (it was the initial transaction in the exchange). However, because Simons and Brokaw did not complete the exchange within 180 days (December 15, 2014 to July 1, 2015 > 180 days), the transaction does not qualify for like-kind exchange treatment.**

**Statements on Standards for Tax Services (SSTS) #3 allows a CPA to rely on information provided by a client. However, if the information appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the CPA, SSTS #3 requires the CPA to make reasonable inquiries about the information provided. SSTS #3 advises the CPA to encourage the client to provide supporting data where necessary. That is, if the CPA has reason to believe, based on other information known to the CPA, that the amounts reported may be incorrect, the CPA should ask the client to provide the supporting documentation to avoid misunderstandings, inadvertent errors, and possible administrative actions (audits) in the future. The CPA should also consider relevant information from the returns of other clients if the information is necessary to properly prepare a return and the use of the other information does not violate any law or rule relating to confidentiality.**

**Applying these requirements to this case, Claude's knowledge of Walter Fenner's return requires him to examine the return (assuming that his firm still prepares the return). An examination of Walter's 2014 return will show the correct date of the sale. If the date of the original exchange is December 15, 2014 (and not January 15, 2015), the CPA should discuss the problem with Brokaw and advise it that the transaction does not qualify for like-kind exchange treatment.**

**Claude is required by SSTS #6 to inform the client of the error in the prior years' tax return. Paragraph (.03) states that upon becoming aware of an error in a client's previously filed return, the CPA should recommend appropriate measures to correct the error. In this case, Brokaw (or Claude's firm on Brokaw's behalf) should file an amended return for 2015. If the client files an amended return, then Claude's firm can prepare the 2016 return. If the client does not agree to file an amended return, then paragraph (.04) of SSTS #6 requires the CPA to consider whether to withdraw from the engagement.**

**Claude should probably consider consulting the firm's own legal counsel before deciding whether to withdraw from the engagement. The potential exists for the firm to violate Rule 301 of The Professional Code of Conduct (relating to confidential client relationship). Under this rule, conversations between Claude and Brokaw are privileged communication and cannot be disclosed without the client's permission. However, because Claude's firm has only reviewed the prior years' tax return and has yet to prepare the current year's tax return, the firm probably has not violated Rule 301.**

**Also, SSTS #6 requires that if the CPA prepares the return, the CPA should insure that the error is not repeated. Since the error occurred when another firm prepared the return, it is unlikely that the error will occur again.**

## Chapter 12

### Check Figures

18. N/A
19.
 

a. Does not meet requirements	b. Meets the requirements
c. Meets the requirements	d. Rebecca and Louise meet the requirements
e. Does not meet requirements	
20.
 

a. Not like-kind	b. Not like-kind
c. Not like-kind	d. Not like-kind
e. Not like-kind	
21.
 

a. Not like-kind	b. Like-kind
c. Not like-kind	d. Like-kind for business portion
e. Like-kind	
22. Recognized gain \$5,000
23. Recognized gain \$0
24.
 

a. Realized loss \$2,000	b. Recognized loss \$0
c. Deferred loss \$2,000	d. \$29,000
25.
 

a. Realized gain \$5,000	b. Recognized gain \$0
c. Deferred gain \$5,000	d. \$17,000
26.
 

a. Amount realized \$75,000	b. Realized gain \$35,000
c. Recognized gain \$10,000	d. Capital gain \$10,000
e. \$40,000	
27.
 

a. Realized gain \$7,000	b. Recognized gain \$7,000
b. Ordinary income \$7,000	d. \$42,000
28.
 

a. Realized loss \$3,000	b. Recognized loss -0-
c. Not required to characterize	d. \$3,000
e. \$15,000	
29.
 

a. Yes	b. Realized loss \$15,000
c. \$0	d. Not required to characterize
e. \$15,000 deferred	f. \$135,000
30.
 

a. No	b. Recognized gain \$500,000
c. \$700,000	
31. Fremont: Realized gain - \$24,000; Recognized gain \$0; basis - \$30,000  
Demont: Realized loss - \$6,000; Recognized loss \$0; basis - \$50,000
32. Structure as sale
33.
 

a. If exchange, no loss recognized	b. \$55,000
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34. Realized gain - \$400; Recognized gain \$0; basis - \$5,800

35. Ordinary income \$2,200
36. a. Boot received \$20,000  
c. \$230,000
37. a. Realized gain \$13,000; Recognized gain \$3,000; basis \$24,000  
b. Realized gain \$16,000; Recognized gain \$5,000; basis \$26,000
38. a. Oscar must pay \$10,000  
c. Recognized gain \$10,000
39. Initially no gain; Constance \$2,000 and \$3,000 gain, Cynthia \$9,000 gain
40. \$5,000 deferred gain; recognized ordinary income (1245 recapture) of \$7,000
41. a. Not qualified replacement  
c. Qualified replacement  
e. Qualified replacement
42. a. Qualified replacement  
c. Not qualified replacement
43. Realized loss \$25,000; Recognized loss \$25,000
44. a. Realized gain \$210,000  
c. \$460,000
45. Elect to recognize gain if it has NOLs or capital losses
46. a. Recognized gain \$165,000  
c. Recognized gain \$60,000; basis \$375,000
47. Recognized gain \$40,000; basis \$0
48. a. S - \$32,000 Y - \$61,000 SB - \$20,000 loss FB - \$30,000  
b. S - \$2,000 Y - \$0 SB - \$20,000 loss FB - \$30,000  
c. S - \$18,000 Y - \$89,000 SB - \$95,000 FB - \$80,000
49. a. -0- b. Recognize gain to utilize NOL
50. a. Recognized loss \$0  
c. Recognized gain \$0
51. a. Recognized gain \$0  
c. Recognized gain \$41,250
52. a. Recognized gain \$0; basis \$155,000 b. Recognized gain \$10,000; basis \$155,000
53. a. Recognized gain \$0; basis \$225,000 b. Recognized gain \$45,000; basis \$225,000
54. a. Recognized gain \$0  
c. Recognized gain \$55,000
55. No gain recognized