

Chapter 8

Tax-Deferred Exchanges

Solutions to Develop Research Skills

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

58. *Exchange of Intangibles (can be solved using free Internet sources)*

Barry is very dedicated to the arts and has made a career of purchasing copyrights to various art forms. Once purchased, he publicizes these works to capitalize on the copyrights and has been very successful. Last year, he acquired a book manuscript that he believes would be better suited to a mainstream publisher. He approaches a publisher about trading the book copyright for the copyright on the words and music for a new musical comedy that he heard the publisher had acquired. Will the exchange qualify as like-kind exchange?

Hint: Regulation Section 1.1031(a)-2(c)(3)

Issue: Will the exchange qualify as a like-kind exchange?

Conclusion: No, the exchange will not qualify as like-kind.

Discussion of Reasoning and Authorities: According to Example 2 provided in Regulation §1.1031(a)-2(c)(3), exchanging a copyright on a novel for a copyright on a song will not constitute a like-kind exchange.

59. *Disease as Casualty (can be solved using Checkpoint® or a similar service)*

Cheryl owned six horses that she and her family used for riding and occasionally showing in hunter-jumper competitions. At the beginning of May, one of the horses showed signs of severe illness and was diagnosed with equine encephalitis. She was required to destroy all of her horses, none of which was insured. The horses had been purchased for \$23,000 but had a current value of \$45,000. What type of a loss does Cheryl have on these horses?

Hint: Rev. Rul. 61-216, 1961-2 C.B. 134

Issue: What type of loss does Cheryl have resulting from the destruction of the horses?

Conclusion: Cheryl has a Section 1231 loss, but she will not be permitted a deduction since the horses were for personal use and not related to a trade or business.

Discussion of Reasoning and Authorities: Because the illness and destruction did not meet the suddenness criteria, it could not be considered a casualty as described under §165(c)(3) and 1231(a). According to Rev. Rul. 61-216, when livestock is destroyed by or on account of disease, the destruction is treated as an involuntary conversion as described in §1033(e). Section 1231(a) governs the loss treatment for the involuntary conversion. The treatment provided by Section 1231(a) is applicable in appropriate cases to a loss caused by the death of livestock from disease, assuming such diseased livestock are property used in the trade or business or capital assets held for more than one year. Thus, the loss is considered a Section 1231 loss. However, Section 1231

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only allows a deduction for capital assets used in a trade or business or held for the production of income. As the horses are for personal use, no deduction is permitted.

60. *Corporate Formation (can be solved using Checkpoint® or a similar service)*

Joe, June, and Jim, three co-workers decide that they want to start their own business. Joe has \$200,000 to contribute, June has equipment valued at \$100,000 (basis = \$90,000) and Jim has real estate suitable for the business valued at \$200,000 (basis = \$110,000). Joe and Jim are each to receive 40 percent of the corporate stock and June is to receive 20 percent. Joe and June transfer title to their property to the corporation immediately. When Jim tries to transfer title to the real estate to the corporation, several legal errors in the title are discovered and he is unable to transfer title until the errors are corrected. Correcting the errors takes over 14 months. In the meantime, the corporation begins operating, renting the building from Jim. In the 15th month, Jim is able to transfer title and receive his stock. Is Jim eligible to use the nonrecognition provisions of Section 351 on this transfer?

Hint: Regulation Section 1.351-1(a)(1) and *Marsan Realty Corp*, TC Memo 1963-297, PH TCM ¶63297, 22 TCM 1513 (1963)

Issue: Will Jim's contribution of the property to the corporation in exchange for stock qualify for nonrecognition under Section 351?

Conclusion: The delay of the contribution should not prohibit Jim from qualifying for nonrecognition under Section 351.

Discussion of Reasoning and Authorities: Regulation §1.351-1(a)(1) states that in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock, such persons must be in control of the corporation to which the property was transferred immediately after the exchange. The regulation further provides that the phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. According to the facts of this case, the delay in transfer was not the result of any action on Jim's part, but due to the legal complications arising from the title transfer. In *Marsan Realty Corp*, TC Memo 1963-297, PH TCM ¶63297, 22 TCM 1513 (1963), it was held that a late transfer qualified where it was clear that the transferors were all obligated to make a transfer of property to a corporation, and the transferors as a group were in control immediately after the transfer even though one of the transferors, due to mere procrastination, did not make his transfer until eight months after the other transfers were made. Jim transferred the title to the corporation as soon as the legal complications were rectified and in the interim, made the building available for use. The facts indicate that Jim had an obligation and intended to transfer the property pursuant to the defined agreement. Therefore, Jim should be eligible to qualify for nonrecognition under Section 351.