Chapter 2
Property: Dispositions

SOLUTIONS MANUAL

Discussion Questions

1. [LO 1] Compare and contrast different ways in which a taxpayer triggers a realization event by disposing of an asset.

   A realization event for tax purposes is created in many ways. Virtually any disposal will result in a sale or other disposition. These include a sale, trade, gift to charity, disposal to the landfill, or destruction in a natural disaster. In a sale or trade (exchange), the taxpayer receives something of value in return for the asset. In contrast, a charitable contribution, disposal, or destruction from a natural disaster generally results in a loss of any remaining basis in the asset without compensation (unless reimbursed by insurance).

2. [LO 1] Potomac Corporation wants to sell a warehouse that it has used in its business for 10 years. Potomac is asking $450,000 for the property. The warehouse is subject to a mortgage of $125,000. If Potomac accepts Wyden Inc.'s offer to give Potomac $325,000 in cash and assume full responsibility for the mortgage on the property, what amount does Potomac realize on the sale?

   When the property disposed of is subject to a liability and the buyer assumes the liability, the relief of debt increases the amount realized. Thus, Potomac's amount realized consists of $450,000, which is cash of $325,000 plus $125,000 relief of debt. This result assumes that the buyer hypothetically transfers cash to the seller in order to pay off the mortgage.

3. [LO 1] Montana Max sells a 2,500-acre ranch for $1,000,000 in cash, a note receivable of $1,000,000 and debt relief of $2,400,000. He also pays selling commissions of $60,000. In addition, Max agrees to build a new barn on the property (cost $250,000) and spend $100,000 upgrading the fence on the property before the sale. What is Max's amount realized on the sale?

   $4,340,000. Anything received by the seller during a sale or exchange is included in the amount realized. Most dispositions result in cash to the seller. However, amount realized includes, but is not limited to, cash, the fair market value of any other property received (e.g. marketable securities or a similar asset), or relief of debt. In addition, selling expenses reduce the amount realized. Therefore, Max's amount realized includes the $1,000,000 of cash, $1,000,000 note receivable, relief of debt of $2,400,000, and is reduced by selling commissions of $60,000 (selling expenses reduce the amount realized, S.C. Chapin, CA-8, 50-1 USTC ¶9171). Anything the seller gives up in the

transaction is added to the basis of the property given up and is not considered part of the amount realized. Therefore, the barn and fence improvements are not considered part of Max's amount realized. Note, however, that making these improvements decreases his realized gain by increasing Montana Max's adjusted basis in the property due to the improvements.

4. [LO 1] Hawkeye sold farming equipment for $55,000. It bought the equipment four years ago for $75,000, and it has since claimed a total of $42,000 in depreciation deductions against the asset. Explain how to calculate Hawkeye's adjusted basis in the farming equipment.

   Hawkeye will calculate its adjusted basis in the farming equipment by reducing the historical cost by any cost recovery deductions taken—namely, depreciation. Therefore, Hawkeye's adjusted basis is $33,000 ($75,000 less $42,000). The tax adjusted basis is usually different than the book adjusted basis. This is because most assets use a different recovery period, cost recovery method (e.g. double declining balance), and convention (e.g. half-year) for tax than for book purposes. See Chapter 10 for how these differences arise. Due to the difference in cost recovery deductions, the adjusted basis is likely different unless the asset is fully depreciated for both book and tax purposes.

5. [LO 1] When a taxpayer sells an asset, what is the difference between realized and recognized gain or loss on the sale?

   The realized gain or loss is simply the amount realized less the adjusted basis of the asset sold. Every sale or disposition results in a realized gain or loss (unless, of course, the amount realized is equal to the adjusted basis). Most realized gains or losses become recognized gains or losses and are included on the taxpayer's tax return and increases (or decreases in the case of a loss) the taxpayer's taxable income and subsequent tax. However, there are some realized gains or losses that are excluded from income or deferred to a later time period.

6. [LO 2] What does it mean to characterize a gain or loss? Why is characterizing a gain or loss important?

   Once a gain or loss is recognized, a taxpayer must determine how the recognized gain or loss affects the taxpayer's tax liability. The character depends on a combination of two factors: purpose or use of the asset and holding period. The purpose or use of the asset is important because the law does not treat all assets equally. The general use categories are: (1) trade or business, (2) for the production of income (rental activities), (3) investment, and (4) personal. Based on these criteria, we can categorize an asset into one of three groups: (1) ordinary, (2) capital, or (3) §1231. Characterizing the gain or loss is important because the tax treatment for gains and losses vary depending on the character. Ordinary gains and losses are taxed at ordinary income rates,

regardless of the holding period. Capital gains on assets held for more than a year have preferential tax rates for non-corporate taxpayers while capital gains on assets held for one year or less do not. §1231 gains and losses receive the best of both worlds—the gains become long-term capital gains and the losses become ordinary. However, to qualify as a §1231 asset, the asset must be used in a trade or business for more than a year.

7. [LO 2] Explain the difference between ordinary, capital, and §1231 assets.

   An ordinary asset is an asset that is held for sale in the ordinary course of a taxpayer's business (e.g. inventory) or arises from sales in the ordinary course of business (e.g. accounts receivable). Capital assets are held for investment (expecting appreciation) or are personal-use assets (e.g. a taxpayer's personal belongings). §1231 assets are used in a trade or business or for the production of income and are held for more than one year. An asset that is used in a trade or business or for the production of income and is held for one year or less is an ordinary asset. Gains on personal use property are capital gains while losses are non-deductible.

8. [LO 2] Discuss the reasons why individuals generally prefer capital gains over ordinary gains. Explain why corporate taxpayers might prefer capital gains over ordinary gains.

   Individual taxpayers prefer capital gains because they may be taxed at preferential rates. Net long-term capital gains are taxed at preferential rates (0, 15, or 20 percent). Short-term capital gains are simply taxed at ordinary rates. Capital gains can offset capital losses, while ordinary gains cannot. Additionally, individual taxpayers can offset $3,000 of net capital losses against ordinary income and carry the remaining capital loss forward indefinitely.

   Even though corporate taxpayers are taxed at the same rate on ordinary income and capital gains, they prefer capital gainsbecause capital gains can offset capital losses. Capital losses cannot be used to offset ordinary income; therefore, capital gains allow corporate taxpayers to benefit from their capital losses. Corporate taxpayerscan carry capital losses back three years and forward five years. However, after the carry back and carry forward periods expire, capital losses expire and are worthless.

9. [LO 2] Dakota Conrad owns a parcel of land he would like to sell. Describe the circumstances in which the sale of the land would generate §1231 gain or loss, ordinary gain or loss, or capital gain or loss. Also, describe the circumstances where Dakota would not be allowed to deduct a loss on the sale.

   The parcel of land could qualify as a capital asset if it is held by Dakota as an investment (e.g. the purpose for holding the land is for expected appreciation in value). The land could qualify as a §1231 asset if Dakota uses it in a trade or

business such as a sole-proprietorship or for the production of income (a rental property) and he uses it for these purposes for more than one year. The land could be ordinary income property to Dakota if it is held in a trade or business or for the production of income for one year or less or if it is considered to be inventory (for example a real-estate dealer). The loss would be non-deductible to Dakota if he held the land for personal-use purposes.

10. [LO 2] Lincoln has used a piece of land in her business for the past five years. The land qualifies as §1231 property. It is unclear whether Lincoln will have to recognize a gain or loss when she eventually sells the asset. She asks her accountant how the gain or loss would be characterized if she decides to sell. Her accountant said that selling §1231 assets gives sellers "the best of both worlds." Explain what her accountant means by "the best of both worlds."

    An asset qualifies as a §1231 asset if used in a trade or business or held for the production of income for more than one year. The tax treatment is sometimes described as receiving "the best of both worlds" because ***net*** *gains receive capital gain treatment and* ***net*** *losses receive ordinary loss treatment. Capital gains are preferable because they are taxed at a preferential rate (for non-corporate taxpayers) and can offset capital losses, which cannot always be offset against ordinary income. Ordinary losses are preferred to capital losses because they offset ordinary income in the current year rather than being accumulated to offset future capital gains.*

11. [LO 3] Explain Congress's rationale for depreciation recapture.

    The purpose of depreciation recapture is to treat the gain on the sale of depreciable assets as ordinary income to the extent the gain is attributable to depreciation (or other cost recovery deductions). The MACRS system allows accelerated deductions that oftenreduce the basis of an asset faster than the real economic decline in value. Thus, depreciation deductionsgenerate an artificial gain on the disposition of depreciable assets. The recapture rules ensure that some or all of the artificial gain is characterized as ordinary similar to the depreciation deductions that created the artificial gain. It is important to note that depreciation recapture does not affect the amount of the gain; rather it affects only the character of the gain. Additionally, depreciation recapture only applies to sales or dispositions resulting in gains (e.g. it does not apply to losses).

12. [LO 3] Compare and contrast §1245 depreciation recapture and §1250 depreciation recapture.

    §1245, sometimes referred to as full recapture, generally applies only to tangible personal property. §1245 recaptures the lesser of the realized gain or the depreciation taken on the asset as ordinary income—thus the full amount of the gain may be recaptured. §1250, sometimes referred to as partial recapture,

applies to real property depreciated under accelerated depreciation methods and real property held 12 months or less.§1250 recapture is relatively rare because real property has been depreciated under the straight-line method since 1987. Property placed in service before 1987 is now fully depreciated, regardless of whether accelerated or straight-line methods were used; as a result, there is no excess depreciation to recapture. However, taxpayers who depreciate real property and hold it for 12 months or less will be subject to §1250 recapture on the full amount of depreciation taken. In addition,§291 and unrecaptured §1250 apply to gains on real property for corporations and non-corporate taxpayers, respectively.

13. [LO 3] Why is depreciation recapture not required when assets are sold at a loss?

When an asset is sold for less than the adjusted basis (basis less cost recovery), there is no depreciation recapture. This is because the real economic value of the asset declined faster than it was depreciated for tax purposes. Therefore, the loss is simply the recovery of the remaining basis in the asset. Depreciation recapture is intended to classify any gain due to prior depreciation as ordinary in character.

14. [LO 3] What are the similarities and differences between the tax benefit rule and depreciation recapture?

Conceptually, both depreciation recapture and the tax benefit doctrine require a taxpayer to take into income an amount deducted in a prior year. However, depreciation recaptureonly recharacterizes the already existing gain from §1231 to ordinary because the taxpayer received an ordinary deduction in the past and requires the amount to be included into ordinary income in the year of sale. Depreciation recapture does not change the amount of the gain. In contrast, the tax benefit doctrine requires a taxpayer to take into income an amount received when an expense was taken in a prior year. For example, if a taxpayer deducts (receives a benefit) state income taxes paid during the year paid, but receives a tax refund in a subsequent year, the taxpayer must include the refund into income.

15. [LO 3, 4] Are both corporations and individuals subject to depreciation recapture when they sell depreciable real property at a gain? Explain.

Both taxpayers used to be subject to §1250 recapture when selling real property. However, because there is no longer any accelerated depreciation on most real property, there is generally no longer any §1250 recapture unless the property is held for 12 months or less on the date of disposition. However, real property sold at a gain is subject to other types of recapture rules. Corporate taxpayers are subject to §291 recapture and non-corporate taxpayers are subject to unrecaptured §1250 rules.

§291 requires corporate taxpayers to recapture 20 percent of the lesser of the gain realized or accumulated depreciation taken. The recaptured portion of the gain is taxed as ordinary income. The remaining gain is §1231 gain.

Non-corporate taxpayers must recognize the lesser of the gain realized or the accumulated depreciation taken as unrecaptured §1250 gain. Unrecaptured §1250 gain is still §1231(not ordinary) gain, but it will be taxed at a maximum rate of 25 percent. The remaining gain is §1231 gain.

16. [LO 4] How is unrecaptured §1250 gain for individuals similar to depreciation recapture? How is it different?

Unrecaptured §1250 gain is similar to depreciation recapture in that the lesser of accumulated depreciation or the gain realized on the sale is separated from the §1231 gain. The difference is that the amount is taxed at a taxpayer's ordinary rate up to a maximum rate of 25 percent; whereas depreciation recapture is taxed at ordinary rates with no maximum rate.

17. [LO 4] Explain why gains from depreciable property sold to a related taxpayer are treated as ordinary income under §1239.

§1239 requires gains on depreciable property sold to related taxpayers to be taxed at ordinary rates because the basis of these assets will be recovered through ordinary depreciation deductions. This rule is essentially like reverse depreciation recapture in that it taxes future depreciation at ordinary rates rather than past depreciation at ordinary rates. The related person definition includes an individual and his controlled corporation or partnership or a taxpayer and any trust in which the taxpayer (or spouse) is a beneficiary.Additional related parties for purposes of §1239 include two corporations that are members of the same controlled group, a corporation and a partnership if the same person owns more than 50 percent of both entities, two S corporations controlled by the same person, and an S corporation and a C corporation controlled by the same person.

18. [LO 5] Bingaman Resources sold two depreciable §1231 assets during the year. One asset resulted in a large gain (the asset was sold for more than it was purchased for) and the other resulted in a small loss. Describe the §1231 netting process for Bingaman.

Bingaman would first determine the gain or loss on each asset. For the gain asset, Bingaman would then determine the depreciation recapture and would recharacterize the gain as ordinary to the extent of depreciation allowed. The remaining gain (the amount in excess of the original basis) would be classified as a §1231 gain. Bingaman would combine the §1231 gain and the loss from the other asset in the §1231 netting process. If the result from combining the gain and loss was a gain, Bingaman would apply the §1231 look-back rule. After

applying the look-back rule, any remaining gain would become treated as a long-term capital gain and enter the capital gains netting process. If the result of the initial§1231 netting process was a loss, the gains and losses would be treated as ordinary gains and losses.

19. [LO 5] Jeraldine believes that when the §1231 look-back rule applies, the taxpayer deducts a §1231 loss in a previous year against §1231 gains in the current year. Explain whether Jeraldine's description is correct.

Jeraldine's description is incorrect. The §1231 look-back rule simply recharacterizes §1231 gain into ordinary gain. This is done to the extent that prior §1231 losses in the prior 5 years received ordinary loss treatment. Jeraldine is correct in that the §1231 gains in the current year are offset against prior §1231 losses—to the extent they haven't been recaptured through the §1231 look-back rule in prior years.

20. [LO 5] Explain the purpose behind the §1231 look-back rule.

The favorable rules of §1231 allow a taxpayer to treat a net §1231 loss as an ordinary loss. The §1231 look-back rule applies when a taxpayer has a net §1231 gain for the year thatwill receive capital gain treatment. The rule recharacterizes the gain to ordinary to the extent the taxpayer received favorable ordinary loss treatment in the prior five years (that have not yet been recaptured). This prevents taxpayersfrom timing their sales of loss assets in one year to receive ordinary treatment and selling their gains in a subsequent year to obtain capital gain treatment.

Without the look-back rule, taxpayers could separate the years in which it sells its gain and loss assets. For example, a taxpayer could sell its loss asset on December 31, year 1 and sell its gain asset on January 1, year 2. This would allow the loss asset to receive ordinary treatment and be offset against ordinary income. The gain asset would be treated as a long-term capital gain, which would be taxed at preferential rates by non-corporate taxpayers.

21. [LO 5] Does a taxpayer apply the §1231 look-back rule in a year when the taxpayer recognizes a net §1231 loss? Explain.

The look-back rule exists to prevent game playing (arbitrage) opportunities. It prevents taxpayers from selling their §1231 loss assets in one year and receiving ordinary loss treatment and then selling their §1231 gain assets in a subsequent year and receiving capital gain treatment. However, if the taxpayer does not have a net §1231 gain in the subsequent years, it can be assumed they are not manipulating the situation, and the look-back rule does not apply to a year in which there is a net §1231 loss.

22. [LO 4, 5] Describe the circumstances in which an individual taxpayer with a net §1231 gain will have different portions of the gain taxed at different rates.

    Non-corporate taxpayers can have §1231 gains taxed at different capital gains rates. Most §1231 gains (from tangible personal property and land) will give rise to regular long-term capital gain, which is treated as a gain to be taxed at a maximum rate of 0/15/20 percent (0 percentif the taxable income including capital gains is less than the maximum zero percent threshold, 20 percent if taxable income is greater than the maximum 15-percent threshold, and 15 percent otherwise). The §1231 gains from real property that are referred to as unrecaptured §1250 gains will be taxed a maximum rate of 25 percent(e.g. at the taxpayer's marginal rate unless his rate exceeds 25 percent). Thus, non-corporate taxpayers can have §1231 gains and, thus, long-term capital gains that are taxed at two rates.

23. [LO 6] Rocky and Bullwinkle Partnership sold a parcel of land during the current year and realized a gain of $250,000. Rocky and Bullwinkle did not recognize gain related to the sale of the land on its tax return. Is this possible? Explain how a taxpayer could realize a gain but not recognize it.

    A realized gain or loss is usually recognized in the year of disposition. However, there are some realized gains or losses that are excluded from taxable income (e.g. gain from the sale of a principal residence—see chapter 14 for a detailed discussion) or deferred (e.g. like-kind exchange or related-person loss), or partially deferred (e.g. an installment sale).

24. [LO 6] Why does the tax code allow taxpayers to defer gains on like-kind exchanges? How do the tax laws ensure that the gains (or losses) are deferred and not permanently excluded from a taxpayer's income?

    In a like-kind exchange, a taxpayer maintains an investment in an asset other than cash and therefore does not have the wherewithal to pay–that is, the taxpayer does not have the means to pay taxes currently. However, in a like-kind exchange where boot (non-like kind property) is received, there is a partial recognition of gain for the transaction.

    The gains are deferred through receiving a carryover basis in the like-kind property received. This defers the gain until the like-kind property received is disposed of rather than permanently excluding the gain from income.

25. [LO 6] Describe the like-kind property requirements for real property for purposes of qualifying for a like-kind exchange. Explain whether land held for investment by a corporation will qualify as like-kind property with land held by an individual for personal use.

For real property, any two pieces of property qualify as like-kind property for purposes of a like-kind exchange as long as they are both either used in a trade or business or held for investment. For example, a New York City skyscraper (relatively little land with relatively substantial building) will qualify as like-kind with a Montana ranch (relatively substantial land holding with relatively little buildings). Real property located in the US and real property located outside the US are not like-kind property.

The land held by both taxpayers must be used in a trade or business or held for investment, thus the exchange will not qualify for like-kind treatment.

26. [LO 6] Salazar Inc., a Colorado company, is relocating to a nearby town. It would like to trade its real property for some real property in the new location. While Salazar has found several prospective buyers for its real property and has also located several properties that are acceptable in the new location, it cannot find anyone that is willing to trade Salazar Inc. for its property in a like-kind exchange. Explain how a third-party intermediary could facilitate Salazar's like-kind exchange.

    If Salazar completed the transaction by selling its old property to one of the prospective buyers and then used the cash to purchase one of the acceptable new properties, it would not be able to take advantage of the like-kind exchange provisions. A third-party intermediary can take control of Salazar's property, sell the property to one of the prospective buyers, and use the cash proceeds to acquire Salazar's desired property. As a result, use of a third party intermediary allows Salazar to accomplish what it cannot do on its own (piece together a transaction that qualifies as a like-kind exchange). However, Salazar must identify the property to be received within 45 days and actually receive the property within 180 days of transferring their property to the third party(or the due date of the tax return including extensions)after Salazar initially transfers property in the exchange.

27. [LO 6] Minuteman wants to enter into a like-kind exchange by exchanging its old New England manufacturing facility for a ranch in Wyoming. Minuteman is using a third-party intermediary to facilitate the exchange. The purchaser of the manufacturing facility wants to complete the transaction immediately but, for various reasons, the ranch transaction will not be completed for three to four months. Will this delay cause a problem for Minuteman's desire to accomplish this through a like-kind exchange? Explain.

    Minuteman can still qualify for a Starker (deferred) exchange as long it meets two timing requirements applicable to like-kind exchanges. First, within 45 days of transferring the property to be given up (New England manufacturing facility) in an exchange, the taxpayer must identify like-kind property to be received (Wyoming ranch). Second, within 180 days of initially transferring the property to be given up in a like-kind exchange, the taxpayer must receive the replacement like-kind property(or the due date of the tax return including extensions)after the

taxpayer initially transfers property in the exchange. In addition, Minuteman must use a third party intermediary to hold the proceeds from the manufacturing facility until the ranch can be closed. The exchange will qualify as long as the new ranch is acquired within the 180-day period following the close of the New England manufacturing facility.

28. [LO 6] Olympia Corporation, of Kittery, Maine, wants to exchange its manufacturing facility for Bangor Company's warehouse. Both parties agree that that Olympia's building is worth $100,000 and that Bangor's building is worth $95,000. Olympia would like the transaction to qualify as a like-kind exchange. What could the parties do to equalize the value exchanged but still allow the exchange to qualify as a like-kind exchange? How would the necessary change affect the tax consequences of the transaction?

    The parties could agree to have Bangor pay Olympia cash or another asset (boot), to equalize the transaction. The receipt of boot does not jeopardize the like-kind exchange treatment. However, Olympia will recognize gain equal to the boot received in the transaction. Any remaining gain is still deferred under the like-kind exchange rules. Boot includes any non-like kind asset: cash, tangible assets, intangibles, etc.

29. [LO 6] Compare and contrast the similarities and differences between like-kind exchanges and involuntary conversions for tax purposes.

    A like-kind exchange involves a trade of real property for other real property used for either business or investment purposes within the specified time period. An involuntary conversion is the replacement of property damaged through a natural disaster, theft, etc. The two transactions are similar in that they both lack (at least a portion of) the wherewithal to pay the tax and thus result in a deferral or partial deferral. The transactions differ in that the definition of qualifying property for involuntary conversions includes personal property whereas these assets do not qualify for like-kind exchanges.For involuntary conversions the personal or real property can be business, investment or personal use property; however, like-kind exchanges require property to be used for business or investment purposes only. In addition, in like-kind exchanges taxpayers defer gain or loss; whereas, in involuntary conversions taxpayers defer gains but may deduct losses as business losses or personal casualty losses from federally-declared disaster areas.

30. [LO 6] What is an installment sale? How do the tax laws ensure that taxpayers recognize all the gain they realize on an installment sale? How is depreciation recapture treated in an installment sale? Explain the gross profit ratio and how it relates to gains recognized under installment method sales.

    Installment sales comprise a sale when any portion of the proceeds is received in a year subsequent to the disposition. The rules require that the realized gain be

recognized ratably as payments are received--unless the taxpayer elects out of the installment method. Therefore, for each dollar received, a portion is return of capital and a portion is the recognition of previously realized gain. Depreciation recapture is required to be recognized in the year of disposition. The recaptured amount is excluded from the gross profit ratio to avoid double taxation (e.g. the gain realized is reduced by the depreciation recapture recognized). The gross profit ratio reflects the percentage of: Gross profit/Contract price where gross profit is calculated as the sales price minus the adjusted basis and the contract price is the sales price less the seller's debt that is assumed by the buyer. The gross profit ratio is used to determine how much of each of these payments will be recognized as gain in the year that the payment is received.

31. [LO6] Mr. Kyle owns stock in a local publicly traded company. Although the stock price has declined since he purchased it two years ago, he likes the long-term prospects for the company. If Kyle sells the stock to his sister because he needs some cash for a down payment on a new home, is the loss deductible? If Kyle is right and the stock price increases in the future, how is his sister's gain computed if she sells the stock?

    A loss generated from a sale between related persons is deferred until the time when the asset is sold by the related purchaser to an unrelated person. Since Kyle sold the stock at a loss to his sister, Kyle's loss is disallowed. When the stock is sold at a gain, the sister can reduce her gain by the amount of Kyle's disallowed loss. If the stock continues to decline in value, the disallowed loss is never recognized for tax purposes.

Problems

32. [LO 1] Rafael sold an assetto Jamal. What is Rafael's amount realized on the sale in each of the following alternative scenarios?

    a. Rafael received $80,000 of cash and a vehicle worth $10,000. Rafael also paid $5,000 in selling expenses.
    b. Rafael received $80,000 of cash and was relieved of a $30,000 mortgage on the asset he sold to Jamal. Rafael also paid a commission of $5,000 on the transaction.
    c. Rafael received $20,000 of cash, a parcel of land worth $50,000, and marketable securities of $10,000. Rafael also paid a commission of $8,000 on the transaction.

    a. $85,000, computed as follows:

Property Received	***Amount***	***Explanation***
(1) Cash	*$80,000*	*Given*
(2) Vehicle	*10,000*	*Given*
(3) Commissions	*(5,000)*	*Given*
Amount Realized	*$85,000*	*(1) + (2) + (3)*

b. $105,000, computed as follows:

Property Received	***Amount***	***Explanation***
(1) Cash	*$80,000*	
(2) Relief of debt	*30,000*	
(3) Commissions	*(5,000)*	
Amount Realized	*$105,000*	*(1) + (2) + (3)*

c. $72,000, computed as follows:

Property Received	***Amount***	***Explanation***
(1) Cash	*$20,000*	
(2) Land	*50,000*	
(3) Marketable securities	*10,000*	
(4) Commissions	*(8,000)*	
Amount Realized	*$72,000*	*(1) + (2) + (3) + (4)*

33. [LO 1] Alan Meer inherits a hotel from his grandmother, Mary, on February 11 of the current year. Mary bought the hotel for $730,000 three years ago. Mary deducted $27,000 of cost recovery on the hotel before her death. The fair market value of the hotel in February is $725,000. (Assume that the alternative valuation date is not used.)
    a. What is Alan's adjusted basis in the hotel?
    b. If the fair market value of the hotel at the time of Mary's death was $500,000, what is Alan's basis?

    a. *$725,000. Alan will have an adjusted basis equal to the fair market value at the date of Mary's death.*
    b. *$500,000. Alan will have an adjusted basis equal to the fair market value at the date of death even though it is lower than Mary's basis at the time of her death.*

34. [LO 1] Shasta Corporation sold a piece of land to Bill for $45,000. Shasta bought the land twoyears ago for $30,600. What gain or loss does Shasta realize on the transaction?

$14,400, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$45,000*	
(2) Adjusted Basis	*30,600*	
Gain(Loss) Realized	***$14,400***	*(1) – (2)*

35. [LO 1] Lassen Corporation sold a machine to a machine dealer for $25,000. Lassen bought the machine for $55,000 and has claimed $15,000 of depreciation expense on the machine. What gain or loss does Lassen realize on the transaction?

($15,000) loss, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$25,000*	*Given*
(2) Adjusted Basis	*40,000*	*$55,000 original basis - $15,000 accumulated depreciation*
Gain(Loss) Realized	***($15,000)***	*(1) – (2)*

36. [LO 1, 2] Hannah Tywin owns 100 shares of MM Inc. stock. She sells the stock on December 11 for $25 per share. She received the stock as a gift from her Aunt Pam on March 20 of this year when the fair market value of the stock was $18 per share. Aunt Pam originally purchased the stock seven years ago at a price of $12 per share. What is the amount and character of Hannah's recognized gain or loss on the stock?

$1,300 long-term capital gain, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$2,500*	*100 shares × $25/share*
(2) Adjusted Basis	*1,200*	*100 shares × $12/share carryover basis from donor*
Gain Recognized	***$1,300***	*(1) – (2)*

At the date of the gift the stock had appreciated in value from the time Aunt Pam purchased the stock. As a result, Aunt Pam's basis will carryover to Hannah when she receives the stock as a gift. Hannah's holding period begins on the date that Aunt Pam acquired the stock because Hannah's basis is a carryover basis. Therefore, the character of the gain is long-term capital gain.

37. [LO 1, 2] On September 30 of last year, Rex received some investment land from Holly as a gift. Holly's adjusted basis was $50,000 and the land was valued at $40,000 at the time of the gift. Holly acquired the land five years ago. What is the amount and character of Rex's recognized gain (loss) if he sells the land on May 12 this year at the following prices?
    a. $32,000
    b. $70,000
    c. $45,000

    a. *$8,000short-term capital loss, computed as follows:*

Description	***Amount***	***Explanation***
(1) Amount Realized	*$32,000*	
(2) Adjusted Basis	*40,000*	*Rex's basis is the fair market value of the land at the date of the gift.*
Gain (Loss) Recognized	***($8,000)***	*(1) – (2)*

Rex's holding period begins on the date of the gift because the loss basis (fair market value) is used to determine the gain or loss on the sale.

b. $20,000 long-term capital gain, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$70,000*	
(2) Adjusted Basis	*50,000*	*Rex's basis is a carryover basis from the donor*
Gain (Loss) Recognized	***$20,000***	*(1) – (2)*

Rex's holding period begins on the date that Holly acquired the stock because Rex's basis is a carryover basis. Therefore, the character of the gain is long-term capital gain.

c. No gain or loss is realized.

Description	***Amount***	***Explanation***
(1) Amount Realized	*$45,000*	
(2) Adjusted Basis	*45,000*	*Rex's basis is deemed to be equal to the amount realized since the amount realized falls between the basis for loss and the basis for gain.*
Gain (Loss) Recognized	***$-0-***	*(1) – (2)*

38. [LO 1, 2] Franco converted a building from personal to business use in May 2016when the fair market value was $55,000. He purchased the building in July 2013for $80,000. On December 15 of this year, Franco sells the building for $40,000. On the date of the sale, the accumulated depreciation on the building was $5,565. What is Franco's recognized gain or loss on the sale?

($9,435) loss, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$40,000*	
(2) Original basis for loss	*55,000*	*Fair market value on the date of conversion since fair market value was lower than basis at the time of conversion*
(3)Accumulated Depreciation	*5,565*	*Given*
(4) Adjusted basis at the date of the sale	*49,435*	*(2) – (3)*
Gain (Loss) Recognized	***($9,435)***	*(1) – (4)*

39. [LO 2] Identify each of White Corporation's following assets as an ordinary, capital, or §1231 asset.

a. Two years ago, White used its excess cash to purchase a piece of land as an investment.
b. Two years ago, White purchased land and a warehouse. It uses these assets in its business.
c. Manufacturing machinery White purchased earlier this year.
d. Inventory White purchased 13 months ago, but is ready to be shipped to a customer.
e. Office equipment White has used in its business for the past three years.
f. 1,000 shares of stock in Black Corporation that White purchased two years ago because it was a good investment.
g. Account receivable from a customer with terms 2/10 net 30.
h. Machinery White held for three years and then sold at a loss of $10,000.

a. Capital, because it is held for investment.
b. The land and building are both §1231 property because White uses the assets in its trade or business and has held the assets property for more than a year.
c. The property is ordinary even though it is used in a trade or business because it has been held for less than one year. Once White has held the machinery for more than a year, it will become §1231 property.
d. Ordinary, because inventory is held in the ordinary course of business.
e. §1231, because the property is used in a trade or business and held for more than one year.
f. Capital, because it is held for investment.
g. Ordinary, because accounts receivable are created in the ordinary course of business.
h. §1231, because the property is used in a trade or business and held for more than one year.

40. [LO 3, 4] In year 0, Canon purchased a machine to use in its business for $56,000. In year 3, Canon sold the machine for $42,000. Between the date of the purchase and the date of the sale, Canon depreciated the machine by $32,000.
    a. What is the amount and character of the gain Canon will recognize on the sale, assuming that it is a partnership?
    b. What is the amount and character of the gain Canon will recognize on the sale, assuming that it is a corporation?
    c. What is the amount and character of the gain Canon will recognize on the sale, assuming that it is a corporation and the sale proceeds were increased to $60,000?
    d. What is the amount and character of the gain or loss Canon will recognize on the sale, assuming that it is a corporation and the sale proceeds were decreased to $20,000?

a. $18,000 ordinary income, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$42,000*	*Given*

(2) Original Basis	*56,000*	*Given*
(3) Accumulated Depreciation	*(32,000)*	*Given*
(4) Adjusted Basis	*24,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*$18,000*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$18,000***	*Lesser of (3) or (5)*
§1231 gain	***$0***	*(5) – (6)*

Because the entire gain is caused by depreciation deductions, the entire gain is treated as ordinary income under §1245.

b. $18,000; there is no difference in calculating the amount and character of the gain between a partnership and a corporation on §1245 property.

c. $36,000 gain ($32,000 ordinary and $4,000 §1231) computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$60,000*	*Given*
(2) Original Basis	*56,000*	*Given*
(3) Accumulated Depreciation	*(32,000)*	*Given*
(4) Adjusted Basis	*24,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*$36,000*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$32,000***	*Lesser of (3) or (5)*
§1231 gain	***$4,000***	*(5) – (6)*

Only the gain caused by depreciation is treated as ordinary income under §1245, the remaining gain is §1231.

d. ($4,000) ordinary loss, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$20,000*	*Given*
(2) Original Basis	*56,000*	*Given*
(3) Accumulated Depreciation	*(32,000)*	*Given*
(4) Adjusted Basis	*24,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*($4,000)*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$0***	*Lesser of (3) or (5)*
§1231 loss	***($4,000)***	*(5) – (6)*

Only gains are treated as ordinary income under §1245, any loss is §1231.

41. [LO 3, 4] In year 0, LongworthPartnership purchased a machine for $40,000 to use in its business. In year 3, Longworth sold the machine for $35,000. Between the date of the purchase and the date of the sale, Longworth depreciated the machine by $22,000.
    a. What is the amount and character of the gain (loss) Longworth will recognize on the sale?
    b. What is the amount and character of the gain (loss) Longworth will recognize on the sale if the sale proceeds were increased to $45,000?

c. What is the amount and character of the gain (loss) Longworth will recognize on the sale if the sale proceeds were decreased to $15,000?

a. $17,000 ordinary income.

Description	***Amount***	***Explanation***
(1) Amount Realized	*$35,000*	*Given*
(2) Original Basis	*40,000*	*Given*
(3) Accumulated Depreciation	*22,000*	*Given*
(4) Adjusted Basis	*18,000*	*(2) - (3)*
(5) Gain/(Loss) Recognized	*$17,000*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$17,000***	*Lesser of (3) or (5)*
§1231 gain	***$0***	*(5) – (6)*

Because the entire gain is caused by depreciation deductions, the entire gain is treated as ordinary income under §1245.

b. $27,000 gain ($22,000 ordinary and $5,000 §1231) computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$45,000*	*Given*
(2) Original Basis	*40,000*	*Given*
(3) Accumulated Depreciation	*22,000*	*Given*
(4) Adjusted Basis	*18,000*	*(2) - (3)*
(5) Gain/(Loss) Recognized	*$27,000*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$22,000***	*Lesser of (3) or (5)*
§1231 gain	***$5,000***	*(5) – (6)*

Only the gain caused by depreciation is treated as ordinary income under §1245, the remaining gain is §1231.

c. ($3,000) ordinary loss, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$15,000*	*Given*
(2) Original Basis	*40,000*	*Given*
(3) Accumulated Depreciation	*22,000*	*Given*
(4) Adjusted Basis	*18,000*	*(2) - (3)*
(5) Gain/(Loss) Recognized	*($3,000)*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$0***	*Given*
§1231 loss	***($3,000)***	*(5) – (6)*

Only gains are treated as ordinary income under §1245, any loss is §1231.

42. [LO 3, 4] On August 1 of year 0, Dirksen purchased a machine for $20,000 to use in its business. On December 4 of year 0, Dirksen sold the machine for $18,000.
    a. What is the amount and character of the gain or loss Dirksen will recognize on the sale?

b. What is the amount and character of the gain or loss Dirksen will recognize on the sale if the machine was sold on January 15 of year 1 instead?

a. ($2,000)§1231 loss treated as ordinary.

Description	***Amount***	***Explanation***
(1) Amount Realized	*$18,000*	*Given*
(2) Original Basis	*20,000*	*Given*
(3) Accumulated Depreciation	*$0*	*
(4) Adjusted Basis	*20,000*	*(2) - (3)*
(5) Gain/(Loss) Recognized	*($2,000)*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$0***	*No recapture on losses.*
§1231 loss	***($2,000)***	*(5) – (6)*

There is no depreciation recapture when §1231 assets are sold at a loss. The loss is a §1231 loss.

b. $3,307 ordinary income.

Description	***Amount***	***Explanation***
(1) Amount Realized	*$18,000*	*Given*
(2) Original Basis	*20,000*	*Given*
(3) Accumulated Depreciation	*$5,307*	*Calculated below*
(4) Adjusted Basis	*14,693*	*(2) - (3)*
(5) Gain/(Loss) Recognized	*$3,307*	*(1) – (4)*
(6) Ordinary income*	***$3,307***	*Lesser of (3) or (5)*
§1231 gain	***$0***	*(5) – (6)*

**No depreciation is allowed on an asset placed in service and disposed of during the same taxable year. Assets held less than one year are ordinary rather than § 1231 assets.*

Depreciation Calculation

Year	***(1) Original Basis***	***(2) Rate***	***(1) x (2) Depreciation***
1	*$20,000*	*14.29%*	*$2,858*
2	*$20,000*	*12.245%**	*$2,449*
			$5,307

**12.245% = 24.49% x .5 (half-year in year of disposition)*

43. [LO 3, 4] Rayburn Corporation has a building that it bought during year 0 for $850,000. It sold the building in year 5. During the time it held the building,Rayburn depreciated it by $100,000. What is the amount and character of the gain or loss Rayburn will recognize on the sale in each of the following alternative situations?

a. Rayburn receives $840,000.
b. Rayburn receives $900,000.

c. Rayburn receives $700,000.

a. $18,000 ordinary income and $72,000 §1231 gain computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$840,000*	*Given*
(2) Original Basis	*850,000*	*Given*
(3) Accumulated Depreciation	*100,000*	*Given*
(4) Adjusted Basis	*750,000*	*(2) – (3)*
(5) Gain/(Loss) Recognized	*$90,000*	*(1) – (4)*
(6) §291 recapture percentage	*20%*	*§291*
(7) §291 recapture base	*90,000*	*Lesser of (5) or (3)*
(8) ***§291 recapture (ordinary income)***	***$18,000***	*(6) x (7)*
§1231 gain	***$72,000***	*(5) – (8)*

b.$20,000 ordinary income and $130,000 §1231 gain computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$900,000*	*Given*
(2) Original Basis	*850,000*	*Given*
(3) Accumulated Depreciation	*100,000*	*Given*
(4) Adjusted Basis	*750,000*	*(2) – (3)*
(5) Gain/(Loss) Recognized	*$150,000*	*(1) – (4)*
(6) §291 recapture percentage	*20%*	*§291*
(7) §291 recapture base	*100,000*	*Lesser of (5) or (3)*
(8) ***§291 recapture (ordinary income)***	***$20,000***	*(6) x (7)*
§1231 gain	***$130,000***	*(5) – (8)*

c. $(50,000) ordinary loss computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$700,000*	*Given*
(2) Original Basis	*850,000*	*Given*
(3) Accumulated Depreciation	*100,000*	*Given*
(4) Adjusted Basis	*750,000*	*(2) – (3)*
(5) Gain/(Loss) Recognized	*($50,000)*	*(1) – (4)*
(6) §291 recapture percentage	*20%*	*§291*
(7) §291 recapture base	*$0*	*Lesser of (5) or (3)*
(8) ***§291 recapture (ordinary income)***	***$0***	*(6) x (7)*
§1231 loss	***($50,000)***	*(5) – (8)*

44. [LO 3, 4] Moran owns a building he bought duringyear 0 for $150,000. He sold the building in year 6. During the time he held the building he depreciated it by $32,000. What is the amount and character of the gain or loss Moran will recognize on the sale in each of the following alternative situations?

a. Moran received $145,000.
b. Moran received $170,000.
c. Moran received $110,000.

a. $27,000 unrecaptured §1250 gain, which is §1231 gain subject to a maximum tax rate of 25 percent, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$145,000*	*Given*
(2) Original Basis	*150,000*	*Given*
(3) Accumulated Depreciation	*32,000*	*Given*
(4) Adjusted Basis	*118,000*	*(2) – (3)*
(5) Gain/(Loss) Recognized	*$27,000*	*(1) – (4)*
(6) ***Unrecaptured §1250 gain (and §1231 gain)***	***$27,000***	*Lesser of (5) or (3)*
(7) Remaining §1231 gain	*$0*	*(5) – (6)*
Total §1231 gain	***$27,000***	*(6) + (7)*

b. §1231 gain of $52,000. Of the $52,000, $32,000 is unrecaptured §1250 gain subject to a maximum 25 percent tax rate and the remaining $20,000 is §1231 gain subject to a maximum rate of 0/15/20 percent. See the following calculations:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$170,000*	*Given*
(2) Original Basis	*150,000*	*Given*
(3) Accumulated Depreciation	*32,000*	*Given*
(4) Adjusted Basis	*118,000*	*(2) – (3)*
(5) Gain/(Loss) Recognized	*$52,000*	*(1) – (4)*
(6) ***Unrecaptured §1250 gain (and §1231 gain)***	***$32,000***	*Lesser of (5) or (3)*
(7) Remaining §1231 gain	*20,000*	*(5) – (6)*
Total §1231 gain	***$52,000***	*(6) + (7)*

c. §1231 loss of ($8,000), calculated as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$110,000*	*Given*
(2) Original Basis	*150,000*	*Given*
(3) Accumulated Depreciation	*32,000*	*Given*
(4) Adjusted Basis	*118,000*	*(2) – (3)*
(5) Gain/(Loss) Recognized	*($8,000)*	*(1) – (4)*
(6) ***Unrecaptured §1250 gain (and §1231 gain)***	***$0***	*Lesser of (5) or (3) but not below zero.*

(7) Remaining §1231 loss	*($8,000)*	*(5) – (6)*
Total §1231 loss	***($8,000)***	*(6) + (7)*

45. [LO 3, 4, 5] Hart, an individual, bought an asset for $500,000 and has claimed $100,000 of depreciation deductions against the asset. Hart has a marginal tax rate of 32 percent. Answer the questions presented in the following alternative scenarios (assume Hart had no property transactions other than those described in the problem):
    a. What is the amount and character of Hart's recognized gain if the asset is tangible personal property sold for $450,000? What effect does the sale have on Hart's tax liability for the year?
    b. What is the amount and character of Hart's recognized gain if the asset is tangible personal property sold for $550,000? What effect does the sale have on Hart's tax liability for the year?
    c. What is the amount and character of Hart's recognized gain if the asset is tangible personal property sold for $350,000? What effect does the sale have on Hart's tax liability for the year?
    d. What is the amount and character of Hart's recognized gain if the asset is a non-residential building sold for $450,000? What effect does the sale have on Hart's tax liability for the year?
    e. Now assume that Hart is a C corporation. What is the amount and character of its recognized gain if the asset is a nonresidential building sold for $450,000? What effect does the sale have on Hart's tax liability for the year (assume a 21 percent tax rate)?
    f. Now assuming that the asset is real property, which entity type should be used to minimize the taxes paid on real estate gains?

    a. $50,000 ordinary income and a $16,000 tax liability on income, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(100,000)*	*Given*
(4) Adjusted Basis	*400,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*$50,000*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$50,000***	*Given*
§1231 gain	***$0***	*(5) – (6)*

Character	***Amount (1)***	***Rate (2)***	***Tax (1) x (2)***
§1245 recapture	*$50,000*	*32%*	*$16,000*
§1231 gain	*$0*	*15%*	*$0*
Tax			***$16,000***

    b. Hart has $100,000 ordinary income and $50,000 of §1231 gain. Hart's tax liability is $39,500, calculated as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$550,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(100,000)*	*Given*
(4) Adjusted Basis	*400,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*$150,000*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$100,000***	*Lesser of (3) or (5)*
§1231 gain	***$50,000***	*(5) – (6)*

Character	***Amount***	***Rate (2)***	***Tax (1) x (2)***
§1245 recapture	*$100,000*	*32%*	*$32,000*
§1231 gain	*$50,000*	*15%*	*$7,500*
Tax			***$39,500***

c. Hart has a §1231 loss of $50,000 and receives tax savings of $16,000 for the loss:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$350,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(100,000)*	*Given*
(4) Adjusted Basis	*400,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*($50,000)*	*(1) – (4)*
(6) Ordinary income (§1245 depreciation recapture)	***$0***	*Lesser of (3) or (5)*
§1231 loss	***($50,000)***	*(5) – (6)*

Character	***Amount***	***Rate (2)***	***Tax (1) x (2)***
§1245 recapture	*$0*	*32%*	*$0*
§1231 loss	*($50,000)*	*32%*	*($16,000)*
Tax benefit			*($16,000)*

d. Hart has a §1231 gain of $50,000 taxed at a maximum 25 percent rate. Hart's tax liability is $12,500, calculated as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(100,000)*	*Given*
(4) Adjusted Basis	*400,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*50,000*	*(1) – (4)*
(6) ***Unrecaptured §1250 gain***	***$50,000***	*Lesser of (5) or (3)*
(7) Remaining §1231 gain	*$0*	*(5) – (6)*
Total §1231 gain	***$50,000***	*(6) + (7)*

Character	***Amount***	***Rate***	***Tax***
Unrecaptured §1250 (§1231 gain)	*$50,000*	*25%*	*$12,500*
Other §1231 gain	*$0*	*15%*	*$0*
Tax			*$12,500*

e. Hart recognizes $10,000 ordinary income and $40,000 §1231 gain. Hart's tax liability is $10,500, calculated as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(100,000)*	*Given*
(4) Adjusted Basis	*400,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*$50,000*	*(1) – (4)*
(6) §291 recapture percentage	*20%*	*§291*
(7) §291 recapture base	*50,000*	*Lesser of (5) or (3)*
(8) ***§291 recapture (ordinary income)***	***$10,000***	*(6) x (7)*
§1231 gain	***$40,000***	*(5) – (8)*

Character	***Amount***	***Rate***	***Tax***
§291gain	*$10,000*	*21%*	*$2,100*
§1231 gain	*$40,000*	*21%*	*$8,400*
Tax			*$10,500*

f. As can be seen from parts (d) and (e), the corporate form will result in a lower tax on sales of real property. This is because the corporation's ordinary tax rate of 21 percent islower than the maximum rate of 25 percent on unrecaptured §1250 gains for noncorporate taxpayers.

46. [LO 4] Luke sold a building and the land on which the building sits to his wholly owned corporation, Studemont Corp. at fair market value. The fair market value of the building was determined to be $325,000; Luke built the building several years ago at a cost of $200,000. Luke had claimed $45,000 of depreciation expense on the building. The fair market value of the land was determined to be $210,000 at the time of the sale; Luke purchased the land many years ago for $130,000.

    a. What is the amount and character of Luke's recognized gain or loss on the building?
    b. What is the amount and character of Luke's recognized gain or loss on the land?

a.$170,000 ordinary income, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$325,000*	*Given*
(2) Original Basis	*200,000*	*Given*
(3) Accumulated Depreciation	*(45,000)*	*Given*
(4) Adjusted Basis	*155,000*	*(2) + (3)*

Ordinary Gain/(Loss) Recognized under §1239*	***$170,000***	*(1) – (4)*

**Luke must recognize ordinary income on the sale of the building under §1239 because (1) he sold it at a gain to a related person (his wholly owned corporation) and (2) the asset is a depreciable asset in the hands of the related person.*

b.$80,000 §1231 gain, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$210,000*	
(2) Original Basis	*130,000*	
(3) Accumulated Depreciation	*0*	
(4) Adjusted Basis	*130,000*	*(2) - (3)*
§1231 Gain Recognized	***$80,000***	*(1) – (4)*

§1239 is not applicable for the land because it is not depreciable to the buyer.

47. [LO 5] Buckley, an individual, began a business two years ago and has never sold a §1231 asset. Buckley owned each of the assets since he began the business. In the current year, Buckley sold the following business assets:

Asset	Original Cost	Accumulated Depreciation	Gain/Loss
Computers	$6,000	$2,000	($3,000)
Machinery	10,000	4,000	(2,000)
Furniture	20,000	12,000	7,000
Building	100,000	10,000	(1,000)

Assuming Buckley's marginal ordinary income tax rate is 32 percent, answer the questions for the following alternative scenarios:

a. What is the character ofBuckley's gains or losses for the current year?What effect do the gains or losses have on Buckley's tax liability?
b. Assume that the amount realized increased so that the building was sold at a $6,000 gain instead. What is the character of Buckley's gains or losses for the current year? What effect do the gains and losses have on Buckley's tax liability?
c. Assume that the amount realized increased so that the building was sold at a $15,000 gain instead. What is the character of Buckley's gains or losses for the current year? What effect do the gains and losses have on Buckley's tax liability?

a. Buckley's net §1245 gain is$7,000 and hisnet §1231 loss is$6,000 and is calculated as follows:

Asset	***Description***	***Amount***
Computers	*§1231 loss**	($3,000)
Machinery	*§1231 loss**	($2,000)

Furniture	*§1245 recapture*	$7,000
Building	*§1231 loss**	($1,000)

**Because Buckley has only§1231 losses they become ordinary losses.*

Character	***Amount***	***Rate (2)***	***Tax (1) x (2)***
§1245 recapture	*$7,000*	*32%*	*$2,240*
§1231 loss	*($6,000)*	*32%*	*($1,920)*
Tax increase			*$320*

b. *Buckley's net §1245 gain is$7,000 and its net §1231 gainis$1,000 and is calculated as follows:*

Asset	***Description***	***Amount***
Computers	*§1231 loss**	($3,000)
Machinery	*§1231 loss**	($2,000)
Furniture	*§1245 recapture*	$7,000
Building	*Unrecaptured §1250 gain***	$6,000

**Because Buckley has only§1231 losses they become ordinary losses.*
***Unrecaptured §1250 gain is a §1231 gain taxed at a maximum rate of 25%*

Character	***Amount***	***Rate (2)***	***Tax (1) x (2)***
§1245 recapture	*$7,000*	*32%*	*$2,240*
*Net §1231 gain**	*$1,000*	*25%*	*$250*
Tax			*$2,490*

**An unrecaptured§1250 gain of $6,000 from the building is offset against §1231 losses of ($5,000) (($3,000 from computer + ($2,000) from machinery), for a net §1231 gain of $1,000.*

c. *Buckley's net §1245 gain is$7,000 and its net §1231 gainis$10,000 and is calculated as follows:*

Asset	***Description***	***Amount***
Computers	*§1231 loss**	($3,000)
Machinery	*§1231 loss**	($2,000)
Furniture	*§1245 recapture*	$7,000
Building	*Unrecaptured §1250 gain***	$10,000
Building	*§1231 gain*	$5,000

**Because Buckley has only§1231 losses they become ordinary losses.*
***Unrecaptured §1250 gain is a §1231 gain taxed at a maximum rate of 25 percent.*

Character	***Amount***	***Rate (2)***	***Tax (1) x (2)***
§1245 recapture	*$7,000*	*32%*	*$2,240*
*Unrecap. §1250**	*$10,000*	*25%*	*$2,500*
Tax			*$4,740*

**Buckley has an unrecaptured §1250 gain (a §1231 gain taxed at 25 percent) of $10,000 from the building and a §1231 gain (taxed at 15 percent) of $5,000. The ($5,000) of §1231 losses (($3,000 from computer + ($2,000) from machinery) are offset against the 15%-taxed §1231 gain first. Therefore, the unrecaptured §1250 gain of $10,000 remains.*

48. (LO3, LO4, LO5) Lily Tucker (single) owns and operates a bike shop as a sole proprietorship. In 2018, she sells the following long-term assets used in her business:

Asset	**Sales Price**	**Cost**	**Accumulated Depreciation**
Building	$ 230,000	$200,000	$52,000
Equipment	80,000	148,000	23,000

Lily's taxable income before these transactions is $160,500. What areLily's taxable income and tax liability for the year?

Lily's taxable income is $197,500 and her tax liability is $42,300. See the following calculations:

Asset	***Sales Price***	***Adjusted basis***	***Gain/ (Loss)***	***Character***
Building	*$ 230,000*	*$148,000*	*$82,000*	*$52,000 is Unrecaptured §1250* *$30,000 is §1231*
Equipment	*80,000*	*125,000*	*(45,000)*	*$(45,000) §1231*

Netting: The $30,000 §1231 gain is offset by the $45,000 §1231 loss. The remaining $15,000 loss then reduces the unrecaptured §1250 gain of $52,000 to $37,000. This gain will be taxed at 25 percent (the lower of her ordinary rate (32 percent) or the maximum 25 percent rate).

Taxable income before transactions	*$ 160,500*
Unrecaptured §1250 gain	*37,000*
Taxable income	***$197,500***
Tax liability	
Ordinary Income: (197,500 – 37,000) = $160,500	
($160,500 –157,500) × 32% +$32,089.50	*=$33,050*
Capital gain: $37,000 × 25%	*9,250*
Total tax liability	***$42,300***

49. (LO3, LO4, LO5) Shimmer Inc. is a calendar-year end, accrual-method corporation. This year, it sells the following long-term assets:

Asset	**Sales Price**	**Cost**	**Accumulated Depreciation**
Building	$ 650,000	$642,000	$37,000
Sparkle Corporation stock	130,000	175,000	n/a

Shimmer does not sell any other assets during the year and its taxable income before these transactions is $800,000. What is Shimmer's taxable income and tax liability for the year?

Shimmer's taxable income is $807,400 and its tax liability is $274,516. See the following calculations:

Asset	***Sales Price***	***Adjusted basis***	***Gain/ (Loss)***	***Character***
Building	*$ 650,000*	*$605,000*	*$45,000*	*$7,400 is §291 ordinary income* *$37,600 is §1231*
Sparkle stock	*130,000*	*175,000*	*(45,000)*	*$(45,000) LTCL*

The $37,600 §1231 gain on the building is treated as a long-term capital gain, which can be offset by the long-term capital loss from the sale of the stock. However, because Shimmer is a corporation, it can only use its capital losses to the extent of its capital gains. The excess loss of $7,400 ($37,600 - $45,000) can be carried back 3 years and/or carried forward 5 years.

Taxable income before transactions	*$800,000*
Ordinary income from sale	*7,400*
Taxable income after transactions	***$807,400***
Tax liability ($807,400 ×21%)	***$169,554***

50. [LO 5] {Planning} Aruna, a sole proprietor, wants to sell two assets that she no longer needs for her business. Both assets qualify as §1231 assets. The first is machinery and will generate a $10,000 §1231 loss on the sale. The second is land that will generate a $7,000 §1231 gain on the sale. Aruna's ordinary marginal tax rate is 32 percent.
    a. Assuming she sells both assets in December of year 1 (the current year), what effect will the sales have on Aruna's tax liability?
    b. Assuming that Aruna sells the land in December of year 1 and the machinery in January of year 2, what effect will the sales have on Aruna's tax liability for each year?
    c. Explain why selling the assets in separate years will result in greater tax savings for Aruna.

a. Aruna's tax will decrease by ($960). Because there is a net §1231 loss of $3,000, both the gain and loss will be characterized as ordinary.

Character	***Amount***	***Rate***	***Tax***
§1231 loss-Ordinary	*($10,000)*	*32%*	*($3,200)*
§1231 gain-Ordinary	*$7,000*	*32%*	*$2,240*
Tax decrease/savings			*($960)*

b. *Aruna's tax will decrease by ($2,150). Because the §1231 gain is recognized in Year 1, the gain will be capital. The §1231 loss in Year 2 will be ordinary.*

Character	***Amount***	***Rate***	***Tax***
§1231 gain-Capital (Year 1)	*$7,000*	*15%*	*$1,050*
§1231 loss-Ordinary (Year 2)	*($10,000)*	*32%*	*($3,200)*
Tax decrease/savings			*($2,150)*

c. *The §1231 rules can be gamed if you understand them. First gains and losses are netted. However, losses may offset ordinary income at the marginal tax rate, while gains can be recognized at preferential rates that are lower than the marginal tax rate. Second, the look-back rules prevent recognizing losses before gains within a five-year period. However, gains may be recognized before losses. If Aruna recognizes her gain before her loss, the §1231 look-back rules do not apply. One additional factor to consider is that the tax savings from the loss is delayed by one year. Thus, if the taxpayer is sensitive to the time value of money, the delay should be considered as well.*

51. [LO 5] Bourne Guitars, a corporation,reporteda $157,000 net §1231 gain for year 6.
    a. Assuming Bourne reported $50,000 of nonrecapturednet §1231 losses during years 1–5, what amount of Bourne'snet §1231 gain for year 6, if any, is treated as ordinary income?
    b. Assuming Bourne's nonrecaptured net §1231 losses from years 1–5 were $200,000, what amount of Bourne's net §1231 gain for year 6, if any, is treated as ordinary income?

    a. *$50,000 of Bourne's gain would be ordinary income and the remaining $107,000 gain is a §1231 gain, computed as follows:*

Description	***Amount***	***Explanation***
(1) Current §1231 gain	*$157,000*	*Given*
(2) Nonrecaptured§1231 losses	*$50,000*	*Given*
(3) Ordinary income	*$50,000*	*Lesser of (1) or (2)*
§1231 gain	*$107,000*	*(1) - (3)*

    b. *The entire $157,000 gain would be ordinary income due to the§1231 look-back rule.*

52. [LO 5] {Planning} Tonya Jefferson (single), a soleproprietor, runs a successful lobbying business in Washington, D.C.She doesn't sell many business assets, but she

is planning on retiring and selling her historic townhouse, from which she runs her business, to buy a place somewhere sunny and warm. Tonya's townhouse is worth $1,000,000 and the land is worth another $1,000,000. The original basis in the townhouse was $600,000, and she has claimed $250,000 of depreciation deductions against the asset over the years. The original basis in the land was $500,000. Tonya has located a buyer that would like to finalize the transaction in December of the current year. Tonya's marginal ordinary income tax rate is 35 percent and her capital gains tax rate is 20 percent.

a. What amount of gain or loss does Tonya recognize on the sale? What is the character of the gain or loss? What effect does the gain or loss have on her tax liability?
b. In addition to the original facts, assume that Tonya reports the following nonrecaptured net §1231 loss:

Year	Net §1231 Gains/(Losses)
Year 1	($200,000)
Year 2	0
Year 3	0
Year 4	0
Year 5	0
Year 6 (current year)	?

What amount of gain or loss does Tonya recognize on the sale? What is the character of the gain or loss? What effect does the gain or loss have on her year 6 (the current year) tax liability?

c. As Tonya's tax advisor you suggest that Tonya sell the townhouse in year 7 in order to reduce her taxes. What amount of gain or loss does Tonya recognize on the sale in year 7?

a.Tonya has a §1231 gain of $250,000 taxed at a maximum 25 percent rate. She also has a §1231 gain of $900,000 ($400,000 from the building and $500,000 from the land) taxed at a 20 percent rate. Tonya's tax liability is $242,500, calculated as follows:

Description of Building Sale	***Amount***	***Explanation***
(1) Amount Realized	*$1,000,000*	*Given*
(2) Original Basis	*600,000*	*Given*
(3) Accumulated Depreciation	*(250,000)*	*Given*
(4) Adjusted Basis	*350,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*650,000*	*(1) – (4)*
(6) ***Unrecaptured §1250 gain***	***$250,000***	*Lesser of (5) or (3)*
(7) Remaining §1231 gain	*$400,000*	*(5) – (6)*
Total §1231 gain	***$650,000***	*(6) + (7)*

Description of Land Sale	***Amount***	***Explanation***
(1) Amount Realized	*$1,000,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(0)*	*Given*
(4) Adjusted Basis	*500,000*	*(2) + (3)*
(5) §1231 Gain/(Loss) Recognized	*500,000*	*(1) – (4)*

Character	***Amount***	***Rate***	***Tax***
Unrecaptured §1250 (§1231 gain)	*$250,000*	*25%*	*$62,500*
Other §1231 gain	*$900,000*	*20%*	*$180,000*
Tax			*$242,500*

b.Tonyahas an ordinary gain of $200,000, due to the §1231 look-back rule.Tonya has a §1231 gain of $50,000 taxed at a maximum 25 percent rate (the other $200,000 was recaptured as ordinary since it was the highest rate §1231 gain. She also has a §1231 gain of $900,000 ($400,000 from the building and $500,000 from the land) taxed at a 20 percent rate.Tonya's tax liability is $262,500, calculated as follows:

Description of Building Sale	***Amount***	***Explanation***
(1) Amount Realized	*$1,000,000*	*Given*
(2) Original Basis	*600,000*	*Given*
(3) Accumulated Depreciation	*(250,000)*	*Given*
(4) Adjusted Basis	*350,000*	*(2) + (3)*
(5) Gain/(Loss) Recognized	*650,000*	*(1) – (4)*
(6) ***Unrecaptured §1250 gain***	***$250,000***	*Lesser of (5) or (3)*
(7) Remaining §1231 gain	*$400,000*	*(5) – (6)*
Total §1231 gain	***$650,000***	*(6) + (7)*

Description of Land Sale	***Amount***	***Explanation***
(1) Amount Realized	*$1,000,000*	*Given*
(2) Original Basis	*500,000*	*Given*
(3) Accumulated Depreciation	*(0)*	*Given*
(4) Adjusted Basis	*500,000*	*(2) + (3)*
(5) §1231 Gain/(Loss) Recognized	*500,000*	*(1) – (4)*

Year	***Net §1231 gain (loss)***	***Recaptured/ Nonrecaptured§1231 losses***	***Notes***	***Ordinary***	***LTCG***
Year 1	*($200,000)*	*$0* *($200,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($200,000)*	
Year 2	*$0*	*$0* *($200,000)*	*Nonrecaptured*		

			losses		
Year 3	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 4	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 5	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 6	*$200,000 (35%)* *$50,000 (25%)* *$900,000 (20%)*	*$200,000* *$0* *$0*	*$200,000 Ordinary* *Nonrecaptured losses*	*$200,000*	*$50,000* *$900,000*

Character	***Amount***	***Rate***	***Tax***
Ordinary	*$200,000*	*35%*	*$70,000*
Unrecaptured §1250 (§1231 gain)	*$50,000*	*25%*	*$12,500*
Other §1231 gain	*$900,000*	*20%*	*$180,000*
Tax			*$262,500*

c.Tonya's nonrecaptured§1231 loss is about to expire. If she delays the sale of her townhouse until January of year 7, there is no longer any recapture because nonrecaptured§1231 losses only carry over for five years. This would leave Tonya with the same result as part a. Tonya has a §1231 gain of $250,000 taxed at a maximum 25percent rate. She also has a §1231 gain of $900,000 ($400,000 from the building and $500,000 from the land) taxed at a 20 percent rate. Tonya's tax liability is $242,500, which is a savings of $20,000 for waiting a few weeks to sell the asset.

Year	***Net §1231 gain (loss)***	***Recaptured/ Nonrecaptured §1231 losses***	***Notes***	***Ordinary***	***LTCG***
Year 1	*($200,000)*	*$0* *($200,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($200,000)*	
Year 2	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 3	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 4	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 5	*$0*	*$0* *($200,000)*	*Nonrecaptured losses*		
Year 6		*$0* *$0*	*Nonrecaptured losses only carry over 5 years*		

Year 7	*$250,000 (25%)* *$900,000 (20%)*				*$250,000* *$900,000*

Character	***Amount***	***Rate***	***Tax***
Unrecaptured §1250 (§1231 gain)	*$250,000*	*25%*	*$62,500*
Other §1231 gain	*$900,000*	*20%*	*$180,000*
Tax			*$242,500*

53. [LO 5] Morgan's Water World (MWW), an LLC, opened several years ago. MWWreported the following net §1231 gains and losses since it began business.Net §1231 gains shown are before the lookback rule.

Year	**Net §1231 Gains/(Losses)**
Year 1	($11,000)
Year 2	5,000
Year 3	(21,000)
Year 4	(4,000)
Year 5	17,000
Year 6	(43,000)
Year 7 (current year)	113,000

What amount, if any, of the year 7 $113,000 net §1231 gain is treated as ordinary income?

After applying the §1231 five-year look back rule, the result is $57,000 ordinary income and $56,000 long-term capital gain.

Year	***Net §1231 gain (loss)***	***Recaptured/ Nonrecaptured §1231 losses***	***Notes***	***Ordinary***	***LTCG***
Year 1	*($11,000)*	*$0* *($11,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($11,000)*	
Year 2	*$5,000*	*($5,000)* *($6,000)*	*Gain is ordinary* *Nonrecaptured losses*	*$5,000*	
Year 3	*($21,000)*	*$0* *($27,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($21,000)*	
Year 4	*($4,000)*	*$0* *($31,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($4,000)*	
Year 5	*$17,000*	*$17,000* *($14,000)*	*Gain is ordinary* *Nonrecaptured losses*	*$17,000*	
Year 6	*($43,000)*	*($43,000)* *($57,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($43,000)*	
Year 7	*$113,000*	*$57,000* *$0*	*$57,000 is ordinary* *No nonrecaptured losses*	*$57,000*	*$56,000*

54. [LO 5] Hans runs a sole proprietorship. Hans has reported the following net §1231 gains and losses since he began business. Net §1231 gains shown are before the lookback rule.

Year	**Net §1231 Gains/(Losses)**
Year 1	($65,000)
Year 2	15,000
Year 3	0
Year 4	0
Year 5	10,000
Year 6	0
Year 7 (current year)	50,000

a. What amount, if any, of the year 7 (current year) $50,000 net §1231 gain is treated as ordinary income?
b. Assume that the $50,000 net §1231 gain occurs in year 6 instead of year 7. What amount of the gain would be treated as ordinary income in year 6?

a. After applying the §1231 five-year look back rule, the entire $50,000 is long-term capital gain.

Year	***Net §1231 gain (loss)***	***Recaptured/ Nonrecaptured §1231 losses***	***Notes***	***Ordinary***	***LTCG***
Year 1	*($65,000)*	*$0* *($65,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($65,000)*	
Year 2	*$15,000*	*$15,000* *($50,000)*	*Gain is ordinary* *Nonrecaptured losses*	*$15,000*	
Year 3	*$0*	*$0* *($50,000)*	*Nonrecaptured losses*		
Year 4	*$0*	*$0* *($50,000)*	*Nonrecaptured losses*		
Year 5	*$10,000*	*$10,000* *($40,000)*	*Gain is ordinary* *Nonrecaptured losses*	*$10,000*	
Year 6	*$0*	*$0* *$0*	*Nonrecaptured losses only carryforward 5 years*		
Year 7	*$50,000*	*$50,000* *$0*	*$50,000 is §1231*		*$50,000*

b. After applying the §1231 five-year look back rule, $40,000 is ordinary income and $10,000 is long-term capital gain.

Year	***Net §1231 gain (loss)***	***Recaptured/ Nonrecaptured §1231 losses***	***Notes***	***Ordinary***	***LTCG***
Year 1	*($65,000)*	*$0* *($65,000)*	*Loss is ordinary* *Nonrecaptured losses*	*($65,000)*	
Year 2	*$15,000*	*$15,000* *($50,000)*	*Gain is ordinary* *Nonrecaptured losses*	*$15,000*	
Year 3	*$0*	*$0* *($50,000)*	*Nonrecaptured losses*		
Year 4	*$0*	*$0* *($50,000)*	*Nonrecaptured losses*		
Year 5	*$10,000*	*$10,000* *($40,000)*	*Gain is ordinary* *Nonrecaptured losses*	*$10,000*	
Year 6	*$50,000*	*$40,000* *$10,000* *$0*	*Gain is ordinary* *§1231* *Nonrecaptured losses only carryforward 5 years*	*$40,000*	*$10,000*

55. [LO 6] Independence Corporation needs to replace some of the assets used in its trade or business and is contemplating the following exchanges:

Exchange	**Asset Given Up by Independence**	**Asset Received by Independence**
A	Office building in Chicago, IL	Piece of land in Toronto, Canada
B	Large warehouse on two acres	Small warehouse on twenty-two acres
C	Office building in Green Bay, WI used in the business	Apartment complex in Newport Beach, CA, that will be held as an investment

Determine whether each exchange qualifies as a like-kind exchange. Also explain the rationale for why each qualifies or does not qualify as a like-kind exchange.

Exchange	
A	*The exchange of an office building in Chicago for a piece of land in Toronto will not qualify because real property used outside the US does not qualify for like-kind treatment.*
B	*The exchange of a large warehouse on two acres for a small warehouse on twenty-two acres qualifies as a like-kind exchange since they are both real property.*
C	*The exchange of the office building in Green Bay, WI for an apartment complex in Newport Beach, CA qualifies as a like-kind exchange since they are both real property that are either used in the business or held for*

	investment.

56. [LO 6] Kase, an individual, purchased some property in Potomac, Maryland, for $150,000 approximately 10 years ago. Kase is approached by a real estate agent representing a client who would like to exchange a parcel of land in North Carolina for Kase's Maryland property. Kase agrees to the exchange. What is Kase's realized gain or loss, recognized gain or loss, and basis in the North Carolina property in each of the following alternative scenarios?
    a. The transaction qualifies as a like-kind exchange and the fair market value of each property is $675,000.
    b. The transaction qualifies as a like-kind exchange and the fair market value of each property is $100,000.

    a. Even though Kasehas a realized gain of $525,000, the recognized gain is $0 because the transaction qualifies as a like-kind exchange and Kase did not receive any boot. Kase receives a carryover basis of $150,000 in the North Carolina property (the same basis Kase had in the Maryland property). See the following computation:

Description	***Amount***	***Explanation***
(1) Amount realized from property	*$675,000*	*Given*
(2) Amount realized from boot (non like-kind property)	*$0*	*Given*
(3) Total amount realized	*$675,000*	*(1) + (2)*
(4) Adjusted basis	*$150,000*	*Given*
(5) ***Gain realized***	***$525,000***	*(3) – (4)*
(6) ***Gain recognized***	***$0***	*Lesser of (2) or (5)*
(7) Deferred gain	*$525,000*	*(5) – (6)*
Adjusted basis in new property	***$150,000***	*(1) – (7)*

    b. Kasehas a realized loss of ($50,000), but the recognized loss is $0 because the transaction qualifies as a like-kind exchange. Kase would have a carryover basis of $150,000. See the following computation:

Description	***Amount***	***Explanation***
(1) Amount realized from property	*$100,000*	*Given*
(2) Amount realized from boot (cash)	*$0*	*Given*
(3) Total amount realized	*$100,000*	*(1) + (2)*
(4) Adjusted basis	*$150,000*	*Given*
(5) ***Loss realized***	***($50,000)***	*(3) – (4)*
(6) ***Loss recognized***	***$0***	*Lesser of (2) or (5)*
(7) Deferred loss	*$50,000*	*(5) – (6)*
Adjusted basis in new property	***$150,000***	*(1) + (7)*

57. [LO 6] {Research} Longhaul Real Estate exchanged a parcel of land it held for sale in Bryan, Texas for a warehouse in College Station, Texas.Will the exchange qualify for like-kind treatment?

    No, Longhaul Real Estate held the land for sale and as such it cannot qualify for like-kind exchange treatment under §1031(a)(2).

58. [LO 6] {Research} {Planning} Twinbrook Corporation needed to upgrade to a larger manufacturing facility. Twinbrook first acquired a new manufacturing facility for $2,100,000 cash, and then transferred the facility it was using (building and land) to White Flint Corporation for $2,000,000 three months later. Does the exchange qualify for like-kind exchange treatment (*Hint*: examine Revenue Procedures 2000-37 and 2004-51)? If not, can you propose a change in the transaction that will allow it to qualify?

    Twinbrook's exchange will not qualify as a parking transaction or reverse Starker exchange. Initially, under Rev. Proc. 2000-37 it would have qualified. However, Rev. Proc. 2004-51 modified the requirements, so that Twinbrook's transaction no longer qualifies.

    Under Rev. Proc. 2004-51, a taxpayer may place property with an accommodation party until the taxpayer can arrange for an exchange. Therefore, if Twinbrook gives the funds to a qualified intermediary who obtains the new property and holds it until Twinbrook can arrange for the transfer of its current property, the exchange will qualify as a Starker or deferred like-kind exchange if the two timing requirements are met. First, the like-kind property to be received is identified within 45 days [§1031(a)(3)(A)]. Second, the like-kind property is received within 180 days of the transfer(or the due date of the tax return including extensions)of the property given up [§1031(a)(3)(B)(i)].

59. [LO 6] {Research} Woodley Park Corporation currently owns two parcels of land (parcel 1 and parcel 2). It owns a warehouse facility on parcel 1. Woodley needs to acquire a new and larger manufacturing facility. Woodley was approached by Blazing Fast Construction (who specializes in prefabricated warehouses) about acquiring Woodley's existing warehouse on parcel 1. Woodley indicated that it prefers to exchange its existing facility for a new and larger facility in a qualifying like-kind exchange. Blazing Fast indicated that it could construct a new manufacturing facility on parcel 2 to Woodley's specification within four months. Woodley and Blazing Fast agreed to the following arrangement. First, Blazing Fast would construct the new warehouse on parcel 2 and then relinquish the property to Woodley within four months. Woodley would then transfer the warehouse facility and land parcel 1 to Blazing Fast. All of the property exchanged in the deal was identified immediately and the construction was completed within 180 days. Does the exchange of the new building for the old building and parcel 1 qualify as a like-kind exchange (see *DeCleene v. Commissioner*, 115 TC 457)?

Even though Woodley is trading real property (old building and Parcel 1) for real property (a new building constructed on Woodley's Parcel 2), the exchange does not qualify as a like-kind exchange. Woodley's facts are similar to those of two cases—DeCleene v. Commissioner and Bloomington Coca-Cola Bottling Co. v. Commissioner (51-1 USTC ¶9320). After applying the step transaction doctrine, the effect was Woodley purchasing a new facility, and not an exchange of unimproved property for improved property, inasmuch as the taxpayer already owned the land on which the new plant was constructed. Blazing Fast could not be a party to an exchange with the taxpayer because the contractor was never the owner of the property that the taxpayer received in the so-called exchange.

60. [LO 6] Metro Corp. traded Land A for Land B. Metro originally purchased Land A for $50,000 and Land A's adjusted basis was $25,000 at the time of the exchange. What is Metro's realized gain or loss, recognized gain or loss, and adjusted basis in Land B in each of the following alternative scenarios?
    a. The fair market value of Land A and of Land B is $40,000 at the time of the exchange. The exchange does not qualify as a like-kind exchange.
    b. The fair market value of Land A and of Land B is $40,000. The exchange qualifies as a like-kind exchange
    c. The fair market value of Land A is $35,000 and Land B is valued at $40,000. Metro exchanges Land A and $5,000 cash for Land B.Land A and Land B are like-kind property.
    d. The fair market value of Land A is $45,000 and Metro trades Land A for Land B valued at $40,000 and $5,000 cash.Land A and Land B are like-kind property.

    a. *If the transaction does not qualify as a like kind exchange, Metro has a realized and recognized gain of $15,000 ($40,000 amount realized minus $25,000 adjusted basis). The basis in Land B is its $40,000 fair market value.*

    b. *Even though Metro has a realized gain of $15,000 ($40,000 - $25,000), the recognized gain is $0 because the transaction qualifies as a like-kind exchange. Metro receives a basis of $25,000 in Land B. See the following computations:*

Description	***Amount***	***Explanation***
(1) Amount realized from Land B	*$40,000*	
(2) Amount realized from boot (cash)	*$0*	
(3) Total amount realized	*$40,000*	*(1) + (2)*
(4) Adjusted basis	*$25,000*	*Given in example*
(5) ***Gain realized***	***$15,000***	*(3) – (4)*
(6) ***Gain recognized***	***$0***	*Lesser of (2) or (5)*
(7) Deferred gain	*$15,000*	*(5) – (6)*
Adjusted basis in LandB	***$25,000***	*(1) – (7)*

c. The realized gain is $10,000 and the recognized gain is $0. Metro's basis in Land B is $30,000. See the following computations:

Description	***Amount***	***Explanation***
(1) Amount realized from Land B	*$40,000*	*Given in example*
(2) Amount realized from boot (cash)	*$0*	*Given in example*
(3) Total amount realized	*$40,000*	*(1) + (2)*
(4) Adjusted basis	*$30,000*	*$25,000 + $5,000 cash*
(5) ***Gain realized***	***$10,000***	*(3) – (4)*
(6) ***Gain recognized***	***$0***	*Lesser of (2) or (5)*
(7) Deferred gain	*$10,000*	*(5) – (6)*
Adjusted basis in LandB	***$30,000***	*(1) – (7)*

d. Metro's realized gain is $20,000 and its recognized gain is $5,000 (the amount of the boot received) because the transaction qualifies as a like-kind exchange. Metro's basis in Land B is $25,000. See the following computations:

Description	***Amount***	***Explanation***
(1) Amount realized from Land B	*$40,000*	*Given in example*
(2) Amount realized from boot (cash)	*$5,000*	*Given in example*
(3) Total amount realized	*$45,000*	*(1) + (2)*
(4) Adjusted basis	*$25,000*	*Given in example*
(5) ***Gain realized***	***$20,000***	*(3) – (4)*
(6) ***Gain recognized***	***$5,000***	*Lesser of (2) or (5)*
(7) Deferred gain	*$15,000*	*(5) – (6)*
Adjusted basis in LandB	***$25,000***	*(1) – (7)*

61. [LO 6] Prater Inc. enters into an exchange in which it gives up its warehouse on 10 acres of land and receives a tract of land. A summary of the exchange is as follows:

Transferred	**FMV**	**Original Basis**	**Accumulated Depreciation**
Warehouse	$300,000	$225,000	$45,000
Land	50,000	50,000	
Mortgage on warehouse	30,000		
Cash	20,000	20,000	

Assets Received	**FMV**
Land	$340,000

What is Prater's realized and recognized gain on the exchange and its basis in the assets it received in the exchange?

Gain realized is $120,000, gain recognized is $10,000, and Prater's adjusted basis in the land is $230,000.

Description	***Amount***	***Explanation***
(1) Amount realized in like-kind	*$340,000*	*Given. FMV of land*
(2) Amount realized from boot	*30,000*	*Mortgage relief*
(3) Total amount realized	*$370,000*	*(1) + (2)*
(4) Adjusted basis	*250,000*	*$225,000 - $45,000 + $50,000 (land) + $20,000 (cash)*
(5) ***Gain Realized***	***$120,000***	*(3) – (4)*
(6) ***Gain recognized***	***$10,000***	*Lesser of [(2) – cash paid or liability assumed] or (5)*
(7) Deferred gain	*$110,000*	*(5) – (6)*
Adjusted basis in new property	***$230,000***	*(1) – (7)*

**Prater has debt relief of $30,000 and can offset this boot with cash paid of $20,000. The offset rules allow a taxpayer to offset debt relief with cash paid or with other liabilities assumed. Consequently, Prater is allowed to net the debt relief against cash paid and he is treated as receiving only the $10,000 net liabilities he's been relieved of as boot.*

62. [LO 6] Baker Corporation owned a building located in Kansas. Baker used the building for its business operations. Last year a tornado hit the property and completely destroyed it. This year, Baker received an insurance settlement. Baker had originally purchased the building for $350,000 and had claimed a total of $100,000 of depreciation deductions against the property. What is Baker's realized and recognized gain or (loss) on this transaction and what is its basis in the new building in the following alternative scenarios?

    a. Baker received $450,000 in insurance proceeds and spent $450,000 rebuilding the building during the current year.
    b. Baker received $450,000 in insurance proceeds and spent $500,000 rebuilding the buildingduring the current year.
    c. Baker received $450,000 in insurance proceeds and spent $400,000 rebuilding the buildingduring the current year.
    d. Baker received $450,000 in insurance proceeds and spent $450,000 rebuilding the buildingduring the next three years.

a. Because Baker reinvested all of the insurance proceeds, it will not recognize any of its $200,000 realized gain. Baker's basis in the new building is $250,000. See the following calculations:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Insurance proceeds*
(2) Adjusted Basis	*$250,000*	*$350,000 – 100,000 accumulated depreciation*
(3) ***Gain Realized***	***$200,000***	*(1) – (2)*
(4) Insurance proceeds	*$450,000*	*(1)*

(5) Proceeds reinvested	*$450,000*	*Given*
(6) Amount not reinvested	*$0*	*(4) – (5)*
(7) ***Gain recognized***	***$0***	*Lesser of (3) or (6)*
(8) Deferred gain	*$200,000*	*(3) – (7)*
(9) Value of replacement property	*$450,000*	*Given*
Basis of replacement property	***$250,000***	*(9) – (8)*

b. Because Baker reinvested all of the insurance proceeds, it will not recognize any of its $200,000 realized gain. Baker's basis in the new building is $300,000. See the following calculations:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Insurance proceeds*
(2) Adjusted Basis	*$250,000*	*$350,000 – 100,000 accumulated depreciation*
(3) ***Gain Realized***	***$200,000***	*(1) – (2)*
(4) Insurance proceeds	*$450,000*	*(1)*
(5) Proceeds reinvested	*$500,000*	*Given*
(6) Amount not reinvested	*$0*	*(4) – (5)*
(7) ***Gain recognized***	***$0***	*Lesser of (3) or (6)*
(8) Deferred gain	*$200,000*	*(3) – (7)*
(9) Value of replacement property	*$500,000*	*$450,000 + $50,000*
Basis of replacement property	***$300,000***	*(9) – (8)*

c. Because Baker reinvested only a portion of the insurance proceeds, it will recognize $50,000 of its $200,000 realized gain. Baker's basis in the new building is $250,000. See the following calculations:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Insurance proceeds*
(2) Adjusted Basis	*$250,000*	*$350,000 – 100,000 accumulated depreciation*
(3) ***Gain Realized***	***$200,000***	*(1) – (2)*
(4) Insurance proceeds	*$450,000*	*(1)*
(5) Proceeds reinvested	*$400,000*	*Given*
(6) Amount not reinvested	*$50,000*	*(4) – (5)*
(7) ***Gain recognized***	***$50,000***	*Lesser of (3) or (6)*
(8) Deferred gain	*$150,000*	*(3) – (7)*
(9) Value of replacement property	*$400,000*	*Given*
Basis of replacement property	***$250,000***	*(9) – (8)*

d. Because Baker took three years to replace the property destroyed in the involuntary conversion, Baker will recognize all of its $200,000 realized gain. Baker's basis in the new building is $450,000. See the following calculations:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$450,000*	*Insurance proceeds*
(2) Adjusted Basis	*$250,000*	*$350,000 – 100,000 depreciation*
(3) ***Gain Realized***	***$200,000***	*(1) – (2)*
(4) Insurance proceeds	*$450,000*	*(1)*
*(5) Proceeds reinvested**	*$0*	*Given*
(6) Amount not reinvested	*$450,000*	*(4) – (5)*
(7) ***Gain recognized***	***$200,000***	*Lesser of (3) or (6)*
(8) Deferred gain	*$0*	*(3) – (7)*
(9) Value of replacement property	*$450,000*	*Given*
Basis of replacement property	***$450,000***	*(9) – (8)*

**The proceeds were not reinvested within the two-year time period; therefore, they are not a qualified reinvestment.*

63. [LO 6] Russell Corporation sold a parcel of land valued at $400,000. Its basis in the land was $275,000. For the land, Russell received $50,000 in cash in year 0 and a note providing that Russell will receive $175,000 in year 1 and $175,000 in year 2 from the buyer.

    a. What is Russell's realized gain on the transaction?
    b. What is Russell's recognized gain in year 0, year 1, and year 2?

    a. *Russell's realized gain is $125,000 (see calculation below).*

    b. *Russell recognizes $15,625 in year 0, $54,688 in year 1, and $54,688 in year 2. See the following calculations:*

Description	***Amount***	***Explanation***
(1) Sales price	*$400,000*	
(2) Adjusted basis	*$275,000*	
(3) ***Realized Gain/Gross profit***	***$125,000***	*(1) – (2)*
(4) Contract price	*$400,000*	*(1) – assumed liabilities (-0-)*
(5) Gross Profit Percentage	*31.25%*	*(3) / (4)*
(6) Payment received in year 0	*$50,000*	
Gain recognized in year 0	***$15,625***	*(6) x (5)*
(7) Payment received in year 1	*$175,000*	
Gain recognized in year 1	***$54,688***	*(7) x (5)*
(8) Payment received in year 2	*$175,000*	
Gain recognized in year 2	***$54,688***	*(8) x (5)*

Note that all of the $125,000 gain realized is recognized over the three-year period.

64. [LO 6] In year 0, Javens, Inc. sold machinery with a fair market value of $400,000 to Chris. The machinery's original basis was $317,000 and Javens's accumulated depreciation on the machinery was $50,000, so its adjusted basis to Javens was $267,000. Chris paid Javens $40,000 immediately (in year 0) and provided a note to Javens indicating that Chris would pay Javens $60,000 a year for six years beginning in year 1. What is the amount and character of the gain that Javens will recognize in year 0? What amount and character of the gain will Javens recognize in years 1 through 6?

Javens recognizes $58,300 of income in year 0 ($50,000 ordinary income and $8,300 of §1231 gain). It also recognizes $12,450 of §1231 gain each year from year 1 through year 6, computed as follows:

Description	***Amount***	***Explanation***
(1) Sales price	*$400,000*	
(2) Original Basis	*$317,000*	
(3) Accumulated Depreciation	*$50,000*	
(4) Adjusted Basis	*$267,000*	*(2) – (3)*
(5) Realized Gain/(Loss)	*$133,000*	*(1) – (4)*
(6) Ordinary income from §1245 depreciation recapture (not eligible for installment reporting)	***$50,000***	*Ordinary income Lesser of (3) and (5)*
(7) Gain eligible for installment reporting	*$83,000*	*(5) – (6)*
(8) Contract price	*$400,000*	*(1) – assumed liabilities (-0-)*
(9) Gross profit percentage	*20.75%*	*(7) / (8)*
(10) Payment received in year 0	*$40,000*	
(11) Gain recognized on payment in year 0	***$8,300***	*(10) ×(9) §1231 gain*
Total gain recognized in year 0	***$58,300***	*(6) + (11)*
(12) Payment received in years 1 through 6 (each year)	*$60,000*	
Gain recognized in years 1 through 6 (with each payment)	***$12,450***	*(12) ×(9) §1231 gain*

65. [LO 6] {Research} Ken sold a rental property for $500,000. He received $100,000 in the current year and $100,000 each year for the next four years. $400,000 of the sales price was allocated to the building and the remaining $100,000 was allocated to the land. Ken purchased the property several years ago for $300,000. When he initially purchased the property, he allocated $225,000 of the purchase price to the building and $75,000 to the land. Ken has claimed $25,000 of depreciation deductions over the years against the building. Ken had no other sales of §1231 or capital assets in the current year. For the year of the sale, determine Ken's recognized gain or loss, the character of Ken's gain, and calculate Ken's tax due because of the sale (assuming his marginal ordinary tax rate is 32 percent). (*Hint:* see the examples in Reg. §1.453-12.)

The sale qualifies as an installment sale. As a result, in the year of the sale Ken has a §1231 gain of $25,000 taxed at a maximum 25percent rate. He also has a §1231 gain of $20,000 taxed at a maximum 15percent rate. In the year of the sale, Ken's tax liability is $9,250. The unrecaptured §1250 gain is recognized before any of the §1231 gain (as indicated by the regulations). The remaining gain is taxed in subsequent years. The computation for the current year is as follows:

Description	***Amount***	***Explanation***
(1) Sales price	*$500,000*	
(2) Adjusted Basis	*$275,000*	*$300,000 - $25,000 accumulated depreciation*
(3) ***Gain Realized/Gross profit***	***$225,000***	*(1) – (2)*
(4) Contract price	*$500,000*	*(1) – assumed liabilities (-0-)*
(5) Gross Profit Percentage	*45%*	*(3) / (4)*
(6) Payment received in year 0	*$100,000*	
Gain recognized in year 0	***$45,000***	*(6) ×(5), $25,000 of unrecaptured §1250 and $20,000 §1231 gain*

Character	***Amount***	***Rate***	***Tax***
Unrecaptured §1250 (§1231 gain)	*$25,000*	*25%*	*$6,250*
Other §1231 gain	*$20,000*	*15%*	*3,000*
Tax			*$9,250*

66. [LO 6] {Planning} Hill Corporation is in the leasing business and faces a marginal tax rate of 21 percent. It has leased a building to Whitewater Corporation for several years. Hill bought the building for $150,000 and claimed $20,000 of depreciation deductions against the asset. The lease term is about to expire and Whitewater would like to acquire the building. Hill has been offered two options to choose from:

Option	**Details**
Like-kind exchange	Whitewater would provide Hillwith a like-kind building. The like-kind buildinghas a fair market value of $135,000.
Installment sale	Whitewater would provide Hill with two payments of $69,000. Itwould use the proceeds to purchase another buildingthat itcould also lease.

Ignoring time value of money, which option provides the greatest after-tax value for Hill, assuming it is indifferent between the proposals based on nontax factors?

Option 1, Description	***Amount***	***Explanation***
(1) Amount realized in like-kind	*$135,000*	
(2) Amount realized in boot	*$0*	

(3) Total amount realized	*$135,000*	
(4) Adjusted basis	*$130,000*	*$150,000 - $20,000 accumulated depreciation*
(5) ***Gain realized***	***$5,000***	*(3) – (4)*
(6) ***Gain recognized***	***$0***	*Lesser of (2) or (5)*
(7) Deferred gain	*$5,000*	*(5) – (6)*
Adjusted basis in new property	***$130,000***	*(1) – (7)*

Option 2 Description	***Amount***	***Explanation***
(1) Sales price	*$136,000*	
(2) Original Basis	*$150,000*	
(3) Accumulated Depreciation	*$20,000*	
(4) Adjusted Basis	*$130,000*	*(2) – (3)*
(5) Realized Gain/(Loss)	*$6,000*	*(1) – (4)*
(6) Ordinary income from §291depreciation recapture (not eligible for installment reporting)*	***$1,200***	*Ordinary income (Lesser of (3) and (5)) × 20%*
(7) Gain eligible for installment reporting	*$4,800*	*(5) – (6)*
(8) Contract price	*$136,000*	*(1) – assumed liabilities (-0-)*
(9) Gross profit percentage	*3.5%*	*(7) / (8)*
(10) Payment received in year 2	*69,000*	
(11) Gain reported in year 2	*$507*	*(9) × (10)*

**The installment method cannot be used to defer the gain related to depreciation recapture.*

Description	***Amount***	***Explanation***
(1) Amount realized	*$136,000*	*Cash from note*
(2) Tax in year 1	*(252)*	*$1,200 gain ×21% tax rate*
(3) Tax in year 2	*(106)*	*$507 gain × 21% tax rate*
After Tax Value	*$135,642*	*(1) – (2) – (3)*

Hill would be better off with Option 2. This option gives a higher after tax value by $642($135,642versus $135,000). Additionally, if it invests its after-tax proceeds from the installment sale in a new building, the basis in option 2 is $5,200 ($135,642 - $130,000) higher, which allows her higher depreciation deductions in the future.

67. [LO 6] Deirdre sold 100 shares of stock to her brother, James, for $2,400. Deirdre purchased the stock several years ago for $3,000.

a. What gain or loss does Deirdre recognize on the sale?

b. What amount of gain or loss does James recognize if he sells the stock for $3,200?

c. What amount of gain or loss does James recognize if he sells the stock for $2,600?

d. What amount of gain or loss does James recognize if he sells the stock for $2,000?

a. Though Deirdre realizes a $600 loss, she is not allowed to recognize any of the loss because she sold the stock to a related person (her brother). See the following computation:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$2,400*	
(2) Basis	*3,000*	
(3) Gain (Loss) Realized	*($600)*	*(1) – (2)*
(4) Disallowed Loss	*(600)*	**no recognized loss on related person sale*
Gain/(Loss) Recognized	***$0***	*(3) – (4)*

b. $200 gain (see calculations below)
c. $0 (see calculations below)
d. ($400) loss (see calculations below)

Description	***Partb***	***Partc***	***Partd***	***Explanation***
(1) Amount Realized	*$3,200*	*$2,600*	*$2,000*	
(2) Adjusted Basis	*2,400*	*2,400*	*2,400*	
(3) Realized Gain (Loss)	*$800*	*$200*	*($400)*	*(1) – (2)*
(4) Benefit of Deirdre's ($600) disallowed Loss	*$600*	*$200*	*$0*	*Lesser of (3) (if a loss, then $0) or $600 (the amount of Deirdre's disallowed loss)*
Recognized Gain/(Loss)	***$200***	***$0***	***($400)***	*(3) – (4)*

Comprehensive Problems

68. Two years ago, Bethesda Corporation bought a delivery truck for $30,000 (not subject to the luxury auto depreciation limits). Bethesda used MACRS 200 percent declining balance and the half-year convention to recover the cost of the truck, but it did not elect §179 expensingand opted out of bonus depreciation. Answer the questions for the following alternative scenarios.
    a. Assuming Bethesda used the truck until it sold it in March of year 3, what depreciation expense can it claim on the truck for years 1 through 3?
    b. Assume that Bethesdaclaimed $18,500 of depreciation expense on the truck before it sold it in year 3. What is the amount and character of the gain or loss if Bethesda sold the truck in year 3 for $17,000, and incurred $2,000 of selling expenses on the sale?
    c. Assume that Bethesda claimed $18,500 of depreciation expense on the truck before it sold it in year 3. What is the amount and character of the gain or loss if Bethesda sold the truck in year 3 for $35,000, and incurred $3,000 of selling expenses on the sale?

    a. *Depreciation expense for years 1 through 3 is $6,000, $9,600, $2,880, respectively. This is calculated under MACRS with a five-year recovery*

period, half-year convention, and 200 percent declining balance method. Because the truck was disposed of during year 3, the depreciation rate in the table is reduced by 50percent. The depreciation expense for each year is calculated as follows:

Year	***(1) OriginalBasis***	***(2) Rate***	***(1) x (2) Depreciation***
1	*$30,000*	*20.00%*	*$6,000*
2	*30,000*	*32.00%*	*9,600*
3	*30,000*	*9.60%**	*2,880*
			$18,480

**9.6% = 19.20% ×.5 (half-year in year of disposition)*

b. Bethesda would recognize $3,500 of ordinary income due to the §1245 depreciation recapture rules, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$15,000*	*$17,000 - $2,000 selling expenses*
(2) Original Basis	*$30,000*	
(3) Accumulated depreciation	*(18,500)*	
(4) Adjusted Basis	*$11,500*	*(2) + (3)*
(5) ***Gain/(Loss) Recognized***	***$3,500***	*(1) – (4)*
(6) §1245 depreciation recapture	***$3,500***	*Lesser of (3) or (5)*
(7) §1231 gain	***$0***	*(5) – (6)*

c. Bethesda would recognize $20,500 of gain. Of that amount, $18,500 will be ordinary income due to the §1245 depreciation recapture rules and the remaining $2,000 will be §1231 gain, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$32,000*	*$35,000 - $3,000 selling expenses*
(2) Original Basis	*$30,000*	
(3) Accumulated depreciation	*(18,500)*	
(4) Adjusted Basis	*$11,500*	*(2) + (3)*
(5) ***Gain/(Loss) Recognized***	***$20,500***	*(1) – (4)*
(6) §1245 depreciation recapture	***$18,500***	*Lesser of (3) and (5)*
(7) §1231 gain	***$2,000***	*(5) – (6)*

69. Hauswirth Corporation sold (or exchanged) a warehouse in year 0. Hauswirth bought the warehouse several years ago for $65,000 and it has claimed $23,000 of depreciation expense against the building.

a. Assuming that Hauswirth receives $50,000 in cash for the warehouse, compute the amount and character of Hauswirth's recognized gain or loss on the sale.
b. Assuming that Hauswirth exchanges the warehouse in a like-kind exchange for some land with a fair market value of $50,000, compute Hauswirth's gain realized, gain recognized, deferred gain, and basis in the new land.
c. Assuming that Hauswirth receives $20,000 in cash in year 0 and a $50,000 note receivable that is payable in year 1, compute the amount and character of Hauswirth's gain in year 0 and in year 1.

a. Hauswirth's recognizes an $8,000 gain: $1,600 of ordinary income under §291 and $6,400 of §1231 gain, computed as follows:

Description	***Amount***	***Explanation***
(1) Amount Realized	*$50,000*	
(2) Original Basis	*65,000*	
(3) Accumulated Depreciation	*(23,000)*	
(4) Adjusted Basis	*$42,000*	*(2) + (3)*
(5) Gain (Loss) Recognized	*$8,000*	*(1) – (4)*
(6) ***Ordinary income (§291depreciation recapture)***	***$1,600***	*Lesser of (3) or (5) × 20%*
§1231 gain	***$6,400***	*(5) – (6)*

b. Because this transaction qualifies as a §1031 like-kind exchange, Hauswirth will not recognize any of its $8,000realized gain (its deferred gain is $8,000). Hauswirth's basis in its new land is $42,000. See the following computations:

Description	***Amount***	***Explanation***
(1) Amount realized from land	*$50,000*	
(2) Amount realized from boot (cash)	*0*	
(3) Total amount realized	*$50,000*	*(1) + (2)*
(4) Adjusted basis	*42,000*	*$65,000 - $23,000*
(5) ***Gain realized***	***$8,000***	*(3) – (4)*
(6) ***Gain recognized***	***$0***	*Lesser of (2) or (5)*
(7) ***Deferred gain***	***$8,000***	*(5) – (6)*
Adjusted basis in new property	***$42,000***	*(1) – (7)*

c. In year 0, Hauswirth recognizes $23,000 of ordinary income and $1,428 of §1231 gain. In year 1, it recognizes $3,571 of §1231 gain, computed as follows:

Description	***Amount***	***Explanation***
(1) Sales price	*$70,000*	
(2) Original Basis	*65,000*	
(3) Accumulated Depreciation	*(23,000)*	

(4) Adjusted Basis	*$42,000*	*(2) + (3)*
(5) Realized Gain(Loss)	*$28,000*	*(1) – (4)*
(6) ***Ordinary income from §291depreciation recapture (not eligible for installment reporting)***	***$4,600***	*Ordinary income Lesser of (3) and (5) × 20%*
(7) Gain eligible for installment reporting	*$23,400*	*(5) – (6)*
(8) Contract price	*$70,000*	
(9) Gross profit percentage	*33.43%*	*(7) / (8)*
(10) Payment received in year 0	*$20,000*	
§1231 gain recognized in year 0	***$6,685***	*(10) ×(9) §1231 gain*
(11) Payment received in year 1	*$50,000*	
§1231 gain recognized in year 1	***$16,715***	*(11) ×(9) §1231 gain*

**Rounding the gross profit percentage to 2 decimal places results in a total recognized gain of $28,001 ($4,600 + $6,685 + $16,715) rather than the $28,000 shown on line (5).*

70. {Research} Fontenot Corporation sold some machinery to its majority owner Gray (an individual who owns 60 percent of Fontenot). Fontenot purchased the machinery for $100,000 and has claimed a total of $40,000 of depreciation expense deductions against the property. Gray will provide Fontenot with $10,000 of cash today and provide a $100,000 note that will pay Fontenot $50,000 one year from now and $50,000 two years from now.
    a. What gain does Fontenot's realize on the sale?
    b. What is the amount and character of the gain that Fontenot must recognize in the year of sale (if any) and each of the two subsequent years? (*Hint*: use the Internal Revenue Code and start with §453, please give appropriate citations.)

a. Fontenot's gain realized is $50,000.

Description	***Amount***	***Explanation***
(1) Amount Realized	*$110,000*	
(2) Original Basis	*100,000*	
(3) Accumulated Depreciation	*(40,000)*	
(4) Adjusted Basis	*$60,000*	*(2) + (3)*
(5) Realized Gain(Loss)	*$50,000*	*(1) – (4)*

b. Fontenot must recognize the entire $50,000 gain. The character of the entire gain is ordinary. Depreciation recapture is not eligible for deferral under the installment method under §453(i), as a result $40,000 of §1245 gain (the lesser of gain realized or depreciation taken) must be recognized as ordinary income during the year of sale. §453(g) generally prohibits use of the installment method when depreciable property is sold to a related person. §453(g)(3) defines related person with respect to §1239(b). Since Gray owns more than 50percent of Fontenot Corporation, they are considered related parties. As a result, the remaining gain is ordinary income under §1239 because the depreciable asset was sold to a related entity. Absent these rules,

the remaining $10,000 of gain would have been eligible for the installment method.

71. Moab, Inc. manufactures and distributes high-tech biking gadgets. It has decided to streamline some of its operations so that it will be able to be more productive and efficient. Because of this decision it has entered into several transactions during the year.

Part (1) Determine the gain/loss realized and recognized in the current year for each of these events. Also determine whether the gain/loss recognized is§1231, capital, or ordinary.

a. Moab Inc. sold a machine that it used to make computerized gadgets for $27,300 cash. It originally bought the machine for $19,200 three years agoand has taken $8,000 depreciation.
b. Moab Inc. held stock in ABC Corp., which had a value of $12,000 at the beginning of the year. That same stock had a value of $15,230 at the end of the year.
c. Moab Inc. sold some of its inventory for $7,000 cash. This inventory had a basis of$5,000.
d. Moab Inc. disposed of an office building with a fair market value of $75,000 for another office building with a fair market value of $55,000 and $20,000 in cash. It originally bought the office building seven years ago for $62,000 and has taken $15,000 in depreciation.
e. Moab Inc. sold land it held for investment for $28,000. It originally bought the land for $32,000 two years ago.
f. Moab Inc. sold another machine for a note receivable in four annual installments of $12,000. The first payment was received in the current year. It originally bought the machine two years ago for $32,000 and had claimed $9,000 in depreciation expense against the machine.
g. Moab Inc. sold stock it held for eight years for $2,750. It originally purchased the stock for $2,100.
h. Moab Inc. sold another machine for $7,300. It originally purchased this machine six months ago for $9,000 and has claimed $830 in depreciation expense against the asset.

Part (2) From the recognized gains/losses determined in part 1, determine the net §1231 gain/loss and the net ordinary gain/loss Moab will recognize on its tax return.Moab, Inc. also has $2,000 of nonrecaptured §1231 losses from previous years.

Part (3) (Forms) Complete Moab, Inc.'s Form 4797 for the year. Use the most current form available.

Part (1)

Asset	***Realized Gain/Loss***	***Recognized Gain/Loss***	***Character***

1a	*$16,100*	*$16,100*	*$8,000 §1245 recapture; $8,100 §1231 gain. Amount realized $27,300 less adjusted basis $11,200 ($19,200 cost - $8,000 depreciation.)*
1b	*-0-*	*-0-*	*No realization*
1c	*2,000*	*2,000*	*Ordinary income*
1d	*28,000*	*20,000**	*$3,000 §291 recapture; $17,000 §1231 gain. Amount realized $75,000 less adjusted basis $47,000 ($62,000 cost less $15,000 depreciation) = $28,000 realized gain.*
1e	*(4,000)*	*(4,000)*	*Long-term capital loss. Amount realized $28,000 less adjusted basis $32,000.*
1f	*25,000*	*13,000***	*$9,000 §1245 recapture; $4,000 §1231 gain. Amount realized $48,000 (4 installments x 4 years) less adjusted basis $23,000 ($32,000 cost less $9,000 depreciation) = $25,000 realized gain.*
1g	*650*	*650*	*Long-term capital gain. Amount realized $2,750 less adjusted basis $2,100 = $650 realized gain.*
1h	*(870)*	*(870)*	*Ordinary loss; not held more than 12 months*

** Moab recognizes $20,000 gain due to the boot received in the like-kind exchange. The remaining gain is deferred.*
***$13,000 recognized gain consists of $9,000 depreciation recapture (required to be recognized in year of sale and not eligible for installment sale treatment) and $4,000 [($16,000 remaining gain/$48,000 amount realized) x $12,000 cash received in year of sale].*

Part (2)
Moab will realize $23,750 in net capital gains and $23,130 in ordinary income, computed as follows:

§1231 Netting Process

Description	***Amount***	***Explanation***
(1) §1231 gain	*$29,100*	*$8,100 from 1a +17,000 from 1d +4,000 from 1f*
(2) §1231 loss	*-0-*	
(3) Net §1231 gain	*$29,100*	*(1) + (2)*
(4) Nonrecaptured §1231 losses	*$2,000*	*Ordinary*
Net §1231 gain	***$27,100***	*(3) – (4); treated as LTCG*

Ordinary Income:

Description	***Amount***	***Explanation***
(1) §1245 recapture	*$17,000*	*$8,000 from 1a + 9,000*

		from 1f
(2) §291 recapture	*3,000*	*From 1d*
(3) Ordinary income	*2,000*	*From 1c*
(4) Ordinary loss	*(870)*	*From 1h*
(5) Ordinary income from §1231 netting	*2,000*	*Lookback rule*
Total	***$23,130***	*(1) +(2) + (3) +(4)*

Capital Gains and Losses:

Description	***Amount***	***Explanation***
(1) Capital gain	*$27,750*	*$650 from 1g + 27,100 from §1231 netting*
(2) Capital loss	*(4,000)*	*From 1e*
Net capital gain	***$23,750***	*(1) +(2)*

Part (3)

Moab's Form 4797 appears as follows:

Form **4797**

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.

▶ Go to www.irs.gov/Form4797 for instructions and the latest information.

OMB No. 1545-0184

2017

Attachment Sequence No. **27**

Name(s) shown on return: Moab, Inc.

Identifying number

1 Enter the gross proceeds from sales or exchanges reported to you for 2017 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions. 1

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

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis plus improvements and expense of sale	(g) Gain or (loss) combine lines 6 and 9

3 Gain if any, from Form 4684, line 39	3	
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	1,000
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	11,300
6 Gain if any, from line 32, from other than casualty or theft	6	2,500
7 Combine lines 3 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	35,100
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were completely used up in 2017, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8 Nonrecaptured net section 1231 losses from prior years. See instructions	8	2,000
9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions.	9	27,100

Part II Ordinary Gains and Losses (see instructions)

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

Machinery	2016	2016	200	Cost	9,000	(610)

11 Loss, if any, from line 7	11	( )
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	2,000
13 Gain, if any, from line 31	13	4,000
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	3,000
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	3,000
17 Combine lines 10 through 16	17	21,190
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the gain from Form 4684, line 35, column (b)(ii), on line 15 below. If your section 1231 losses are more than your section 1231 gains, enter -0- here and on line 15 below. See instructions	18a	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	21,190

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11893N Form **4797** (2017)

Form 4797 (2017) Page 2

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

19 (a) Description of section 179, 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Machinery	2015	2018
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 instructions)	20	27,300			
21 Cost or other basis plus expense of sale	21	19,200			
22 Depreciation (or depletion) allowed or allowable	22	8,000			
23 Adjusted basis. Subtract line 22 from line 21	23	11,200			
24 Total gain. Subtract line 23 from line 20	24	16,100			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a	8,000			
b Enter the smaller of line 24 or 25a	25b	8,000			
26 If section 1250 property: If straight line depreciation was used, enter in line 26g, unless a superior method is used, enter					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the smaller of line 24 or line 26a. See instructions	26b				
c Subtract line 26b from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the smaller of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the smaller of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and diffusion. See instructions	28a				
b Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the smaller of line 24 or 29a. See instructions	29b				

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

30 Total gains for all properties. Add property columns A through D, line 24	30	16,100
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	8,000
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 39. Enter the portion from other than casualty or theft on Form 4797, line 6	32	8,100

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

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

Form 4797 (2017)

72. {Research} Vertovec Inc., a large local consulting firm in Utah, hired several new consultants from out of state last year to help service their expanding list of clients. To aide in relocating the consultants, Vertovec Inc. purchased the consultants' homes in their prior location if the consultants were unable to sell their homes within 30 days

of listing them for sale. Vertovec Inc. bought the homes from the consultants for 5 percent less than the list price and then continued to list the homes for sale. Each home Vertovec Inc. purchased was sold at a loss. By the end of last year, Vertovec had suffered a loss totaling $250,000 from the homes. How should Vertovec treat the loss for tax purposes? Write a memo to Vertovec Inc. explaining your findings and any planning suggestions that you may have if Vertovec Inc. continues to offer this type of relocation benefit to newly hired consultants.

Facts: *As an inducement to relocate, Vertovec purchased several consultants' homes if they were unable to sell them within 30 days of listing them for sale. The homes were purchased for 5% less than the list price, and subsequently sold by real estate firm. Vertovec suffered a loss totaling $250,000 from the homes.*

Issue: *How should Vertovec treat the loss for tax purposes?*

Authorities: *§82.*
§132(a)(6).
§162.
§1001(a).
§1011.
§1221.
Rev. Rul. 2005-74, 2005-51 IRB, 1153.
Rev. Rul. 82-204, 1982-2 C.B. 192.
Corn Products Refining Co. v. Comr., 350 U.S. 46 (1955).

Conclusion: *The transaction is treated as two sales. The first is a sale from the employee to the employer. The second is a sale from the employer to the purchaser. Because the homes are not purchased in the ordinary course of Vertovec's trade or business the losses are capital in nature.*

Analysis: *The primary question for Vertovec is whether it becomes the owner of the residential property or is simply a facilitator of the sale for the employee. Rev. Rul. 82-204 held that homes purchased under a home-buying plan by the employer, to assist its relocating employees were purchases and subsequent sales. The decision also notes that the residence was not held in the taxpayer's ordinary course and did not meet the scope of exceptions contained in §1221 as indicated in Corn Products and should be classified as a capital asset. As a result, the capital gain or loss is amount realized under §1001 reduced by the taxpayer's basis (§1011).*

Rev. Rul. 2005-74 clarified the situations in which the transfer of the residence was considered a sale between the employee and employer and when the employer's expenses were deductible. Given the similarity between Vertovec's facts and Scenario 1 of Rev. Rul. 2005-74, Vertovec's losses will be capital in nature.

Notwithstanding this recommendation, if the arrangement could be modified similar to Scenario 3 Rev. Rul. 2005-74 so that the benefits and burdens of ownership did not pass to the employer the expenses could be deducted as ordinary expenses under §162. §162 allows employers to deduct moving expense reimbursements as an ordinary, necessary, and reasonable business expense. Employees must include in income amounts received as moving expense reimbursements under§82 unless the amounts are specifically excluded from income under§132(a)(6).

73. [Tax Forms] WAR (We Are Rich) has been in business since 1985. WAR is an accrual method sole proprietorship that deals in the manufacturing and wholesaling of various types of golf equipment. Hack & Hack CPAs have filed accurate tax returns for WAR's owner since WAR opened its doors. The managing partner of Hack & Hack (Jack) has gotten along very well with the owner of WAR – Mr. Someday Woods (single). However, in early 2018, Jack Hack and Someday Woods played a round of golf and Jack, for the first time ever, actually beat Mr. Woods. Mr. Woods was so upset that he fired Hack & Hack and has hired you to compute his 2018 taxable income. Mr. Woods was able to provide you with the following information from prior tax returns. The taxable income numbers reflect the results from all of Mr. Woods' activities *except for the items separately stated*. You will need to consider how to handle the separately stated items for tax purposes. Also, note that the 2013–2017 numbers do not reflect capital loss carryovers.

	2013	**2014**	**2015**	**2016**	**2017**
Ordinary taxable income	$4,000	$2,000	$94,000	$170,000	$250,000
Other items not included in ordinary taxable income					
Net gain (loss) on disposition of §1231 assets	$3,000	10,000		($6,000)	
Net long-term capital gain (loss) on disposition of capital assets	($15,000)	$1,000	($7,000)		($7,000)

In 2018, Mr. Woods had taxable income in the amount of $480,000 *before* considering the following events and transactions that transpired in 2018:

a. On January 1, 2018, WAR purchased a plot of land for $100,000 with the intention of creating a driving range where patrons could test their new golf equipment. WAR never got around to building the driving range; instead, WAR sold the land on October 1, 2018, for $40,000.

b. On August 17, 2018, WAR sold its golf testing machine, "Iron Byron" and replaced it with a new machine "Iron Tiger." "Iron Byron" was purchased and

installed for a total cost of $22,000 on February 5, 2014. At the time of sale, "Iron Byron" had an adjusted tax basis of $4,000. WAR sold "Iron Byron" for $25,000.

c. In the months October through December 2018, WAR sold various assets to come up with the funds necessary to invest in WAR's latest and greatest invention–the three dimple golf ball. Data on these assets are provided below:

Asset	Placed in Service (or purchased)	Sold	Initial Basis	Accumulated Depreciation	Selling Price
Someday's black leather sofa (used in office)	4/4/17	10/16/18	$3,000	$540	$2,900
Someday's office chair	3/1/16	11/8/18	$8,000	$3,000	$4,000
Marketable securities	2/1/15	12/1/18	$12,000	$0	$20,000
Land held for investment	7/1/17	11/29/18	$45,000	$0	$48,000
Other investment property	11/30/16	10/15/18	$10,000	$0	$8,000

d. Finally, on May 7, 2018, WAR decided to sell the building where they tested their plutonium shaft, lignite head drivers. WAR purchased the building on January 5, 2005, for $190,000 ($170,000 for the building, $20,000 for the land). At the time of the sale, the accumulated depreciation on the building was $50,000. WAR sold the building (with the land) for $300,000. The fair market value of the land at the time of sale was $45,000.

Part 1: Compute Mr. Woods's taxable income *after* taking into account the transactions described above.
Part 2: Compute Mr. Woods's tax liability for the year. (Ignore any net investment income tax for the year and assume the 20 percent qualified business income deduction is included in taxable income before these transactions.)
Part 3: Complete Mr. Woods's Form 8949, Schedule D, and Form 4797 (use the most current version of these schedules) to be attached to his Form 1040. Assume that asset bases are not reported to the IRS.

Part 1: *Mr. Woods's taxable income is determined as follows:*

This table determines the gains, losses and character for each of the dispositions.

	Sales Price	***Adjusted Basis***	***Gain/Loss***	***Character***
Land	*$40,000*	*$100,000*	*$(60,000)*	*Ordinary Loss*
Iron Byron	*25,000*	*4,000*	*21,000*	*$18,000 = §1245 Ordinary Income; $3,000 = §1231. Adjusted basis is $22,000 cost less depreciation $18,000.*
Sofa	*2,900*	*2,460*	*440*	*§1245 Ordinary income. Adjusted basis is initial basis $3,000 less $540 depreciation.*
Chair	*4,000*	*5,000*	*(1,000)*	*§1231 loss. Adjusted basis is initial basis $8,000 less depreciation $3,000.*
Marketable Securities	*20,000*	*12,000*	*8,000*	*LTCG*
Land - Investment	*48,000*	*45,000*	*3,000*	*LTCG*
Investment Property	*8,000*	*10,000*	*(2,000)*	*LTCL*
Building	*255,000*	*120,000*	*135,000*	*$50,000 Unrecaptured §1250 gain; $85,000 §1231 gain. Adjusted basis is $170,000 less $50,000.*
Land -Bldg	*45,000*	*20,000*	*25,000*	*§1231 gain*

Once the gains and losses have been characterized, they are netted in the §1231 netting process as follows:

§1231 Netting		***Notes on netting:***
Step 1 *- depreciation recapture*		
§1245 Iron Byron	*$18,000*	
§1245 Sofa	*440*	
	$18,440	*Ordinary Income*
Step 2 *- §1231 G/L netting*		
Gains – Iron Byron	*$3,000*	
Building	*85,000*	
Land	*25,000*	
Losses – Chair	*(1,000)*	*§1231 losses first offset regular §1231 gains before unrecaptured §1250 gains.*
	$112,000	
Unrecaptured §1250 Gain – Bldg	*50,000*	
Step 3 *- Lookback rule*		*Reclassify unrecaptured §1250 gains before regular §1231 gains*
	$50,000	*$6,000 will be Ordinary Income* *$44,000 Unrecaptured §1250 LTCG at 25%*

$112,000 0/15/20% LTCG

The capital gains and loss netting process follows the §1231 netting process as follows:

Capital G/L netting

	Long term			
Short term	*28%*	*25%*	*0/15/20%*	
		$ 44,000	*$ 112,000*	
	(5,000)			*LTCL carryforward*
			8,000	
			3,000	
			(2,000)	
	(5,000)	*$ 44,000*	*$ 121,000*	
	5,000 →	*(5,000)*		
		$ 39,000	*$ 121,000*	*Net LTCG*

Mr. Woods's taxable income is calculated as follows:

Taxable Income:	
Taxable income before transactions	*$480,000*
Ordinary loss - land	*(60,000)*
Recapture	*18,440*
Ordinary income from lookback	*6,000*
LTCG @ 25%	*39,000*
LTCG @ 0/15/20%	*121,000*
Taxable income	***$604,440***

Part 2: *Mr. Woods's tax liability is calculated as follows:*

Tax Liability:	
Calculate Ordinary income (604,440 – 39,000 – 121,000)	*$444,440*
Tax on ordinary income: $444,440 - $200,000 = $244,440 x 35% = $85,554 + $45,689.50	*$131,244*
Tax on 25% Gain: $39,000 x 25%	*9,750*
*Tax on 0/15/20% Gain (taxed at 20%): $121,000 x 20%**	*24,200*
Tax liability	*$165,194*

*******The 0/15/20% gain is taxed at 20% because Woods' taxable income is above the maximum 15-percent threshold amount of $425,801 for 2018.*

Part 3: *Mr. Woods's Form 8949, Schedule D, and Form 4797 would be completed as follows:*

8949 — **Sales and Other Dispositions of Capital Assets** — **17**

Sonnedry Woods

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short-term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

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

☐ (A) Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see Note above)

☐ (B) Short-term transactions reported on Form(s) 1099-B showing basis wasn't reported to the IRS

☐ (C) Short-term transactions not reported to you on Form 1099-B

(a) Description of property (Example: 100 shs. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis (see instructions)	Adjustment, if any, to gain or loss. If you enter an amount, enter a code in column (f). See the separate instructions. (g) Gain or loss. Subtract (e) from (d)	(h) Amount of adjustment	(i) Gain or loss. Combine (g) and (h)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 1b (if Box A above is checked), line 2 (if Box B above is checked), or line 3 (if Box C above is checked) ▶							

Note: If you checked Box A above but the basis reported to the IRS was incorrect, enter in column (e) the basis as you report it on Form 8949, and enter in column (g) the adjustment to correct the basis. See column (g) in the separate instructions for how to figure the amount of the adjustment.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768G Form **8949** (2017)

Form 8949 (2017) Attachment Sequence No. 12A Page 2

Name(s) shown on return. Do not enter name and SSN or taxpayer identification no. if not required by a form or other doc. | Social security number or taxpayer identification number

Bernadine Woods

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

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

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

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

- ☐ (D) Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☑ (E) Long-term transactions reported on Form(s) 1099-B showing basis wasn't reported to the IRS
- ☐ (F) Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price)	(e) Cost or other basis (see the instructions for column (e) in the separate instructions)	Adjustment, if any, to gain or loss. If you enter an amount, explain it on the separate line below. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract (e) from (d) and combine the result with column (g)
Mutual fund sales	2/1/13	8/2/18	25,000	27,000			(2,000)
Investment land	7/3/71	1/20/18	40,000	36,000			4,000
Other investment property	11/5/16	10/14/18	9,000	11,000			(2,000)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, line 8b, if Box D above is checked, line 8e if Box E above is checked, or line 8h if Box F above is checked ▶			76,000	74,000			2,000

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

Form 8949 (2017)

SCHEDULE D (Form 1040)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.

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

2017

Name(s) shown on return: Your social security number

Simply Whole

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Combine the amounts in columns (d), (e), and (g)
1a Totals for all short-term transactions reported on Form(s) 8949 for which basis was reported to the IRS and for which no adjustments or codes are required. However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b.				
1b Totals for all transactions reported on Form(s) 8949 with Box A checked				
2 Totals for all transactions reported on Form(s) 8949 with Box B checked				
3 Totals for all transactions reported on Form(s) 8949 with Box C checked				
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ( )
7 Net short-term capital gain or (loss). Combine lines 1a through 6 in the rightmost column. If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Combine the amounts in columns (d), (e), and (g)
8a Totals for all long-term transactions reported on Form(s) 8949 for which basis was reported to the IRS and for which you have no adjustments or gain or loss from sales of collectibles. However, if you choose to report all these sales on Form 8949, leave this line blank and go to line 8b.				
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked	70,000	67,000		3,000
10 Totals for all transactions reported on Form(s) 8949 with Box F checked				
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ( )
15 Net long-term capital gain or (loss). Combine lines 8a through 14 in the rightmost column. Then, go to Part III on the back				15

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H Schedule D (Form 1040) 2017

Form **4797**

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.

▶ Go to www.irs.gov/Form4797 for instructions and the latest information.

17

Name(s) shown on return

Identifying number

Summary Worksheet

1 Enter the gross proceeds from sales or exchanges reported to you for 2017 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 below ... 1

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

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) subtract (f) from the sum of (d) and (e)
Equipment	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Trucking land	[illegible]	[illegible]	[illegible]		[illegible]	[illegible]

3 Gain, if any, from Form 4684, line 39 ... 3

4 Section 1231 gain from installment sales from Form 6252, line 26 or 37 ... 4

5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824 ... 5

6 Gain, if any, from line 32, from other than casualty or theft ... 6 [illegible]

7 Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: ... 7 [illegible]

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) on Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

All other filers. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter gain from line 7 as long term capital gain on the Schedule D filed with your return. Skip lines 8, 9, 11, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years. See instructions ... 8 [illegible]

9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the smaller of line 5 or line 7 on line 10 below and enter the gain from line 7 as ordinary income in Part III, line 21. ... 9 [illegible]

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gain or (loss) from installment sales from Form 6252, line 25 or 36 ... 10

11 Ordinary gain or (loss)	(a)	(b)	(c)	(d)	(e)	(f)
Equipment	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

11 Loss, if any, from line 7 ... 11 [illegible]

12 Gain, if any, from line 7 or amount from line 8, if applicable ... 12 [illegible]

13 Gain from line 31 ... 13 [illegible]

14 Net short-term capital gain from Schedule D ... 14

15 Ordinary gain from installment sales from Form 6252, line 29 or 40 ... 15

16 Ordinary gain or (loss) from like-kind exchanges from Form 8824 ... 16

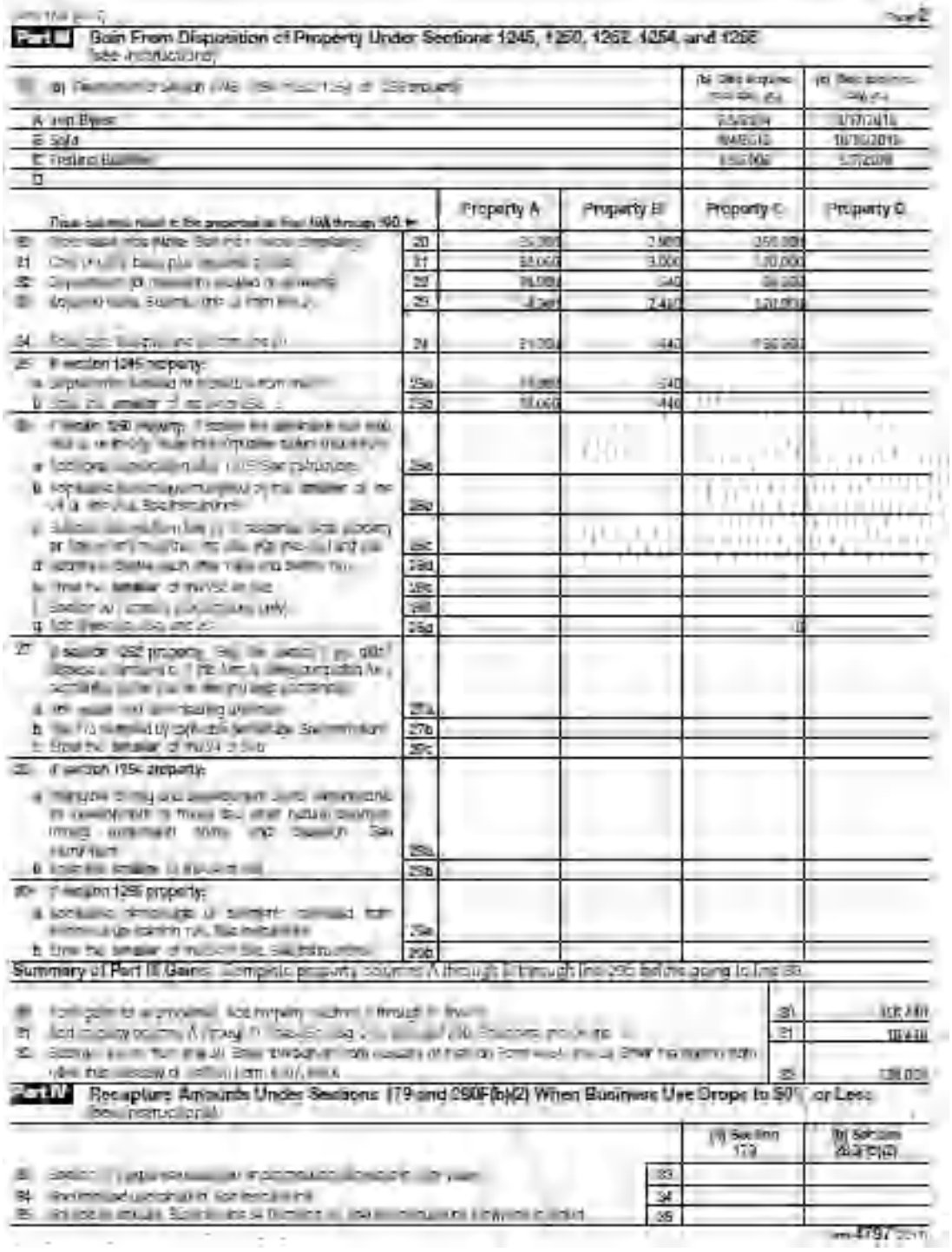
17 Combine lines 10 through 16 ... 17 [illegible]

18 For all amounts shown on line 17 above, see the section that most applies to your situation. If you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 17 as ordinary income in Part III, line 21.

a Enter the smaller of line 10 or line 17 ... 18a

b Subtract line 18a from line 17. Enter the remainder here and on line 21 in Part III ... 18b [illegible]

For Paperwork Reduction Act Notice, see separate instructions. Form **4797** (2017)



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

		Property A	Property B	Property C	Property D
20					
21					
22					
23					
24					
25					
25a					
25b					
26					
26a					
26b					
26c					
26d					
26e					
26f					
26g					
27					
27a					
27b					
27c					
28					
28a					
28b					
29					
29a					
29b					

Summary of Part III Gains (complete property columns A through D through line 29b before going to line 30)

30	30	
31	31	
32	32	

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

		(i) Section 179	(ii) Section 280F(b)(2)
33	33		
34	34		
35	35		

Form 4797 (2017)

74. Fizbo Corporation is in the business of breeding and racing horses. Fizbo has taxable income of $5,000,000 other than from these transactions. It has nonrecaptured §1231 losses of $10,000 from 2014 and $13,000 from 2012.

Consider the following transactions that occur during 2018:

a. A building with an adjusted basis of $300,000 is totally destroyed by fire. Fizbo receives insurance proceeds of $400,000, but does not plan to replace the building. The building was built 12 years ago at a cost of $420,000 and was used to provide lodging for employees.
b. Fizbo sells four acres of undeveloped farmland (used for grazing) for $50,000. Fizbo purchased the land 15 years ago for $15,000.
c. Fizbo sells a racehorse for $250,000. The racehorse was purchased four years ago for $200,000. Total depreciation taken on the racehorse was $160,000.
d. Fizbo exchanges equipment that was purchased three years ago for $300,000 for $100,000 of IBM common stock. The adjusted basis of the equipment is $220,000. If straight-line depreciation had been used, the adjusted basis would be $252,000.
e. On November 1, Fizbo sold XCON stock for $50,000. Fizbo had purchased the stock on December 12, 2017 for $112,000.

Part 1: After ALL netting is complete, what is Fizbo's total amount of income from these transactions to be treated as ordinary income or loss? What is its capital gain or loss?

Part 2: What is Fizbo's taxable income for the year after including the effects of these transactions?

Part 1: *Fizbo's ordinary income/loss and capital gains/losses are as follows:*

This table determines the gains, losses and character for each of the dispositions.

Asset	***Amount Realized***	***Adjusted Basis***	***Gain/(Loss)***	***Character***
Building	*$400,000*	*$300,000*	*$100,000*	*$20,000 is §291 gain*
				$80,000 is §1231 gain
Farm land	*50,000*	*15,000*	*35,000*	*$35,000 §1231 gain*
Racehorse[1]	*250,000*	*40,000*	*210,000*	*160,000 §1245 recapture*
				50,000 §1231 gain
Equipment	*100,000*	*220,000*	*(120,000)*	*§1231 loss*
XCON Stock	*50,000*	*112,000*	*(62,000)*	*STCL*

Once the gains and losses have been characterized, they are netted in the §1231 netting process as follows:

<u>§1231 Netting:</u>
Step 1: recapture:

§291 from building	*$20,000*	
§1245 from racehorse	*<u>160,000</u>*	
	$180,000	*Ordinary income*

Step 2: net §1231 gains and losses:

[1]In the racing business, racehorses are considered to be analogous to equipment for a manufacturing business.

G: Building	*$80,000*
Farm land	*35,000*
Racehorse	*50,000*
Equipment	*(120,000)*
Net §1231 Gain	*$45,000*

Step 3: Lookback losses: Ordinary income = $10,000 §1231 = $35,000

The §1231 gains are combined with the other capital gains and losses:

Capital Gain/Loss Netting:

§1231	*$35,000*
Capital loss from stock	*(62,000)*
Net capital loss	*$(27,000)*

Ordinary income:

Depreciation recapture	*$180,000*
Lookback	*10,000*
Total	*$ 190,000*

Capital gain/loss: *$ (27,000)*

Part 2: *Fizbo's taxable income is determined as follows:*

Taxable income before transactions	*$5,000,000*
Ordinary income	*190,000*
Taxable income	*$5,190,000*

Note that Fizbo may not reduce its taxable income by the net capital loss. Corporations' capital losses are limited to their capital gains.