

Chapter 7

Property Dispositions

Solutions to Develop Research Skills

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

61. *Property Transactions (can be solved using free Internet sources)*

A number of specific transactions do not necessarily follow the general tax provisions applicable to property transactions. Following are a group of transactions that are subject to specific tax provisions. For each of the situations, you are to answer the questions and cite the source for your answer.

- a. Martin, a securities dealer, bought 100 shares of Datacard stock on April 5 of year 5 for \$10,500. Before the end of that day he identified the stock as being held for investment purposes.
 1. Never having held the stock for sale to customers, he sold the stock on May 22 of year 6 for \$11,500. How much and what kind of gain or loss does he have?
 2. Assume that later in year 5 he starts trying to sell the stock to customers and succeeds in selling it on May 1 of year 6 for \$9,000. How much and what kind of gain or loss does he have?
- b. Ruth subdivided a piece of real estate she had owned for seven years into 12 lots. Each lot was apportioned a \$10,000 basis. In year 2, she sold four lots for \$15,000 apiece with selling expenses of \$500 per lot.
 1. How much and what kind of gain or loss does Ruth have?
 2. If, in year 3, she sold two more lots for \$20,000 apiece and incurred selling expenses of \$500 per lot, how much and what kind of gain or loss does she have?
- c. For 60 years, Shakia owned 1,000 acres of land in Kentucky on which coal was being mined under a royalty arrangement. Shakia received \$164,000 in the current tax year in royalties. The coal's adjusted basis for depletion was \$37,000. Determine the amount and type of gain Shakia realizes on the income.
- d. Howard owned a large farm on which he raised a variety of farm animals. Determine the type of gain or loss he would realize on the following sales:
 1. a six-month-old calf
 2. a 1-1/2 -year-old foal
 3. six-week-old chickens
 4. a 6-year-old bull
 5. a 12-year-old mare
 6. six-month-old lambs
 7. a 2-year-old ram

Solution: Hint: The answers are found in the Internal Revenue Code.

- a. 1. Under 1236(a), a gain by a dealer may be treated as a capital asset providing the security was, before the close of the day on which it was acquired, clearly identified in the dealer's

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records as a security held for investment. In addition, the security may not, at any time after the close of such day, be held by the dealer primarily for sale to customers in the ordinary course of his trade or business. As such, Martin meets the requirements under Section 1236(a) and will be permitted to treat this as a sale of a capital asset rather than a sale of inventory. Thus, Martin's \$1,000 gain (\$12,500 – \$11,500) is a long-term capital gain.

2. Under Section 1236(b), if at any time the security was clearly identified in the dealer's records as a security held for investment, an ordinary loss can not be recognized. Therefore, Martin is required to treat the \$1,500 loss (\$9,000 – \$10,500) as a capital loss. Even though it was placed back into inventory, ordinary loss treatment is not permitted.

b. 1. Under Section 1237(a), a taxpayer is not considered to be a real estate dealer solely because the taxpayer subdivided the tract of real property for purposes of sale. Furthermore, the real property must be held by the taxpayer for a period of 5 years. Providing that no substantial improvement has been made to the land, Ruth will be entitled to treat the profit from the sale as a long-term capital gain. Her LTCG from the sale of the four lots is \$18,000 [4 x (\$15,000 - \$10,000 - \$500)].

2. Section 1237(b) states that if more than 5 lots contained in the same tract of real property are sold, the gain from the sale of any lot shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of business to the extent of 5 percent of the selling price. In year 3, Ruth sold the 6th lot. Pursuant to this section, Ruth may be required to recognize five percent of the selling price for the lots sold this year (and in any future years) as potential ordinary income. Expenses incurred will be used to reduce the ordinary income. From the sale of the two lots sold in year 3, Ruth will have \$1,000 of ordinary income and \$18,000 of long-term capital gain. This is calculated following the examples provided in Regulation 1.1237(e)(2):

Selling Price (\$20,000 x 2)	\$40,000
Basis (\$10,000 x 2)	<u>(20,000)</u>
Excess over basis	\$20,000
5% of selling price (\$40,000 x 5%)	\$2,000
Less: Expenses of sale (\$500 x 2)	<u>(1,000)</u>
Amount of gain realized that is treated as ordinary income	<u>\$1,000</u>
Excess over basis	\$20,000
Less: 5% of selling price	(2,000)
Less: Excess of expenses over 5% of selling price	<u>(0)</u>
Amount of gain realized that is treated as long-term capital gain	<u>\$18,000</u>

c. Pursuant to Section 631(c), the difference between the amount realized from the disposal of coal and the adjusted depletion basis shall be considered as though it were a gain or loss, providing the property was held more than 1 year and the owner retains an economic interest in the coal. Based on the facts provided, Shakia appears to meet these requirements. Shakia has owned the property for 60 years and retains an economic interest in the coal, even though it is mined through a royalty arrangement by another party. Following the provisions of this section, she has a long-term capital gain of \$127,000 (\$164,000 – \$37,000) on the sale of the coal.

d. Pursuant to Section 1231(a)(3), a Section 1231 gain or loss is any recognized gain or loss on the sale or exchange of property used in the trade or business. Under Section 1231(b)(3), certain requirements must be met for livestock to be treated as a Section 1231 asset. Cattle and horses, regardless of age, must be held by the taxpayer for 24 months or more from the date of acquisition. Other livestock, regardless of age, must be held by the taxpayer for 12 months or more from the date of acquisition. Poultry is not included under the definition of livestock for

purposes of Section 1231 treatment. If the animals do not meet these requirements, Howard will have ordinary income. Based on the facts provided and assuming that Howard owned the animals since birth, the following is Howard's treatment for the sale of each of the listed animals:

1. Ordinary; 2. Ordinary; 3. Ordinary; 4. Section 1231; 5. Section 1231; 6. Ordinary 7. Section 1231.

62. *Sale of Incomplete Equipment (can be solved using free Internet sources)*

A subsidiary of Corporation A, an electrical utility located in Springfield, and a subsidiary of Corporation B, a diversified manufacturer also located in Springfield, formed a joint venture under the general partnership laws of their state. The partnership was formed to construct and ultimately operate another electrical generating plant. Sufficient excess space was provided at the plant site to accommodate substantial future additions to the initial generating equipment. Three years after construction of the generating equipment had been started and was 50 percent complete, the partnership on the advice of its financial counselors began negotiations with a consortium of businessmen for the possible sale and leaseback of the generating equipment. Thirteen months later, when the plant was complete, the deal was finally made with the consortium for the sale and leaseback of the generating equipment. The sale resulted in a gain of \$500,000 that the partnership treated as \$250,000 of Section 1231 gain and \$250,000 as ordinary income. Was the partnership correct in its determination of the type of gain recognized?

Hint: Rev. Rul. 75-524, 1975-2 CB 342; PLR 9147004.

Issue: What is the proper treatment of the gain recognized from the sale and leaseback of the generating equipment?

Conclusion: The partnership should treat one-half of the gain as Section 1231 gain and the other half as ordinary income.

Discussion of Reasoning and Authorities: From the beginning, the joint venture's purpose was to build and operate the generating plant. The joint venture was not formed for the purpose of selling the generating plant. It was only after three years, on the advice of its financial advisors, that the partnership considered the sale and leaseback of the property. These facts are nearly identical to those in PLR 9147004. Under this private letter ruling, the issue regarding the sale/leaseback was whether the plant might be property held by the partnership for sale to customers in the ordinary course of its trade or business. Since the partnership's initial intention was not to sell the plant, but rather to construct, own and operate the plant, it was determined that the sale/leaseback met the requirements for Section 1231 treatment.

In Rev. Rul. 75-524, the IRS provided that only the gain on that portion of the property actually completed prior to 6 months before the date of sale is considered as held for more than 6 months for purposes of Section 1231 treatment. The portion that was not completed before the 6 month period prior to sale will be treated as ordinary income. The law has since been revised to make the requisite holding period one year. The facts provide that at the time negotiations began, which was 13 months prior to the sale date, the equipment was 50 percent completed. Although the generating equipment was completed by the time of sale, only 50 percent of the construction was complete at least one year prior to the sale. Therefore, the portion of construction that was completed more than one year prior to the sale will be given Section 1231 treatment. As such, 50 percent of the gain would be Section 1231 gain. The remaining 50 percent of the gain would be ordinary income.

63. *Sale of Property Held for Expansion (can be solved using Checkpoint® or a similar service)*

Sheralyn was in the wholesale distribution business for pecans and peanuts grown in Georgia. She and her brother owned and operated several warehouses. Seven years ago, they purchased property for another warehouse in the eastern part of Georgia because the nut crop had been getting

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progressively larger over the past several years. Early last year they had plans drawn up for the warehouse and had gotten several bids from contractors. Unfortunately, Sheralyn's brother was killed in an auto accident just days before they were to sign papers to begin the construction. Sheralyn knew that she would not be able to manage their existing warehouses and oversee the construction of this new facility. She abandoned plans to construct the warehouse and put the property up for sale. It was sold early this year at a \$125,000 loss. How should Sheralyn treat the loss on the sale?

Hint: *Carter-Colton Cigar Company*, 9 T.C. 219

Issue: What is the character of the loss realized by Sheralyn's business as a result of the sale of the property?

Conclusion: Sheralyn's business will be able to recognize a Section 1231 loss on the sale of the property.

Discussion of Reasoning and Authority: In *Carter-Colton Cigar Company vs. Comm.* (9 T.C. 219), the petitioner purchased unimproved real estate with the intention of erecting a building to be used by the business. Plans and specifications were prepared, but the original purpose was later abandoned after one of the owners died. The property was then sold at a loss. The Court found that since the property was originally intended to be used in the business, but was later sold as a result of unforeseen circumstances, the loss would be treated as ordinary as opposed to capital. Similar to the Carter-Colton case, Sheralyn's abandonment of the original plans to develop the property should not cause the property to be treated as a capital asset. Given the intervening death of her brother, there was a reason for Sheralyn to abandon construction and sell the land. Therefore, the loss resulting from the sale is not a capital loss, but rather a Section 1231 loss.