TDBT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

1040 Deskbook

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Interactive Self-study CPE

Companion to PPC's 1040 Deskbook

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

INTRODUCTION

Companion to PPC's 1040 Deskbook consists of 3 interactive self-study CPE courses. These are companion courses to PPC's 1040 Deskbook designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **December 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S 1040 DESKBOOK

COURSE 1

Passive Activities and Pass-through Entities (TDBTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers passive activities and basis adjustments for partners and S corporation shareholders. The first lesson covers passive activity gains and losses, how they are defined, when they can be used to offset income, and some common exceptions to the rules. The second lesson covers the partner and S corporation shareholder basis adjustments, the at-risk loss limitations, and how to report unreimbursed expenses and the sale of ownership interests.

PUBLICATION/REVISION DATE: December, 2010

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook.*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of and experience with the preparation of Form 1040.

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Passive Activities

Completion of this lesson will enable you to:

- Identify what constitutes a passive activity and the requirements to qualify as one.
- Determine the requirements for individual material participation by a taxpayer.
- Recognize the allocation of suspended losses to multiple passive activities and how a taxpayer should report them.
- Identify common exceptions to the passive loss rules, including installment sales, rental activities, net lease property and exceptions for real estate professionals.

Lesson 2—Pass-through Entities

Completion of this lesson will enable you to:

- Identify basis adjustments required by various pass-through items from a partnership.
- Recognize the at-risk loss limitations and carryforwards for partners and S corporation shareholders.

- Determine the S shareholder basis and the adjustments required by various S corporation pass-through items.
- Apply the reporting rules for unreimbursed expenses and the sale of ownership interests for partners and S corporation shareholders, determine how beneficiaries are tax on income from estates and trusts, and the rules governing partner guaranteed payments.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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Tax & Accounting—R&G
TDBTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

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Lesson 1: Passive Activities

INTRODUCTION

The passive activity loss (PAL) rules in IRC Sec. 469 and related regulations were designed to curb perceived abuses of tax shelters. However, these rules affect activities other than those generally thought of as tax shelters. They must be considered when virtually any loss is shown in an individual's tax return. Under the PAL rules, items of income, deduction, gain, or loss must be separated into two broad categories: passive activities and nonpassive activities.

A passive activity is generally (1) *any* rental activity (except those of certain real estate professionals or (2) a business activity in which the taxpayer does not materially participate. Certain activities appear to be rental activities but meet a specific exception provided in the regulations. The PAL rules for partnership or S corporation income, deductions, and credits are applied at the partner or shareholder level (i.e., the individual's tax return).

Taxpayers generally may use passive activity losses and deductions only to offset income and gains from other passive activities. Passive activity losses generally cannot offset income from nonpassive sources such as salaries, income from a trade or business in which the taxpayer materially participates, or portfolio income. Losses from passive activities in excess of passive income are suspended and carry forward indefinitely to offset future passive activity income, or are recognized upon disposition of the passive activity. Form 8582 is used to compute the currently deductible and suspended portion of passive activity losses.

IRC Sec. 469 also limits the use of credits arising from passive activities. In general, credits from passive activities may offset current tax to the extent attributable to net passive income.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify what constitutes a passive activity and the requirements to qualify as one.
- Determine the requirements for individual material participation by a taxpayer.
- Recognize the allocation of suspended losses to multiple passive activities and how a taxpayer should report them.
- Identify common exceptions to the passive loss rules, including installment sales, rental activities, net lease property and exceptions for real estate professionals.

Activity Defined

Significance of Determining an Activity

The definition of an activity for PAL purposes and whether a group of activities can be treated as a single activity depends on facts and circumstances. The taxpayer can use *any reasonable method* to determine whether one or more trade or business activities constitute an appropriate *economic unit* for measuring gain or loss and thus treated as a single activity. For example, two businesses conducted at the same location do not necessarily comprise a single activity, and operations conducted through two separate pass-through entities do not necessarily result in separate activities. Similarly, activities in the same line of business but at different locations are not necessarily grouped together. The regulations identify the following factors to consider in determining whether activities constitute an appropriate economic unit:

1. Similarities and differences in types of trades or business.
2. Extent of common control and ownership.
3. Geographic location.
4. Interdependencies between the activities (e.g., the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books).

Grouping Multiple Activities

The definition of an activity has great importance because an activity is the unit of measurement for several important determinations under the passive loss rules:

1. Material participation is determined at the activity level (i.e., if two activities are grouped together as a single activity, material participation must be shown only in the activity as a whole; whereas, if the activities were grouped separately, material participation must be shown in each activity).

2. Active participation tests are determined on an activity basis for the $25,000 rental real estate loss exception.

3. Suspended losses become allowable upon complete disposition of an entire activity in a taxable transaction.

Example 1A-1 Interdependent businesses grouped as one activity.

Allen has 100% ownership of an S corporation that produces ceramic pottery. He materially participates in this business and is also employed by the corporation on a full-time basis. Much of his success has been a result of using high-grade clay and pigments. His supplier has had difficult times maintaining operations and faces possible closure. To prevent the loss of his supplier, Allen purchases a 75% interest in the supplier's business. However, he will not have significant personal involvement in that business due to time constraints. Under IRC Sec. 469(h), Allen does not meet the material participation requirement for the supply company. However, Allen can choose to treat the supply company and his S corporation as one activity since there is an interdependence between the two companies. As a result, the hours Allen spends materially participating in his S corporation extend to the supply company and both business will be treated as active (not passive) on Allen's 1040.

Example 1A-2 Multiple business activities.

John operates a sole proprietorship business that supplies computer hardware and parts to small businesses. He works full-time in this activity. Along with three former co-workers, John establishes a new S corporation to refurbish computer hardware. He then purchases the hardware from the S corporation for resale in his sole proprietorship.

Although John does not personally participate in the S corporation's operations, his proprietorship and interest in the S corporation constitute an appropriate economic unit. Therefore, under Reg. 1.469-4(c) he may treat the two activities as one activity for PAL purposes.

Because John materially participates in his proprietorship, he would also be deemed to materially participate in the S corporation operation (because they have been aggregated as a single activity). Accordingly, any losses shown on the S corporation Schedule K-1 would be nonpassive and fully deductible (provided he has enough basis).

A rental activity may not be grouped with a trade or business activity unless the grouping constitutes an *appropriate economic unit* and (1) the rental activity is insubstantial in relation to the business activity (or vice versa) or (2) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity involving the rental of items for use in the trade or business may be grouped with the business activity. Furthermore, an activity involving the rental of real property and an activity involving the rental of personal property may not be treated as a single activity unless the personal property is provided with the real property.

In *Candelaria*, a Texas District Court allowed a taxpayer to combine a rental and nonrental activity as a single economic unit for the PAL rules, thus permitting income from his radiological services business to be offset by losses from his radiological equipment rental LLC. The court stated that it would consider whether an activity was insubstantial under the 80/20 rule, but that the rule would be only one pertinent factor it considered in determining the question of whether the rental activity was insubstantial in relation to a trade or business activity. The other

qualitative factors that influenced the court's decision were that (1) the reason for the rental activity's existence was to serve the trade or business activity, (2) the rental activity had no employees, (3) the rental activity provided no services to the community, and (4) the rental activity had no customers other than the trade or business activity.

In another decision, an Indiana District Court focused on the qualitative issues of the interdependence between activities and on quantitative factors measuring the gross income and a ratio of fair market value. The taxpayers owned multiple interests in limited partnerships owning rental property, and a rental property management company whose only income came from management fees paid by those partnerships. The court found the management company insubstantial in relation to the limited partnerships in that it accounted for only seven to ten percent of the total gross income of the combined entities and only two to three percent of their combined assets. Thus, the court ruled that the activities could be treated as one economic unit, which meant the passive losses of the limited partnerships could offset the net income of the management company.

In *Schumacher*, the taxpayer owned 90% of an S corporation in the business of flight training, aircraft rental, charter services, and aircraft sales. He acquired additional equipment and aircraft that he leased exclusively to the S corporation. The Tax Court found the leasing activity to be insubstantial in relation to the S corporation's business activity. The most significant fact was that the taxpayer created and operated the leasing activity solely for the S corporation's benefit. As a result, the leasing activity could be grouped with the S corporation's business activity.

Example 1A-3 Combining an insubstantial rental activity with a business activity.

Jay owns a building in which he operates a dress shop on a full-time basis. The building also contains two rental spaces—one leased to a restaurant and the other to a beauty parlor. Gross receipts from the rentals are 15% of total gross receipts. Jay can group the rental activity with the business activity if that grouping is an appropriate economic unit, and the rental activity is insubstantial to the business activity. In determining this, Jay looks to such factors as gross receipts, square footage of each activity, and time and employment factors of each. Although the regulations do not define the term *insubstantial*, the IRS Passive Activity Audit Guide states that if less than 20% of gross receipts come from either a business or rental source, it generally is considered insubstantial. Based on these facts, Jay concludes that the two activities (dress shop and leasing) constitute an appropriate economic unit because the rental is insubstantial. Therefore, he reports the rentals on Schedule E but does not treat the net rental income or loss as a passive activity reportable on Form 8582. (The rental activity is considered nonpassive because it is grouped with the dress shop activity in which Jay materially participates.)

Example 1A-4 Combining rental and business activities due to common ownership.

Hal and Wanda are married and file a joint return. Hal is the sole owner of an S corporation that operates a grocery business. Wanda is the sole owner of another S corporation that owns and rents a building. Part of the building is rented to the grocery business owned by Hal's corporation (the grocery store rental). The grocery business activity and the grocery store rental activity are not insubstantial in relation to each other. Hal and Wanda are considered one taxpayer since they file a joint return. Accordingly, they are considered to own the same proportionate interests (100%) in both the grocery business and grocery store rental activities. Therefore, the grocery business and grocery store rental activities can be grouped together if they constitute an appropriate economic unit. However, the remainder of the rental activity (not involving the grocery business) may not be grouped with the grocery business. By grouping the activities, an otherwise passive loss from the rental activity could offset nonpassive income from the grocery business (if the taxpayers materially participate in the business).

A limited partner or limited entrepreneur (meaning a person other than a limited partner who does not actively participate in management) in specified tax shelter activities generally may not group those activities with any other activity. The specified tax shelter activities include the production or distribution of films or videotapes, farming, leasing of Section 1245 property, and exploring for or exploiting oil and gas resources or geothermal deposits. However, a taxpayer who is a limited partner or limited entrepreneur can group these activities with another activity in the same type of business, if appropriate under the facts and circumstances.

Example 1A-5 Grouping limited partnership activities.

Will is an oil and gas driller with extensive drilling and exploration activities operated through his sole proprietorship. Will has also invested in several oil and gas exploration limited partnerships within his geographic location, primarily to gain access to information about other operators and their drilling results in areas contiguous to his own drilling activities. Despite the general prohibition against combining a limited partner interest in a tax shelter activity with any other activity, Will can combine his oil and gas drilling limited partner interests with his oil and gas drilling proprietorship as a single activity because they are in the same line of business, and it would seem appropriate to do so under the facts and circumstances.

Because closely held and personal service C corporations are separate taxable entities, grouping their activities together with those held directly by the shareholder is meaningful only for purposes of determining if the taxpayer materially participates in an activity, and not for purposes of determining whether an activity is excepted from the definition of a rental activity, which is automatically treated as passive under IRC Sec. 469(c)(2).

Once activities have been grouped together, the taxpayer cannot change the groupings in subsequent tax years unless an original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate. The IRS reserves the right to adjust the taxpayer's groupings if they fail to reflect appropriate economic units.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following can create a passive activity for a taxpayer?

    a. A trade or business in which the taxpayer actively participates.

    b. A rental activity in which the taxpayer is a real estate professional.

    c. A trade or business in which the taxpayer does not materially participate.

2. Which of the following statements is correct regarding passive activity gains and losses?

    a. To offset gains and losses from passive activities taxpayers generally may only use other passive activity losses and deductions.

    b. Losses from passive activities in excess of passive income cannot be carried forward and used in subsequent years.

3. The definition of an activity has great importance because an activity is the unit of measurement for several important determinations under the passive loss rules. Which of the following is determined at the activity level?

    a. Suspended losses are not allowed in an activity that is completely disposed.

    b. Material participation is determined at the level of the activity.

    c. The active participation test does not apply when applying the rental real estate exception.

4. Ray owns a building in which he operates a donut shop on a full-time basis. The building has two rental spaces which he rents to a woodcarving shop and a beauty parlor. Under which of the following circumstances can Ray combine the rentals and the donut shop as a single activity?

    a. Jay can consider the rentals a passive activity if he groups them with the donut shop.

    b. The total gross receipts from the rentals are 18% of the total receipts from the donut shop and the rentals.

    c. Ray keeps a separate set of books for the rentals, so he can group them as a single activity.

5. A limited partner or limited entrepreneur in specified tax shelter activities generally may not group those activities with any other activity not in the same type of business. Which of the following activities is one of the specified tax shelter activities?

    a. The operation of a movie theater.

    b. The exploring for or exploiting oil and gas resources or geothermal deposits.

    c. A partnership interest in a grocery store.

    d. An interest in a dress shop.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following can create a passive activity for a taxpayer? **(Page 3)**

   a. A trade or business in which the taxpayer actively participates. [This answer is incorrect. Active participation in an activity is not sufficient to prevent losses from being classified as passive as stated in IRC Sec. 469 detailing passive activity loss rules. It is used for determining if a taxpayer is eligible for the $25,0000 loss exception in a real estate activity.]

   b. A rental activity in which the taxpayer is a real estate professional. [This answer is incorrect. A passive activity usually includes any rental activity for a taxpayer. But, real estate professionals have a different set of criteria and may treat otherwise passive rental estate activities as nonpassive if the taxpayer materially participates in the rental activity according to IRC Sec. 469.]

   c. A trade or business in which the taxpayer does not materially participate. [This answer is correct. According to the passive activity loss rules detailed in IRC Sec. 469, one of the factors that can create a passive activity is a business activity in which the taxpayer does not materially participate.]

2. Which of the following statements is correct regarding passive activity gains and losses? **(Page 3)**

   a. To offset gains and losses from passive activities taxpayers generally may only use other passive activity losses and deductions. [This answer is correct. According to IRC Sec. 469, losses and deductions generated by a passive activity can only be used to offset passive income and gains, except in special cases. Passive activity losses generally cannot offset income from nonpassive sources such as salaries, income from a trade or business in which the taxpayer materially participates, or portfolio income.]

   b. Losses from passive activities in excess of passive income cannot be carried forward and used in subsequent years. [This answer is incorrect. Losses from passive activities in excess of passive income are suspended and carry forward indefinitely to offset future passive activity income, or are recognized upon disposition of the passive activity as stated in IRC Sec. 469.]

3. The definition of an activity has great importance because an activity is the unit of measurement for several important determinations under the passive loss rules. Which of the following is determined at the activity level? **(Page 3)**

   a. Suspended losses are not allowed in an activity that is completely disposed. [This answer is incorrect. Suspended losses become allowable upon complete disposition of an entire activity in a taxable transaction.]

   b. Material participation is determined at the level of the activity. [This answer is correct. Material participation is determined at the activity level. For example, if two activities are grouped together as a single activity, material participation must be shown only in the activity as a whole; whereas if the activities were grouped separately, material participation must be shown in each activity.]

   c. The active participation test does not apply when applying the rental real estate exception. [This answer is incorrect. When determining the definition of an activity, the active participation test determines the activity basis for the $25,000 rental real estate loss exception.]

4. Ray owns a building in which he operates a donut shop on a full-time basis. The building has two rental spaces which he rents to a woodcarving shop and a beauty parlor. Under which of the following circumstances can Ray combine the rentals and the donut shop as a single activity? **(Page 3)**

   a. Jay can consider the rentals a passive activity if he groups them with the donut shop. [This answer is incorrect. If Jay is able to group the activities together, the rental activities are considered nonpassive

because it is grouped with a nonpassive activity, the donut shop, since Jay materially participates in that activity.]

b. The total gross receipts from the rentals are 18% of the total receipts from the donut shop and the rentals. [This answer is correct. One of the factors for Ray to be able to group the rental activities with the business activity is if the rental activity is insubstantial to the business activity. Although the regulations do not define the term insubstantial, the IRS Passive Activity Audit Guide states that if less than 20% of gross receipts come from either a business or rental source, it is generally considered insubstantial.]

c. Ray keeps a separate set of books for the rentals, so he can group them as a single activity. [This answer is incorrect. The decision whether two businesses can be grouped is not determined by the accounting method used by the taxpayer.]

5. A limited partner or limited entrepreneur in specified tax shelter activities generally may not group those activities with any other activity not in the same type of business. Which of the following activities is one of the specified tax shelter activities? **(Page 3)**

a. The operation of a movie theater. [This answer is incorrect. Movie theaters can be grouped with other similar or related businesses as detailed in Reg. 1.469-4(d)(3).]

b. The exploring for or exploiting oil and gas resources or geothermal deposits. [This answer is correct. According to Reg. 1.469-4(d)(3), the specified activities for this purpose include the production or distribution of films or videotapes, farming, leasing of Section 1245 property, and exploring for or exploiting oil and gas resources or geothermal deposits. These activities can only be grouped with activities of the same kind.]

c. A partnership interest in a grocery store. [This answer is incorrect. Grocery stores are not one of the types of businesses specified in the grouping rules for a limited partner or limited entrepreneur under Reg. 1.469-4(d)(3).]

d. An interest in a dress shop. [This answer is incorrect. Based on Reg. 1.469-4(d)(3), a dress shop is not one of the specified tax shelter activities specified not allowed to be grouped by a limited partner or limited entrepreneur.]

Material Participation

A taxpayer's level of participation in a nonrental activity determines whether it is passive or nonpassive. To be nonpassive, the taxpayer must materially participate in the activity. This is important to sole proprietors, partners, and S corporation shareholders because of the deduction limitations placed on passive activity losses. In addition, material participation is determined on an annual basis; because a taxpayer qualifies in one year does not automatically qualify him or her in subsequent tax years. Special rules also apply to real estate professionals who materially participate in rental real estate activities.

Tests for Determining Material Participation

Material participation occurs when the taxpayer's involvement in the trade or business (or rental real estate activity for real estate professionals as discussed later in this lesson) is regular, continuous, and substantial. Reg. 1.469-5 and Temp. Reg. 1.469-5T establish guidelines to determine material participation. Any work an individual performs in an activity in which he or she owns an interest (when the work is done) generally is considered participation. However, not all participation is considered material. An individual materially participates in an activity if *any one* of the following tests is met:

1. *More Than 500 Hours Test.* The taxpayer participates in the activity for more than 500 hours during the year.

2. *Substantially All Participation Test.* The taxpayer's participation in the activity constitutes substantially all of the participation by all individuals (including nonowners) in the activity for the year.

3. *More Than 100 Hours Test.* The taxpayer's participation is more than 100 hours during the year, and no other individual (including nonowners) participates more hours than the taxpayer. (See Example 1B-1.)

4. *Significant Participation Activity (SPA) Test.* The activity is a significant participation activity in which the taxpayer participates for more than 100 hours during the year and the taxpayer's annual participation in all significant participation activities is more than 500 hours. [A significant participation activity is generally a trade or business activity (other than a rental activity) that the taxpayer participates in for more than 100 hours during the year but does not materially participate (under any of the material participation tests other than this test).] (See Example 1B-3.)

5. *Prior-year Material Participation Test.* The taxpayer materially participated in the activity for any five tax years (whether or not consecutive) during the 10 immediately preceding tax years. (See Example 1B-2.)

6. *Personal Service Activity Test.* For a personal service activity, the taxpayer materially participated for any three tax years (whether or not consecutive) preceding the current tax year. (Personal service includes the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.)

7. *Facts and Circumstance Test.* Based on all the facts and circumstances, the taxpayer participates on a regular, continuous, and substantial basis during the year. Future regulations are to provide further guidance for this test. However, temporary regulations indicate that if an individual participates in an activity for 100 hours or less during the year, this "facts and circumstances" test is not available. Participating in the management of an activity is not considered for this test if (a) any person (other than the taxpayer) received compensation for performing services in the management of the activity, or (b) any individual spent more hours during the tax year performing management services than the taxpayer (whether or not the individual was compensated for the management services).

In applying the material participation rules, the following should be considered:

1. Limited partners *generally* are not considered to materially participate in activities of the limited partnership. Instead of the availability of all seven tests to determine material participation, a limited partner must pass either the first, fifth, or sixth test. (See discussion later in this lesson.)

2. If a taxpayer's spouse materially participates in an activity, the taxpayer is also considered to materially participate, even if the spouse does not own any interest in the activity, or file a joint return with the taxpayer. (See Example 1B-4.)

3. If a taxpayer has significant participation activities (as defined in test 4), but fails to meet the 500-hour test for combined significant participation activities, only the aggregate net income from significant participation activities will be characterized as nonpassive; any aggregate net losses will be characterized as passive. (See Example 1B-3.)

4. Taxpayers can substantiate participation in an activity using any reasonable method. Documentary evidence may include, but is not limited to, identification of services provided, approximate hours spent, appointment books, calendars, and narrative summaries. Contemporaneous daily logs or reports are not required but may assist the taxpayer in establishing credibility.

Although the regulations allow taxpayers to use any reasonable method for substantiating participation, oral testimony does not constitute a narrative summary and a later ballpark guesstimate will not provide the necessary substantiation. Likewise, estimates of hours spent, for which the taxpayer's only written documentation was his planning calendar containing planned activities for the month written before the activities were undertaken, were not sufficient. The notations were never updated to reflect actual time spent. Thus, taxpayers should be advised to maintain a written record supporting their actual participation in the activity.

In *Mordkin*, the taxpayer challenged the validity of the 500-hour test because it focuses strictly on the quantity and not the quality of time devoted to an activity. However, the court rejected the taxpayer's arguments and upheld the validity of the test. Practitioners should continue to monitor judicial interpretations of the material participation rules set forth in the regulations.

Example 1B-1 Material participation: "more than 100 hours" test.

Mike is a full-time manager of a local electronics store. He is also a 50% partner in First Consulting with his neighbor, Joe. Mike and Joe perform the only services for the partnership and, under a written agreement, work equal hours performing consulting services. Mike and Joe do their consulting work on weeknights and Saturdays. They each work eight hours per week. Although neither Mike nor Joe participates in the activity for more than 500 hours during the year, they are both considered to materially participate in the partnership because they both participate more than 100 hours during the year and no one else participates in the partnership for more hours than they do (i.e., they pass test 3 discussed earlier).

Example 1B-2 Material participation: ownership requirement for look-back tests.

Between 2001 and 2005, David worked full-time for ABC Inc., an S corporation. He did not own any stock in ABC during this period. In 2006, he retired and bought stock in ABC. David performs consulting services for ABC during 2010, working less than 100 hours during the year. David does not currently meet the 500-hour test or the 100-hour test for materially participating in ABC. Although he worked more than 500 hours in the activity for 5 of the previous 10 years, these years are not includable in the 5-out-of-10-year test since he did not then own an interest in ABC. Had David been a shareholder during the period 2001–2005 and materially participated in those years, he would be considered to materially participate in ABC for 2010 because he meets the 5-out-of-10-year test (i.e., he would pass test 5 discussed earlier).

Example 1B-3 Material participation: 500 hours in all significant participation activities.

Jane is a full-time teacher, but she also owns an interest in two partnerships engaged in a consulting business. Jane significantly participates in both, performing more than 100 hours during the year in each, but she does not participate in either for more than 500 hours. Her partners participate to a greater extent than Jane. During 2009, she participated 150 hours in Partnership A and 450 hours in Partnership B.

Since the aggregate participation in all of Jane's significant participation activities is more than 500 hours, she is considered to materially participate in each activity (under test 4 discussed earlier), although she does not meet the 500-hour or 100-hour test for either activity. If partnerships A & B could properly be grouped together

as one activity under Reg. 1.469-4(c), Jane would be considered to materially participate in both under the 500-hour test.

Variation: Assume same facts as above, except that Jane participates in Partnership A for only 70 hours a year. Partnership A is not a significant participation activity (because she participates less than 100 hours) so it cannot be combined with Partnership B to meet the more-than-500-hours-in-all-significant-participation-activities test. If the two partnership activities cannot properly be grouped together as a single economic unit under Reg. 1.469-4(c), Partnership A will be a passive activity and Partnership B will be a significant participation activity. However, if the two partnerships can be grouped together, Jane will be considered a material participant in the combined activity (under test 1, the 500-hour test) so that income and losses from both partnerships will be nonpassive.

Nonqualifying Participation. Any work done by an individual in an activity in which he owns an interest (when the work is done) generally is treated as participation, without regard to the capacity in which the individual does the work. Under this general rule, menial tasks as well as supervision and management duties qualify in determining whether an individual has met the material participation standards. However, an exception applies if the work is not of a type that is customarily done by the owner of an activity and one of the principal purposes for the performance of the work is to avoid passive activity status under the material participation test.

Example 1B-4 Work not customarily performed by owners.

Edward, an attorney, owns a general partnership interest in a professional sports team. He does essentially no work for the team and learns that this lack of material participation limits his share of the activity's substantial tax loss. Accordingly, Edward arranges for the team to hire his wife as an office receptionist for an average of 15 hours per week during the tax year. By this, he hopes to pass the 500-hour material participation test.

Generally, participation in an activity by a taxpayer's spouse is treated as participation by the taxpayer. However, the work done by Edward's wife is not treated as material participation because work as an office receptionist is not work customarily done by an owner of a sports team. Furthermore, one of Edward's principal purposes for arranging this employment was to avoid limitation of the pass-through loss because of the material participation test.

A second exception exists to the general rule that any form of work done in an activity is participation. This exception focuses on work done by an individual in a capacity as an investor in an activity. Work done as an investor for the individual's own benefit is not treated as material participation unless the person is directly involved in the day-to-day management or operations of the activity.

Example 1B-5 Work performed as an investor.

Henry is retired and owns 40% of the stock in an S corporation that conducts an auto dealership business. Henry was never employed or active on a day-to-day basis in the corporation; he acquired his 40% ownership via inheritance from his brother. As a major shareholder, Henry receives the weekly and monthly financial statements of the business. He spends about 12 hours per week on average (or 600 hours per year) studying and reviewing these statements, compiling summaries of revenue and expense figures for his own use, and monitoring the general operations of the dealership. However, all of these activities are in a nonmanagerial capacity since they relate to Henry's position as an investor. Accordingly, he is not a material participant in this activity, and his 40% share of the income or loss from this S corporation is deemed to be from a passive activity.

Exceptions to Material Participation Rules

In general, the seven tests discussed earlier are used for determining material participation for any business activity in which a taxpayer is involved (or rental real estate activity in which a real estate professional is involved). If one or more of the tests are passed, the activity is nonpassive and the PAL rules do not apply. However, two exceptions to this general rule apply to:

1. Working interests in an oil or gas activity.

2. Limited partnership interests.

Oil and Gas Working Interest Exception. A working interest in oil and gas property is automatically *not* treated as an interest in a passive activity if the taxpayer holds the working interest directly or through an entity that does not limit the taxpayer's liability. An entity limits the taxpayer's liability if it is (1) a limited partnership in which the taxpayer is not a general partner, (2) an S corporation, or (3) an entity that limits (under applicable state law) potential liability to a determinable fixed amount (such as an LLC). Regardless of passive or nonpassive status, working interest income generally is subject to self-employment tax when held directly or in a general partnership or joint venture arrangement.

Example 1B-6 Treatment of working interest in oil and gas activities.

Charles is both a general and limited partner in a partnership that owns a working interest in oil and gas property. Because Charles is a general partner in each well drilled pursuant to the working interest, his entire interest in each well is treated as nonpassive. If a net loss occurs from this activity, Charles is entitled to fully deduct the loss; the PAL rules do not apply.

However, if his wife holds the general partner interest, any loss allocable to Charles as a limited partner will *not* qualify for the working interest exception to the PAL rules. Even though a husband and wife filing a joint return generally are considered one taxpayer for passive activity purposes, Temp. Reg. 1.469-1T(j)(2)(iii) treats them as separate taxpayers (whether or not filing jointly) for purposes of qualifying for the working interest exception.

Once a taxpayer has claimed a loss or credit as nonpassive under the working interest exceptions, any subsequent income or gain from the property (as well as allowable credits attributable to the property) is also treated as nonpassive, even though the property may have been transferred to an entity that limits liability. This rule applies only if nonpassive losses or credits were claimed in a year when the taxpayer did not materially participate.

Limited Partner Exception. In general, a limited partnership interest is automatically considered a passive activity. However, passive treatment will not be imposed on limited partners if any of the following conditions are satisfied:

1. Limited partner participates in the activity for more than 500 hours during the year.

2. Limited partner materially participated for any five of the previous 10 years.

3. Activity is a personal service activity (see material participation test 6 discussed earlier in this lesson), and the limited partner materially participated in the activity for any three preceding years.

Example 1B-7 Limited partner interest is not a passive activity.

Ted, a qualified appraiser, is a limited partner in an appraisal firm. He acquired his limited partner interest four years ago and has been working full-time in the firm since then. Even though Ted receives a Schedule K-1 indicating he is a limited partner, the activity is a personal service activity in which Ted has materially participated for at least three preceding years. Accordingly, Ted's limited partner interest is not a passive activity. (Even if the activity was not one of the qualifying personal service activities, Ted would still qualify as materially participating since he worked in the activity more than 500 hours during the year.)

In *Gregg*, a district court found that members of an LLC should not automatically be treated as limited partners for PAL purposes. More recently, the Tax Court and the Court of Federal Claims ruled against IRS attempts to characterize taxpayer interests in LLPs and LLCs as passive due only to the limited liability nature of the entities. In *Garnett*, the Court ruled the taxpayers held their ownership interests in LLPs and LLCs as similar to a general partner rather than a limited partner even though the taxpayers did have limited liability with respect to the interests. *Thompson* addressed LLC membership and concluded, among other reasons, that an LLC is not substantially equivalent to a limited partnership and if the court had to categorize his membership as either a limited or general partner's interest, it most closely resembled that of general partner in Temp. Reg. 1.469-5T(e)(3)(ii). Thus, the taxpayers in *Gregg*, *Garnett*, and *Thompson* could use all of the seven tests for material participation under Temp. Reg. 1.469-5T(a) to determine whether their share of a loss from an LLC was passive or nonpassive. In March 2010,

the IRS acquiesced in result only in the *Thompson* case. This essentially means that the IRS may disagree with the Court's findings, but will not file an appeal in the case. It is believed that any member actively participating in the daily activities of an LLC (such as a law or accounting firm) should be excluded from limited partner treatment—even if the member is not a manager.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Participation for the purpose of determining material participation is defined to be:

    a. Frequent and substantial purchases from the activity.

    b. Work performed by an employee when they have no ownership interest in the activity.

    c. Any work performed by a taxpayer in an activity in which the taxpayer owns an interest.

7. One of the guidelines for establishing material participation is referred to as the "more than 100 hours" test. Which of the following statements best describes the test?

    a. The taxpayer's participation is more than 100 hours during the year, and no other individual (including nonowners) participates more hours than the taxpayer.

    b. The taxpayer only works 100 hours in the activity and is the only person who substantially participates in the activity.

    c. The taxpayer worked 100 hours in the previous year to constitute material participation.

    d. To constitute material participation, the taxpayer works more than 100 hours, but not more than 500 hours in a year.

8. Dr. Smith has been experiencing health issues for most of the current year. He is concerned about passing the material participation test for his group medical practice. Currently, he has participated less than 50 hours this year, but participated 1,500 hours last year and each of the preceding 3 years. Is there any way Dr. Smith can satisfy the material participation test for current year?

    a. No, he did not meet the more than 500 hours test for the current year so he must report the income from the practice as passive.

    b. No, Dr. Smith did not provide substantially all of the participation by all individuals in the activity for the year.

    c. No, he did not meet the more than 100 hours test for the current year.

    d. Yes, Dr. Smith provided personal service and materially participated in the group practice in more than three of the years prior to the current year.

9. Robert is a full-time software engineer for a government agency. He and his friend Andrew are each 50% partners in First Geeks Consulting. Robert and Andrew are the only ones who perform services for the partnership. They have a written agreement to work an equal number of hours performing consulting services. Robert and Andrew each work eight hours per week. Robert and Andrew each participates in the activity for only 400 hours during the year. Which of the following statements is correct?

    a. Neither Robert nor Andrew materially participated in First Consulting, since they do not work more than 500 hours in the company in a year.

    b. Both Robert and Andrew materially participate in First Geeks Consulting.

10. In general, a limited partnership interest is automatically considered a passive activity. However, passive treatment will not be imposed on limited partners if any one of three conditions is satisfied. Which of the following is a condition that must be satisfied for the limited partner exception?

    a. A limited partner who owns at least a 50% limited partnership interest will not be required to treat any losses from the partnership as passive.

    b. A limited partner who materially participated for any five of the previous 10 years in the partnership will not be required to treat any losses from the partnership as passive.

    c. A limited partner who participated in the activity for more than 100 hours during the year will not have to treat the activity as passive.

    d. A limited partner who materially participated for 3 of the previous 10 years in an activity that is not considered a personal service activity.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Participation for the purpose of determining material participation is defined to be: **(Page 10)**

    a. Frequent and substantial purchases from the activity. [This answer is incorrect. This does not define material participation, but rather the function of a good customer.]

    b. Work performed by an employee when they have no ownership interest in the activity. [This answer is incorrect. Participation for purposes of material participation requires an ownership interest in the activity.]

    c. Any work performed by a taxpayer in an activity in which the taxpayer owns an interest. [This answer is correct. Material participation occurs when the taxpayer's involvement in the trade or business (or rental real estate activity for real estate professionals) is regular, continuous and substantial as defined by IRC Sec. 469(h)(1).]

7. One of the guidelines for establishing material participation is referred to as the "more than 100 hours" test. Which of the following statements best describes the test? **(Page 10)**

    a. The taxpayer's participation is more than 100 hours during the year, and no other individual (including nonowners) participates more hours than the taxpayer. [This answer is correct. Reg. 1.469-5 and Temp. Reg. 1.469-5T establishes guidelines to determine material participation. One of those tests is the "more than 100 hours" test, which is explained as a taxpayer's participation is more than 100 hours during the year, and no other individual (including nonowners) participates more hours than the taxpayer.]

    b. The taxpayer only works 100 hours in the activity and is the only person who substantially participates in the activity. [This answer is incorrect. Another way that a taxpayer can materially participate in an activity is if the taxpayer's participation in the activity constitutes substantially all of the participation by all individuals (including nonowners) in the activity for the year according to Reg. 1.469-5. This test does not have an hours requirement.]

    c. The taxpayer worked 100 hours in the previous year to constitute material participation. [This answer is incorrect. One of the tests for material participation is if the taxpayer materially participated in the activity for any five years (whether or not consecutive) during the 10 immediately preceding tax years as stated in Reg. 1.469-5. The number hours does not make a difference in this test.]

    d. To constitute material participation, the taxpayer works more than 100 hours, but not more than 500 hours in a year. [This answer is incorrect. There are numerous tests in determining material participation. According to Reg. 1.469-5, one method of determining material participation is the significant participation test which states if the taxpayer participates for more than 100 hours during the year and the taxpayer's annual participation in all significant participation activities more than 500 hours.]

8. Dr. Smith has been experiencing health issues for most of the current year. He is concerned about passing the material participation test for his group medical practice. Currently, he has participated less than 50 hours this year, but participated 1,500 hours last year and each of the preceding 3 years. Is there any way Dr. Smith can satisfy the material participation test for current year? **(Page 10)**

    a. No, he did not meet the more than 500 hours test for the current year so he must report the income from the practice as passive. [This answer is incorrect. The 500 hour test is only one of several tests given as guidelines for determining material participation according to Reg. 1.469-5. Dr. Smith might be able to satisfy the material participation under one of the other required, since only one of the tests is required to be met for the individual to materially participate.]

    b. No, Dr. Smith did not provide substantially all of the participation by all individuals in the activity for the year. [This answer is incorrect. The test requiring substantially all participation is only one test that could be met

as required by Reg. 1.469-5. Dr. Smith has other tests he can met to materially participate in the group medical practice for the year.]

c. No, he did not meet the more than 100 hours test for the current year. [This answer is incorrect. The 100 hour test only is one of several tests given as a guideline for determining material participation as detailed in Reg. 1.469-5. Dr. Smith has a choice of other tests he can qualify for material participation.]

d. Yes, Dr. Smith provided personal service and materially participated in the group practice in more than three of the years prior to the current year. [This answer is correct. One of the tests for satisfying the material participation requirement is the "Personal Service Activity Test." For a personal service activity, if taxpayer materially participated in an activity for any three tax years preceding the current tax year he is considered to materially participate for the current year as explained in Reg 1.469-5.]

9. Robert is a full-time software engineer for a government agency. He and his friend Andrew are each 50% partners in First Geeks Consulting. Robert and Andrew are the only ones who perform services for the partnership. They have a written agreement to work an equal number of hours performing consulting services. Robert and Andrew each work eight hours per week. Robert and Andrew each participates in the activity for only 400 hours during the year. Which of the following statements is correct? **(Page 10)**

a. Neither Robert nor Andrew materially participated in First Consulting, since they do not work more than 500 hours in the company in a year. [This answer is incorrect. According to Reg. 1.469-5, one test to determine material participation in a company is the more than 500 hours test, but Robert and Andrew may be eligible for material participation based on another test detailed in the regulations.]

b. Both Robert and Andrew materially participate in First Geeks Consulting. [This answer is correct. Since both Robert and Andrew both participate more than 100 hours during the year and no one else participates in the partnership more hours than they do, they are considered to materially participate in the company under Reg. 1.469-5.]

10. In general, a limited partnership interest is automatically considered a passive activity. However, passive treatment will not be imposed on limited partners if any one of three conditions is satisfied. Which of the following is a condition that must be satisfied for the limited partner exception? **(Page 10)**

a. A limited partner who owns at least a 50% limited partnership interest will not be required to treat any losses from the partnership as passive. [This answer is incorrect. The passive nature of a loss from a partnership is not determined by the ownership interest owned by the partner for the limited partner exception as detailed in Temp. Reg. 1.469-5T(e)(2).]

b. A limited partner who materially participated for any five of the previous 10 years in the partnership will not be required to treat any losses from the partnership as passive. [This answer is correct. Even a limited partner that does not satisfy the material participant requirement in the current year will not be required to treat any losses from the partnership as passive if the partner materially participated in any five of the previous 10 years according to Temp. Reg. 1.469-5T(e)(2).]

c. A limited partner who participated in the activity for more than 100 hours during the year will not have to treat the activity as passive. [This answer is incorrect. One of the limited partner exceptions noted in Temp. Reg. 1.469-5T(e)(2) is that a limited partner that participates in the activity for more than 500 hours, not 100 hours, during the year will not have to adopt passive treatment.]

d. A limited partner who materially participated for 3 of the previous 10 years in an activity that is not considered a personal service activity. [This answer is incorrect. For a limited partner to not be imposed with passive treatment, the activity must be a personal service activity and the limited partner must materially participate in the activity for any three preceding years as referenced in Temp. Reg. 1.469-5T(e)(2).]

Allocation of Suspended Losses to Multiple Passive Activities

Suspended passive losses carry forward indefinitely to offset future passive activity income. Generally, these losses can be deducted against future passive activity income from any passive activity source and not merely from the activity that created the loss. However, passive loss carryforwards from publicly traded partnerships (PTPs) are subject to a special rule that states they can only be used against income or gain from that specific partnership.

Initially, passive activities are segregated into two categories: rental real estate activities with active participation, and all other passive activities. Rental realty activities are put into a separate category because of the favorable exception that allows qualifying taxpayers to deduct up to $25,000 of passive losses from rental real estate activities against nonpassive income.

IRS Form 8582 (Passive Activity Loss Limitations) and its related worksheets are used to aggregate the taxpayer's various items of passive activity income, gain, loss, and deduction, and to figure the amount of any passive loss allowed for the current tax year.

Reporting Requirements for Suspended Losses

Suspended net passive losses carry forward to future years until the taxpayer generates net passive activity income or disposes of the particular activity in a qualifying disposition. Since the disposition rule allows the taxpayer to deduct suspended losses from a particular activity, overall suspended passive losses must be allocated annually to specific passive activities. In addition, a carryforward schedule of suspended passive losses should be maintained for each activity. Within Form 8582, Worksheets 5 and 6 are available for this purpose. Worksheet 7 is used instead of Worksheet 6 when an activity has a suspended loss consisting of different characters of loss (e.g., capital loss, ordinary loss, etc.) that will be reported on two or more different forms or schedules in the return. These worksheets do not have to be filed with the return. Instead, they should be maintained as part of the taxpayer's records.

Example 1C-1 Allocation of suspended losses among activities.

Bill Berry is a limited partner in three partnerships generating 2010 passive losses of $1,000, $2,000, and $5,000, respectively. A fourth investment, Partnership D Ltd., produced passive income of $5,000 in 2010. (No suspended losses exist from prior years.) Bill's Form 8582 reports $5,000 of current year passive losses offsetting $5,000 of current year passive income, leaving $3,000 of carryover to 2011. The worksheets on the subsequent pages of Form 8582 report the allocation of the $5,000 loss deductible in the current year and the $3,000 suspended loss. These allocations are based on each activity's loss amount in proportion to the total loss.

Example 1C-2 Allocation of suspended losses among rental activities.

Art Apple is a partner in three partnerships. Two of the partnerships are active participation rental realty activities (APRRAs) that qualify for the $25,000 rental realty loss exception. Art has no suspended loss carryovers and has AGI (as modified before passive losses) of $90,000. The 2010 income and loss figures from these activities are:

Activity	Income (Loss)
A Partnership (an APRRA)	$ (50,000)
B Partnership (an APRRA)	25,000
C Ltd. Partnership	(50,000)

Art's Form 8582 reports total 2010 allowed losses of $50,000 from the offset of $25,000 of losses against the $25,000 of income plus the $25,000 loss allowed under the exception for rental real estate. Worksheets report the allocation of this $50,000 current-year loss, as well as the allocation of the $50,000 suspended loss.

Suspended Capital Losses

A taxpayer may have multiple passive activities that include capital asset transactions in the activities. Because there are multiple long-term capital loss categories, the IRS issued IRS Ann. 98-12 to clarify its position. There has

been no further guidance issued to address changes to capital gain rates since they were lowered by the 2003 Act; however, treatment is expected to be the same as that under IRS Ann. 98-12. The following example illustrates that guidance.

Example 1C-3 Allocation of suspended losses among different capital loss rate groups.

Tom Smith has transactions from two activities in 2010. Activity 1 has a passive activity prior year suspended long-term capital loss (28% rate group) of $1,000, and a current year long-term capital loss (15% rate group) of $3,000. Activity 2 has a passive activity prior year suspended long-term capital loss (28% rate group) of $230, and current year net income of $1,100 from Schedule E (passive). Worksheet 3 of Form 8582 is completed first to show that Activity 1 has a suspended loss of $4,000 and Activity 2 an overall gain of $870. Line 16 of Form 8582 shows a loss allowed of $1,100 for 2010. Worksheet 5, Form 8582, is then completed showing that Activity 1 has a suspended loss of $3,130 ($4,000 overall loss less $870 used to offset gain from Activity 2). All of the $230 suspended loss (28% rate group) in Activity 2 is allowed for that activity. The last step is to use Worksheet 7 of Form 8582 to determine the portion of the suspended loss attributable to the 28% and 15% rate loss groups in Activity 1. This calculation is based upon the ratio that the loss in each rate group bears to the total loss of both rate groups. Then the allowed losses of each group are simply the difference between the total losses of each group and the unallowed losses of each group.

The IRS also comments that it is advisable to keep a record of the unallowed 28% and 15% rate losses to figure the passive activity loss for these transactions *next year*. Thus, for passive activity purposes, they will retain their rate-group character until fully absorbed in future years.

Passive Activities and Their Disposition

Types of Dispositions

Complete, Fully Taxable Disposition. Suspended passive losses are deductible in the year when the taxpayer disposes of his entire interest in the passive activity (i.e., a complete disposition) in a fully taxable transaction to an unrelated party. Then, both current and suspended losses generated by that activity (as well as any loss on disposition) are fully deductible.

In reporting the complete disposition of a passive activity, its current-year income or loss is combined with prior-year suspended losses for the activity. If the net result is (1) an overall gain and the taxpayer has other passive activities, or (2) an overall loss and the taxpayer has net income or gain from other passive activities, the income and losses are posted to Worksheet 1, 2, or 3 of Form 8582. The overall loss from the disposed activity is nonpassive to the extent it exceeds net income and gains from other passive activities. For this purpose, net passive income and net passive losses from all of the taxpayer's other passive activities should be netted before any excess passive income is applied against the current and suspended passive losses from the disposed activity. If combining current-year income or loss from the disposed activity with the activity's suspended losses results in (1) an overall gain or loss, and no other passive activities exist, or (2) an overall loss, and the taxpayer has a net loss from other passive activities, gain or loss from the activity is not posted to Form 8582; instead, the various components (i.e., capital versus ordinary gain/loss) are reported on the applicable forms (e.g., Schedule E or D, or Form 4797).

Example 1D-1 Reporting an overall loss in year of disposition.

Hans sells his entire interest in ABC, Ltd., a passive activity, to an unrelated party and recognizes a gain of $1,000. He has $6,500 of suspended loss carryovers from ABC, and also is allocated a current year operating loss of $500. In addition, Hans has $2,000 of net passive income from other activities. His net loss from ABC for the year is $6,000 ($1,000 of gain less $7,000 of current and suspended losses). Because he has net income from another activity, Hans reports the loss on Form 8582. The first $2,000 of the loss is applied against his other passive income of $2,000; the remaining $4,000 loss is treated as nonpassive (and fully deductible) because of the disposition rule.

If the disposition of a passive activity results in a capital loss, the $3,000 capital loss limitation is applied before any offset against nonpassive ordinary income is permitted.

Example 1D-2 Claiming suspended passive losses upon disposition of an activity.

Roger, a single taxpayer, had the following suspended passive losses carried over to 2010:

- $10,000 from ABC Ltd. Partnership.
- $5,000 from XYZ Ltd. Partnership.

On July 1, 2010, Roger sold his entire interest in ABC to an unrelated party. The sale generated a $15,000 long-term capital gain. In addition, the 2010 Schedule K-1 from ABC reflected a $1,500 ordinary loss. The XYZ Schedule K-1 for 2010 reported a $3,000 ordinary loss. How does Roger compute his allowable passive loss deduction and suspended loss for the year?

The first step is to determine that Roger has an overall passive gain allocable to ABC of $3,500 ($15,000 gain on disposition less suspended and current losses totaling $11,500). Since he has another passive activity, the $3,500 gain must be reported on Form 8582 and will offset a portion of the XYZ loss.

Partial Dispositions. A taxpayer can generally claim suspended losses only upon the complete disposition of the activity in a fully taxable transaction (see preceding discussion). However, a partial disposition can be treated as a complete disposition if *substantially all* of the activity is disposed of and the taxpayer can establish with reasonable certainty the carryover deductions and credits, and the current-year income, deductions, and credits allocable to that part of the activity. According to the IRS Passive Activity Audit Guide, taxpayers need to keep a separate set of books and records for the disposed part of the activity to meet this requirement.

When a taxpayer disposes of less than an entire interest in an activity (i.e., partial disposition that cannot be treated as a complete disposition), the passive or nonpassive nature of the gain or loss is determined by his level of participation in the activity in the year of disposition. If the activity is passive, gain or loss is also passive and treated as part of the net passive income or loss from the activity for the year of the partial disposition.

Consequences of Grouping Interests in the Same Activity Together. How activities are grouped can determine whether there is a complete or partial disposition of an activity in a taxable transaction.

Example 1D-3 Effect of activity groupings on complete disposition rule.

Fran owns a 30% interest in a golf supply shop. Teeoff, a general partnership, owns the remaining 70%. Fran is also a 25% owner of Teeoff. She does not materially participate in either activity. Fran has $50,000 and $5,000 of suspended passive activity losses attributable to her direct and indirect interests, respectively, in the golf supply shop.

In 2009, Fran sells her entire partnership interest resulting in a $3,000 gain. Since she held both a direct and indirect interest in the same activity, the two interests constitute an appropriate economic unit and were thus grouped by Fran into one activity under the PAL rules. Because of this grouping, the disposition of her partnership interest is not a complete disposition of her interest in the golf supply shop. Therefore, the $55,000 of suspended losses attributable to her direct and indirect interests cannot be fully deducted under the complete disposition rule.

Death of Taxpayer. On a decedent's final return, suspended passive losses are deductible to the extent they are greater than the excess (if any) of basis attributable to the passive activity property in the hands of the transferee over adjusted basis of such property immediately before death. Any remaining PALs expire unused at the date of death.

Example 1D-4 Adjusting suspended losses for step-up in basis upon death of taxpayer.

John, a single taxpayer, died on September 1, 2009. His suspended loss carryover from XYZ Ltd. Partnership was $10,000. At the time of death, John's estate received a $2,500 step-up in the tax basis of XYZ. (John's partnership interest was appraised at $20,000 and had an adjusted tax basis of $17,500.) Therefore, on John's final Form 1040, only $7,500 of the suspended loss is deductible ($10,000 – $2,500 Section 1014 step-up).

Sale of a Residence. Sometimes rental property is converted into the taxpayer's residence and later sold for a gain wholly or partially excluded under IRC Sec. 121. In that case, the property was presumably not disposed of in a fully taxable transaction, so it would appear any suspended passive losses from the time the residence was a rental property must continue to be carried forward and can only be used to offset passive income from other sources. However, this issue is not specifically addressed in the regulations, and some practitioners have taken the position that given that the sale of a principal residence does represent a *recognized* transaction, with tax exclusion *available* under IRC Sec. 121, any suspended passive losses become available at the time of the sale.

Carryover Basis Transactions. Dispositions of passive activities in carryover basis transactions (e.g., contribution to a partnership or corporation in exchange for an ownership interest, a like-kind exchange, or an involuntary conversion) do not trigger the deduction of suspended passive losses. Instead, the suspended losses can be used by the transferor to offset other passive income, or are fully deductible when the transferor disposes of the stock or other property (in a fully taxable transaction) received in exchange for the passive activity. If, despite the nontaxability of these transactions, gain is recognized because boot is transferred, any gain recognized from such boot is passive income.

Disposition Involving Related Party. When a taxpayer transfers an interest in a passive activity to a family member or other related party [as described in IRC Sec. 267(b) or 707(b)(1)] other than by gift, suspended passive losses in excess of gain on disposition continue to be carried forward by the transferor taxpayer. These losses can be deducted against income from other passive activities held by the transferor taxpayer, or, if earlier, against nonpassive income when the transferee disposes of the property in a fully taxable transaction with an unrelated party.

Gift Transfers. If the taxpayer transfers his interest in a passive activity by gift, any suspended passive losses generally increase the recipient's basis in the activity. This basis increase is deemed to occur immediately before the gift. However, when property acquired by gift is ultimately disposed of, the FMV limitation applies. The donee's adjusted basis for computing *loss* on the sale is the lesser of carryover basis from the donor, or FMV at the time of the gift. Therefore, if the activity is eventually sold at a loss, suspended losses that were added to the donee's basis will not be deductible to the extent they caused the donee's basis to exceed FMV at the time of the gift.

Example 1D-5 Gift of partnership interest with suspended passive losses.

Tim gifts a partnership interest with a $3,000 basis and a $5,000 FMV to his daughter, Maddie. At the time of the gift, Tim has $1,400 of suspended passive losses attributable to the partnership interest. The suspended losses are not deductible by Tim but are added to Maddie's basis in the partnership interest. Thus, Maddie's basis is $4,400.

Example 1D-6 Basis limitation after gift.

Assume the same facts as in the previous example, except the FMV of the partnership interest on the date of the gift is $4,000. If Maddie sells the partnership interest at a loss, her basis is limited to $4,000 (lesser of carryover basis or FMV). Thus, $400 of the $1,400 suspended passive loss vaporizes and can never be used because of the FMV limitation.

Divorce Transfers. IRC Sec. 1041(b) states that property a spouse receives incident to divorce is treated as acquired by gift. Therefore, the IRS has applied the Section 469(j)(6) rules discussed above to divorce transfers (see "Gift Transfers" in previous paragraph). In the IRS Market Segment Specialization Program (MSSP) guide on passive activity losses (released 5/30/96), the IRS stated that transfers incident to divorce should be treated as gifts and the suspended losses of the donor spouse added to the basis passing to the receiving spouse. Thus, the recipient's deduction of the suspended passive losses is effectively deferred until the property is sold.

Installment Sales. An installment sale of an entire interest in a passive activity that generated suspended passive losses will result in recognition of the suspended losses over the term of the installment obligation in the same ratio as the gain on the sale is recognized.

Example 1D-7 Electing out of installment sale method to free up suspended loss.

George owns a rental property in which he does not actively participate. It has an adjusted basis of $100,000 and suspended passive losses totaling $20,000 as of December 31, 2009. On January 2, 2010, George sells the property for $101,000, payable $10,100 of principal per year plus interest for 10 years.

George's gain on the sale is $1,000, and he will recognize $100 of the gain each year for 10 years. He will also be able to deduct $2,000 ($20,000 ÷ 10 years) of the suspended loss each year, starting in 2010.

If George had sold the property for $99,999 (a loss on sale of $1), all of the $20,000 suspended loss would be allowable in 2010.

Variation: George could elect out of the installment method. The election would result in a 2010 gain of $1,000 (assuming the sale at $101,000), and the allowance of all suspended losses ($20,000) in 2010.

Disposition of an Interest in a Pass-through Entity with Multiple Activities

Gain or loss from the disposition of an interest in a pass-through entity (partnership or S corporation) that conducts more than one activity (including trade or business, rental, or investment activities) must be allocated among the different activities. Thus, gain or loss may be part passive and part nonpassive, depending on the nature of the entity's activities.

Allocable gain or loss can occur from either a partial or full disposition of the interest. Allocable gain can also occur when a distribution from the partnership or S corporation exceeds the taxpayer's adjusted basis in the interest.

A taxpayer must allocate gain or loss from the disposition among the entity's activities on the applicable valuation date. This date is selected by the pass-through entity and normally is either (1) the date of disposition of the interest, or (2) the beginning of the pass-through entity's tax year in which the disposition occurs. Gain/(loss) allocable to each activity is determined as follows:

$$\text{Total Gain (Loss)} \times \frac{\text{Taxpayer's net gain/(loss) on disposition of the individual activity for FMV}}{\text{Taxpayer's net gain/(loss) on disposition of all activities generating gain/(loss) at FMV}}$$

If an allocation cannot be made using this method, gain/(loss) must be allocated among the entity's activities based on FMV of its interest in the activities on the applicable valuation date. Thus, gain/(loss) recognized by a taxpayer from a disposition or from a distribution in excess of basis in the pass-through entity's interest can be passive, nonpassive, or portfolio income—depending on the activities in which the entity is engaged.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. Passive loss carryforwards from publicly traded partnerships (PTPs) are subject to a special rule concerning how the losses can be utilized. Which of the following statements regarding passive loss carryforwards from a PTP is correct?

    a. Passive losses from a PTP can be carried forward indefinitely to offset future passive activity income.

    b. Passive losses from a PTP can only be used against income or gain from that specific partnership.

    c. Passive losses from a PTP can only be deducted from the activity that created the loss.

12. The first step to calculating suspended passive losses is to segregate the losses into two categories. Which of the following is the categories that the suspended passive losses would be classified?

    a. Passive losses and suspended losses.

    b. Ordinary losses and passive losses.

    c. Rental real estate activities with no participation and all other passive losses.

    d. Rental real estate activities with active participation and all other passive losses.

13. Which of the following best describes how a taxpayer with multiple activities should track suspended passive losses?

    a. Track each activity by updating passive losses generated and utilized each year by the type of losses (e.g., capital loss, ordinary loss, etc.) that will be reported on two or more different forms or schedules in the return.

    b. Track activities by updating a single schedule of passive losses generated and utilized each year by the type of losses (e.g., capital loss, ordinary loss, etc.) that will be reported on two or more different forms or schedules.

14. Which of the following is correct about suspended passive losses on a decedent's final return?

    a. Suspended passive losses are not deductible because all suspended losses expire at the date of death.

    b. They can only be deducted in the year after the death by the estate of the deceased.

    c. Deductible to the extent they exceed the basis attributable to the passive activity property and any remaining PALs expire unused at the date of death.

    d. All passive losses incurred in the year of death and all passive losses carried to the year of death are fully deductible on the decedent's final return.

15. In an installment sale of an entire interest in a passive activity that generated suspended passive losses, how will the suspended losses be recognized?

    a. The total gain is recognized when the final balance of contract is collected.

    b. Over the term of the installment obligation in equal amounts each year.

    c. Immediately in the year that the installment sale is disposed.

    d. Over the term of the installment obligation in the same ratio as the gain on the sale is recognized.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. Passive loss carryforwards from publicly traded partnerships (PTPs) are subject to a special rule concerning how the losses can be utilized. Which of the following statements regarding passive loss carryforwards from a PTP is correct? **(Page 19)**

    a. Passive losses from a PTP can be carried forward indefinitely to offset future passive activity income. [This answer is incorrect. Suspended passive losses carry forward indefinitely to offset future passive activity income, except for passive loss carryforwards for a PTP. Publicly traded partnerships are subject to a special rule detailed in IRC Sec. 469(k).]

    b. Passive losses from a PTP can only be used against income or gain from that specific partnership. [This answer is correct. According to IRC Sec. 469(k), passive loss carryforwards from publicly traded partnerships (PTPs) are subject to a special rule that states they can only be used against income or gain from that specific partnership.]

    c. Passive losses from a PTP can only be deducted from the activity that created the loss. [This answer is incorrect. It is not correct for a PTP or any other entity. Generally, the losses can be deducted against future passive activity income from any passive activity source and not merely from the activity that created the loss, but PTPs are subject to special rules explained in IRC Sec. 469(k).]

12. The first step to calculating suspended passive losses is to segregate the losses into two categories. Which of the following is the categories that the suspended passive losses would be classified? **(Page 19)**

    a. Passive losses and suspended losses. [This answer is incorrect. The taxpayer will need to determine how to segregate passive losses on Form 8582 for the IRS, but suspended losses are not taken into consideration in the first step.]

    b. Ordinary losses and passive losses. [This answer is incorrect. As required on IRS Form 8582, two categories must be identified when the taxpayer is considering passive activities. Ordinary losses is not a passive activity for the taxpayer.]

    c. Rental real estate activities with no participation and all other passive losses. [This answer is incorrect. Taxpayer will need to identify real estate activities with active participation, not rental real estate with no participation.]

    d. Rental real estate activities with active participation and all other passive losses. [This answer is correct. Initially, passive activities are segregated into two categories: rental real estate activities with active participation, and all other passive activities. Rental real estate activities are put into a separate category because of the favorable exception that allows qualifying taxpayers to deduct up to $25,000 of passive losses from rental real estate activities against nonpassive income.]

13. Which of the following best describes how a taxpayer with multiple activities should track suspended passive losses? **(Page 19)**

    a. Track each activity by updating passive losses generated and utilized each year by the type of losses (e.g., capital loss, ordinary loss, etc.) that will be reported on two or more different forms or schedules in the return. [This answer is correct. The activity losses must adjusted and carried forward each year. It is important to know the different types of losses that make up the carryforward, since the disposition rule allows the taxpayer to deduct suspended losses from a particular activity and overall suspended passive losses must be allocated annually to specific passive activities.]

    b. Track activities by updating a single schedule of passive losses generated and utilized each year by the type of losses (e.g., capital loss, ordinary loss, etc.) that will be reported on two or more different forms or

schedules. [This answer is incorrect. The taxpayer will need details for each activity and should keep separate schedules for each. Within Form 8582, Worksheets 5 and 6 are available for this purpose. Worksheet 7 is used instead of Worksheet 6 when an activity has a suspended loss consisting of different characters of loss that will be reported on two or more different forms or schedules in the return.]

14. Which of the following is correct about suspended passive losses on a decedent's final return? **(Page 20)**

    a. Suspended passive losses are not deductible because all suspended losses expire at the date of death. [This answer is incorrect. Suspended losses can be used after death, but only if included on the decedent's final return according to IRC Sec. 469(g)(2).]

    b. They can only be deducted in the year after the death by the estate of the deceased. [This answer is incorrect. The use of the suspended losses is limited to the final return of the deceased and does not include the estate of the deceased as noted in IRC Sec. 469(g)(2).]

    c. Deductible to the extent they exceed the basis attributable to the passive activity property and any remaining PALs expire unused at the date of death. [This answer is correct. According to IRC Sec. 469(g)(2), the law allows the deduction of suspended passive losses to the extent they exceed basis attributable to the passive activity property. Any remaining PALs expire unused at the date of death.]

    d. All passive losses incurred in the year of death and all passive losses carried to the year of death are fully deductible on the decedent's final return. [This answer is incorrect. Passive losses are limited on a decedent's final return as detailed in IRC Sec. 469(g)(2).]

15. In an installment sale of an entire interest in a passive activity that generated suspended passive losses, how will the suspended losses be recognized? **(Page 20)**

    a. The total gain is recognized when the final balance of contract is collected. [This answer is incorrect. The rules detailed in IRC Sec. 469(g)(3) match the recognition of gain with the receipt of the principal.]

    b. Over the term of the installment obligation in equal amounts each year. [This answer is incorrect. The loss must be recognized in proportion to gain recognized each year. The gain would only be recognized in equal amounts each year if the contract is written in a way that the taxpayer recognized the same amount of gain in each year.]

    c. Immediately in the year that the installment sale is disposed. [This answer is incorrect. If the taxpayer wishes to recognize the losses in the year of disposition, the taxpayer would need to elect out of the installment method.]

    d. Over the term of the installment obligation in the same ratio as the gain on the sale is recognized. [This answer is correct. According to IRC Sec. 469(g)(3), an installment sale of an entire interest in a passive activity that generated suspended passive losses will result in recognition of the suspended losses over the term of the installment obligation in the same ratio as the gain on the sale is recognized.]

Special Rules for Rental Activities

Rental activities (except rental real estate activities owned and materially participated in by real estate professionals) are generally deemed passive activities automatically, regardless of whether the taxpayer materially participates. This general rule is statutory and applies whether the rental property is real estate or personal property unless an exception provides otherwise. Generally, an activity is a rental activity if tangible property held in connection with the activity is used or held for use by customers, and the gross income of the activity represents amounts paid principally for the use of the property.

Six Exceptions to Treatment as Rental Activities

Temp. Reg. 1.469-1T(e)(3)(ii) provides six exceptions whereby the following activities are not categorized as rental activities for PAL purposes even though gross income is received for the use of the property:

1. Average period of customer use or rental is seven days or less (e.g., a vacation condo or motel).

2. Average period of customer use is 30 days or less, and significant personal services are provided (e.g., dude ranch, hotel or other temporary lodging where housekeeping and/or other valet services are provided). Significant personal services are defined only as services performed by individuals using a *relevant facts and circumstances test*. Services provided along with the use of realty, such as cleaning and maintenance of common areas, routine repairs, trash collection, providing of security, etc., are not considered significant personal services. Neither is travel between the owner's home and rental properties to inspect and maintain units or to attend condominium association meetings. In *Hairston*, the taxpayer argued that equipment owned personally and leased to a controlled S corporation (which leased it to third parties for an average rental period of 30 days or less) qualified for this exclusion from the definition of rental activity. The court determined that the lease to the S corporation was long-term because the S corporation had access to the equipment for an indefinite period. The end-user's lease term was irrelevant.

3. Extraordinary personal services are provided by or on behalf of the owner, without regard to the average period of customer use. The services must be performed by individuals, and the use of the property by customers is incidental to their receipt of such services, such as with a hospital or a boarding school's dormitories.

4. Rental of the property is incidental to a nonrental activity of the taxpayer. This exception applies when property is held for investment or business use and the gross rental income from the property for the year is less than 2% of the lesser of the unadjusted basis of the property or its FMV. If the property is used in a trade or business activity, the taxpayer must also own an interest in the activity during the year and have used the property predominantly in the trade or business activity during the year or during at least two of the preceding five tax years.

5. Taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers (e.g., a golf course).

6. Taxpayer, in his or her capacity as an owner, provides the property for use in an activity conducted by a partnership, S corporation, or a joint venture in which he or she owns an interest, and the activity is not a rental activity. Thus, if a partner, for example, contributes the use of property to a partnership, none of his or her distributive share of the partnership's income is rental income, unless the partnership is engaged in a rental activity. Whether property is provided in the taxpayer's capacity as an owner is determined based on all the facts and circumstances. In Ltr. Rul. 9722007, the IRS found that owners who formally leased property to their S corporation were engaged in a rental activity rather than in providing property to the S corporation in their capacity as owners. Unfortunately, the ruling does not explain what criteria must be present for a formal lease to exist.

An activity meeting one of these exceptions is not considered a rental activity for PAL purposes. However, for five of these exceptions (items 1–3, 5, and 6), the activity could be considered a business activity, and thus the taxpayer's degree of participation (under the material participation rules discussed earlier) must be tested to determine

whether the activity is passive or nonpassive. The fourth item, incidental rental, would not default to business treatment. In the case of an incidental rental, the activity will usually be considered an investment activity and associated expenses are deductible as investment expenses under IRC Sec. 212 (miscellaneous itemized deductions subject to the 2% AGI floor).

Example 1E-1 Lease of land is incidental to nonrental activity.

Last year Sue paid $200,000 for 500 acres of unimproved land in a rural area. She anticipates that in the next five years the value of the property will appreciate significantly, at which point she plans to sell the land. In the interim, Sue agrees to lease the land to a neighboring rancher for $3,500 a year. Because the rental of the land is incidental to Sue's primary purpose of holding for appreciation, and the income she receives is less than 2% of the property's unadjusted basis, the income is not considered to be from a rental activity.

$25,000 Rental Real Estate Exception

A special favorable exception for rental real estate activities may allow the first $25,000 of net passive losses from such activities to be deducted against the taxpayer's nonpassive income when the taxpayer actively participates in the activity. When married taxpayers file separately, the allowance is $12,500 per taxpayer if the couple lived apart for the entire year; otherwise, the allowance is zero if they did live together during the year.

The $25,000 allowance is phased out for taxpayers with higher AGIs. The amount is reduced by 50% of the amount by which the taxpayer's modified AGI exceeds $100,000 ($50,000 for married taxpayers filing separately). (See Example 1E-4 for the definition of modified AGI.) Accordingly, as a taxpayer's modified AGI increases from $100,000 to $150,000, the $25,000 allowance decreases from $25,000 to zero.

Active Participation Requirement. To qualify for the $25,000 allowance, the taxpayer must *actively participate* in the rental activity during the tax year the loss is incurred. The taxpayer must also have at least a 10% (by value) ownership interest in the activity at all times during the tax year, and this interest may generally not be that of a limited partner.

The active participation standards are much less stringent than the material participation standards discussed earlier in this lesson. Active participation does *not* require regular, continuous, and substantial involvement in the operations. Instead, the taxpayer must participate in a significant way, such as making management decisions or arranging for others to perform services (e.g., repairs) for the rental activity. Management activity qualifying under the active participation test includes approving new tenants, setting rental policies and terms, and approving capital expenditure or repair decisions.

Example 1E-2 Active participation: managing the property.

Dean lives in New York but owns a rental property in Chicago. He receives all rent through the mail and has not been to Chicago to see the rental property for more than a year. If problems occur or repairs are needed, he hires someone in Chicago to perform the work. Dean continues to set the policy on rentals and approves tenants when vacancies occur. Because Dean owns at least 10% of the rental activity, makes all management decisions, and provides for others to perform services for the property in his absence, he actively participates even though he does not visit the property.

Example 1E-3 Active participation: silent partner fails the test.

Dave and Kevin are equal shareholders in an S corporation that owns an apartment building in Minneapolis. Dave lives in Minneapolis; Kevin lives in Los Angeles. Dave makes all management decisions for the rental property. He inspects it on a regular basis and collects all rent. Kevin has had no involvement whatsoever with the property since he invested in it several years ago. Both Dave and Kevin meet the ownership test under IRC Sec. 469(i)(6). However, since Kevin has had no contact with the property and makes no management decisions, he does not actively participate in the property. Dave actively participates in the property as he makes all management decisions. Consequently, Dave can deduct up to $25,000 of his share of S corporation losses against his nonpassive income, but Kevin's S corporation losses are considered passive.

Example 1E-4 $25,000 rental loss allowance phase-out.

Ted acquired an apartment building in 2009. Because of vacancies during remodeling, he incurred a $35,000 loss in the current year. Ted is not a real estate professional and has no other passive activities. He actively participates in operating the building. His current year income before any passive loss limitation consists of the following:

Form W-2 wages	$ 20,000
Schedule C proprietorship	100,000
Schedule E rental loss	(35,000)
IRA deduction	(2,000)
SE tax deduction	(5,825)
Tentative AGI	$ 77,175

The $25,000 rental realty loss allowance is reduced by 50% of the amount by which modified AGI exceeds $100,000. Modified AGI (MAGI) is AGI computed without regard to any (1) passive loss deductions, (2) IRA deductions, (3) taxable social security and railroad retirement benefits, (4) income exclusion for interest on U.S. Series EE or I bonds used for higher education, (5) income exclusion for employer-provided adoption assistance, (6) deduction for interest on higher education loans, (7) deduction for qualified tuition and related expenses (if extended beyond 2009; it expired on December 31, 2009), (8) the Section 199 domestic production activities deduction, or (9) rental real estate losses considered nonpassive because the taxpayer is a real estate professional who materially participates in the activity.

Ted's current year modified AGI is computed as follows:

	Based on the IRS Instructions	Based on IRC Sec. 469(i)(3)(F)
Tentative AGI	$ 77,175	$ 77,175
Addback:		
IRA deduction	2,000	2,000
Passive rental loss	35,000	35,000
SE tax deduction	5,825	—
Modified AGI	$ 120,000	$ 114,175
Allowable rental loss:		
[$25,000 − 50% ($120,000 − $100,000)]	$ 15,000	
[$25,000 − 50% ($114,175 − $100,000)]		$ 17,913

Following the IRS instructions requires Ted to defer an additional $2,913 ($17,913 − $15,000) of his rental loss (i.e., 50% of his $5,825 SE tax deduction).

Net Lease Property. Typically, it will be difficult for taxpayers to demonstrate active participation in a net lease property, since such an arrangement transfers the operating expenses (and thus any related work) from the owner to the tenant. The owner's only obligation is usually to pay the interest and taxes on the property.

The term *net lease* is not defined under IRC Sec. 469. However, according to the IRS Passive Activity Audit Guide, a net lease is a lease arrangement where the tenant pays most or all of the expenses. Drawing from the definition found in pre-1986 law concerning investment interest, the Guide states that a net lease exists when (1) deductions (other than interest, taxes, and depreciation) are less than 15% of gross rents, or (2) the lessor is guaranteed a specific return or against loss of income. A net lease rental activity in which the taxpayer cannot establish active participation is detrimental when the activity incurs a net loss (the loss is not eligible for the $25,000 loss allowance). However, if the activity generates net income (which is often the case in net lease arrangements), net lease

classification may be beneficial. The income from the net lease property can be used to offset other passive losses without affecting a taxpayer's use of the $25,000 rental loss allowance on other qualifying properties. But, because a net lease is a rental subject to the passive loss rules, it is not considered investment property for the limitation on investment interest expense.

Example 1E-5 Net lease property.

George leases an office building to an unrelated tenant. Under the lease arrangement, the tenant must pay the operating costs of the building. George is not involved in approving capital expenditure or repair decisions, although he did approve the tenant and negotiate the rental terms.

This is a rental activity because none of the exceptions to the rental activity definition (see discussion earlier in this lesson) apply. During the year, the only expenses George incurred were for interest, taxes, and depreciation. If this is a net lease arrangement, George will have a difficult time establishing that he actively participates in the activity.

Since George's deductions (other than interest, taxes, and depreciation—the only deductions he has) are less than 15% of gross rents, this could be considered a net lease arrangement. Therefore, George may not be able to establish active participation and thus may not be eligible for the $25,000 rental realty allowance. However, he probably can pass the test if he can arrange with the tenant to take a more active role in making capital expenditure and repair decisions, even though he does not pay for these costs.

Vacation Home Rentals

Residential real property that a taxpayer both uses personally and rents falls into one of three categories for tax purposes: (1) personal residence, (2) vacation home, or (3) rental property with some personal use. Under IRC Sec. 469(j)(10), the passive activity loss (PAL) rules do not apply to any rental activity that involves a taxpayer's residence and is subject to the Section 280A loss limitation rules (i.e., vacation home).

Therefore, the only rental properties with owner use that are subject to the PAL rules are those in category 3 (i.e., rental property with some personal use). These properties are rented during the year, and have personal usage by the owner (or attributed to the owner) that does not exceed the greater of 14 days or 10% of rental days. Because the PAL rules apply, a taxpayer who actively participates in the activity is eligible for the $25,000 rental realty allowance. However, if the average period of customer rental is seven days or less (which is common with rental of resort condominiums), the activity is not a rental activity. This means the taxpayer must meet the more stringent material participation requirements to offset losses from the activity against nonpassive income. The $25,000 rental realty loss allowance does not apply.

Example 1E-6 Vacation home with limited personal use rented through rental pool.

Joan owns a condo in Aspen. The condo is rented and day-to-day operations are managed through a rental pool; Joan inspects the condo and common grounds twice a year. She also reviews monthly reports provided by the rental pool and sets the rental rates, along with other condo owners.

During the year, Joan's condo was rented for 60 days (average customer rental was seven days). Joan used the condo personally for 14 days. She received $12,000 in rental income and incurred $25,000 of expenses, of which $18,000 was allocated to rental use. The expenses allocated to personal use included $1,000 of interest expense.

The condo is used personally for fewer than 15 days per year. Therefore, it is treated as a rental home with some personal usage, and the net rental loss is not subject to the Section 280A vacation home limitations. It is, however, subject to the PAL limitations. Under the passive activity rules, the condo is not a rental activity because the average period of customer rental is seven days or less. This means that Joan must establish material participation to deduct the $6,000 rental loss in the current year. Joan probably will not be able to establish material participation and thus, the $6,000 loss will be limited under the passive activity rules. The $1,000 of interest expense allocated to personal use is nondeductible personal interest because the property is by definition not a personal residence.

Variation 1: If Joan increased her personal use to 15 days (instead of 14 days), the condo would be classified as a vacation home. Under the Section 280A vacation home rules, a net loss from the rental would not be allowed (but expenses of $12,000 may be deducted to fully offset the income). Also, the $1,000 of interest expense allocated to personal use would be deductible (if qualified residential interest) on Schedule A. The vacation home loss carryover (the amount disallowed under IRC Sec. 280A) is allowed only against future income from the condo; it is not deductible upon disposition of the condo, as would be the case if the PAL rules applied.

Variation 2: If average customer use had exceeded seven days, it would have been a rental activity eligible for the $25,000 rental real estate loss allowance because Joan's activities would have constituted active participation. However, if Joan is not able to use this allowance (e.g., because the $25,000 allowance is phased out due to her modified AGI or she has already used the $25,000 allowance on other properties), she may still consider increasing her personal use to allow a current-year interest deduction of $1,000 on Schedule A under the vacation home rules.

General Investment of Net Income from Self-rented Property

General Treatment of Self-rented Property

The self-rented property regulations prohibit using net income from the rental of property to offset other passive losses if the property is rented for use in a trade or business in which the taxpayer materially participates (other than certain development activities). However, rental income pursuant to a written, binding contract entered into before February 19, 1988 is not subject to the income recharacterization rules.

Example 1F-1 Income-producing self-rented property denied passive status.

Robin is an investor in a limited partnership that has produced annual losses averaging $10,000 over the past few years; he does not have passive income to offset these losses. Robin materially participates and is sole shareholder in his trucking business, which is an S corporation. He is considering personally purchasing a building to house and repair trucks. Robin would then rent this property to his trucking business for use as an additional shop, thereby creating (he hopes) passive income on his Form 1040 which can offset the passive loss from the limited partnership.

Robin's idea to generate passive income would not work. A taxpayer involved in renting property to a trade or business in which he owns an interest and materially participates must recharacterize the net rental income from the property to nonpassive status. Thus, Robin's net passive rental income would be zero and the passive losses from the limited partnership would continue to be suspended under the PAL rules.

Rental to C Corporations

When Reg. 1.469-2(f)(6) was first issued and for several years thereafter, it was unclear whether leasing property to a C corporation in which the taxpayer materially participated was subject to the recharacterization rule. However, final regulations in Reg. 1.469-4 state that a taxpayer's activities subject to IRC Sec. 469 include those conducted through a C corporation. Several decisions have specifically upheld the application of this regulation to a lease arrangement involving a C corporation as tenant. Accordingly, an individual who owns property that is leased to any entity (whether a partnership, S corporation, or C corporation) in which that individual materially participates will find that the net rental income is recharacterized as nonpassive income.

According to the IRS Passive Activity Audit Guide, net rental income from a closely held C corporation is subject to recharacterization as nonpassive income. Thus, the IRS has directed its examiners to look for these rental arrangements during audits and review them for proper application of the recharacterization rules.

Property Rented Incidental to a Development Activity

Another recharacterization rule applies to income from property rented incidental to a development activity. Rental of property by a developer for less than 12 months is recharacterized from passive income to business income for purposes of the passive activity loss rules. Losses are not affected by the recharacterization rule.

Net Income from Rental of Nondepreciable Property

Net income from rental property is not considered passive if less than 30% of the unadjusted basis of the property is depreciable. Instead, it is considered portfolio income.

Example 1G-1 Rental income recharacterized as portfolio income.

Bill purchased a vacant lot for $40,000 and constructed a storage shed on it for $10,000. During the current year, Bill leased the property to a trucking company to park its trailers and use the shed for storage. Bill had net income from the rental property of $3,000. Since this was a rental activity, Bill assumed the $3,000 was passive income that could be offset by passive losses from limited partner interests he owns.

Since less than 30% of the unadjusted basis of the property is depreciable ($10,000/$50,000 = 20%), the activity's net income is treated as portfolio income. Therefore, Bill cannot offset this income with passive losses.

If real property is subject to recharacterization in the year it is sold, gain from the disposal is also subject to recharacterization. For the recharacterization rule to apply, the activity must be treated as a rental activity under the Section 469 rules. If one of the rental exceptions applies, the activity is not subject to this recharacterization rule; instead, the passive or nonpassive nature of the activity depends on the taxpayer's participation.

Exception for Real Estate Professionals

Real estate professionals may treat otherwise passive rental real estate activities as nonpassive if the taxpayer materially participates in the rental activity. Losses from such activities can be used to offset wages, interest, and other nonpassive income. This treatment is only available to eligible individual taxpayers and closely held C corporations who are considered to materially participate in the rental real estate activity. An individual is an eligible taxpayer for any tax year if :

1. more than 50% of personal services performed by the taxpayer in all trades or businesses during the tax year are performed in real property trades or businesses in which the taxpayer materially participates, *and*

2. the taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses in which the taxpayer materially participates. This criteria requires actual performance of services. The Tax Court disallowed a taxpayer's "on call" and "willing to work" hours to count towards this 750-hour requirement.

Defining Real Property Trades or Businesses

A *real property trade or business* is broadly defined to include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage. Reg. 1.469-9(d) provides that a facts and circumstances test applies in determining the taxpayer's real property trades and businesses and that any reasonable method may be used in applying that test.

To be eligible for these special rules, the taxpayer must materially participate in real property trades or businesses rather than participate in business activities involving real estate transactions. This suggests that the benefits of these rules may be unavailable to individuals who are only peripherally involved in real property trades and businesses.

Although real estate agents are engaged in regular sales of real property, most states prohibit them from acting as brokers without a license. Even after issuance of the regulations, it was unclear if the term *brokerage* in the Code's definition of eligible businesses limits eligibility to those who are licensed brokers or instead refers more broadly to the general activity of real estate sales. However, in the *Agarwal* case, the Tax Court held that a licensed real estate agent's activities counted towards satisfying the real estate professional's exception to the passive activity rules, even though the agent was not a broker under state law. The Court determined that under the Section 469 rules, the term *broker* has its common or ordinary meaning and includes any person whose activities include (1) selling,

exchanging, purchasing, or leasing real property; (2) offering to do those activities; (3) negotiating the terms of a real estate contract; (4) listing real property for sale, lease, or exchange; or (5) procuring prospective sellers, purchasers, lessers, or lessees. Therefore, it appears real estate agents should qualify for the benefits of IRC Sec. 469(c)(7) (assuming they satisfy the more-than-50% and more-than-750-hours tests).

If a taxpayer is trying to qualify as a real estate professional on the basis of a rental real estate business with multiple rental real estate interests and he has a job unrelated to those activities, which takes up a substantial amount of time, it may be impossible to qualify as a real estate professional without making the election to treat all rental real estate interests as a single activity (the election is explained later in this key issue). Because real estate trades or businesses that satisfy the real estate professional rules require the taxpayer to materially participate, the taxpayer must show material participation in each rental activity for that activity to help in satisfying the 50% and 750-hour requirements.

Example 1H-1 Defining real property trades or businesses.

Tom, a lawyer, spends 85% of his time working on real estate legal matters. His brother, Dick, spends 92% of his time in the real estate mortgage business. Both spend more than 750 hours in their respective businesses during the year. Each has several rental properties that have substantial losses each year. It appears that neither can treat the rental losses as nonpassive since neither is involved in a real property trade or business as defined by the Code, even though each spends a substantial amount of time dealing with real property (real estate legal and mortgage activities do not count as real estate trades or businesses). Taxpayers in businesses that fall into this category (which probably also includes real estate appraisers and inspectors) should be careful to document their participation and continue to monitor IRS activity in this area.

Example 1H-2 Qualifying to treat rental real estate activities as nonpassive.

Biff is a general partner in Bluffview Partners and Mountainview Partners, two calendar-year partnerships formed to own and rent office buildings. He is the sole general partner in each of the partnerships and employs a small staff of legal, accounting, and maintenance personnel. Biff spends approximately 600 hours per year performing services for each of the partnerships (total of 1,200 hours); he performs no other personal services for any other business. Biff's share of each partnership's rental real estate losses for the year is $20,000 (total of $40,000).

More than 50% of the time Biff spends on all trade or business activities during the year is spent in real property trades or businesses in which he materially participates—in fact, 100% of his time is spent on those activities. Biff also spends more than 750 hours on real property trade or business activities in which he materially participates during the year. Biff is considered to materially participate in each of the two partnership activities under the 500-hour rule. (See discussion of material participation later in this lesson.) Therefore, Biff meets both the requirements for treating the $40,000 of partnership losses as currently deductible nonpassive losses.

Material Participation by Real Estate Professionals

Material participation plays a role in two distinct aspects of the relief provision for real estate professionals. First, when determining whether a taxpayer qualifies as a real estate professional, only real property trades or businesses in which the taxpayer materially participates are counted for purposes of the 50% and 750-hour tests. Second, once it is determined that a taxpayer qualifies as a real estate professional, the nonpassive treatment is available only for *rental* real estate activities in which the real estate professional materially participates. Thus, a taxpayer must pass two material participation hurdles before a rental activity receives nonpassive treatment.

The material participation standards under these special relief rules are the same as those otherwise applicable to passive activities. Thus, the taxpayer is considered to have materially participated in an activity if he meets one of the seven tests (or three tests for a limited partner interest) previously outlined for that activity. A rental real estate activity may not be grouped with any nonrental real estate activity for purposes of determining material participation in that rental real estate activity. When determining material participation in rental real estate activities, each interest of the taxpayer in a rental real estate activity is treated as a separate activity. (The taxpayer can elect to treat all interests in rental real estate activities as a single activity (see the discussion later in this lesson.)

Example 1H-3 Determining eligibility for real estate professional rules when nonrental real estate activities are involved.

Assume the same facts as in Example 1H-2, except (1) Mountainview was formed to develop and rent an office building, (2) Biff spent 460 hours on the development activity and 140 hours on the rental activity, and (3) Biff had an assistant who spent more hours than he did on each of the activities.

Biff cannot group Mountainview's development and rental real estate activities together because a rental real estate activity may not be grouped with a nonrental real estate activity under the material participation guidelines. Therefore, he fails to meet the material participation test for either activity. Thus, the 460 hours he spends on the development activity and the 140 hours he spends on the rental activity are not considered when determining whether he is an eligible real estate professional. Although he meets the material participation test for Bluffview's rental real estate activity, the 600 hours of material participation at Bluffview do not satisfy either the 50% or the 750-hour test. As a result, he fails to qualify as an eligible real estate professional and all of the partnership losses are passive.

Treatment of Services Performed by Spouse. For a husband and wife, the 50% and 750-hour tests are satisfied only if one spouse individually satisfies the tests (or if both individually satisfy the tests). However, for determining material participation in an activity, the existing rules apply—allowing participation by one spouse to count as participation for the other spouse . Therefore, a husband and wife are eligible to take advantage of the special rule for real estate professionals if, during the tax year, *either* spouse materially participates in the rental real estate activity, and one spouse performs more than 50% of his or her personal services and more than 750 hours in real estate trades or businesses in which he or she materially participates. This rule applies regardless of whether the spouses file a joint return.

Example 1H-4 Determining eligibility when both spouses have real estate trade or business activities.

Adam and Ann are married and file a joint tax return for the year. Adam is a partner in two partnerships. He is a 50% partner in a CPA firm that accounts for about 75% of his total work hours (1,950 hours). He spends about 25% of his work hours (650 hours) performing services for Property Appreciation Partners (PAP), a general partnership in which he is a 50% partner (and in which he materially participates). PAP owns and operates residential rental real estate properties. Ann also operates two businesses. She is a 25% partner in an interior design firm that accounts for 50% of her work hours (550 hours) and a 50% partner in a property management firm (in which she materially participates) that accounts for the other 50% of her time (550 hours). Can Adam and Ann treat their rental real estate losses from PAP as nonpassive because of their participation in real estate activities?

No. To take advantage of the special rule for reclassifying rental real estate income or loss as nonpassive, at least one spouse must meet the 50% and 750-hour tests individually. For the year, neither Ann nor Adam individually spends more than 50% of his or her total work hours and more than 750 hours on real estate trades or businesses in which he or she materially participates. Hours spent by each spouse on real estate trades or businesses cannot be combined to qualify for eligibility for the special rule.

Example 1H-5 Using material participation by a spouse to qualify for nonpassive loss treatment.

Ben and Beth are married and file a joint tax return for the year. Ben owns 75% of H&J Partners, a general partnership that brokers commercial real estate properties. Ben spends 70% of his working hours—about 700 hours per year—working for H&J. He also spends 210 hours per year performing services for the local Chamber of Commerce. Ben owns a 10% interest in Mansfield Apartments Partners (MAP), a general partnership owning and leasing residential apartments. He spends about 90 hours per year performing services for MAP. Beth works part-time—about 10 hours per week (520 hours per year) as an apartment manager for MAP (which also has full-time employees). During the year, Ben is allocated a rental loss from MAP of $15,000. Can Ben and Beth deduct the $15,000 loss from MAP as a nonpassive loss on their return?

Yes. The first step is to determine whether Ben is a real estate professional. He meets the test because he spends more than 50% of his total trade or business service hours and more than 750 hours working in real

estate trades or businesses in which he materially participates. He works 700 hours in the brokerage business and 90 hours in the apartment business, for a total of 790 hours. He can include the 90 hours he spends working for MAP because, although he does not individually materially participate in the activity, he is deemed to materially participate (under the 500-hour rule) after considering the 520 hours his spouse, Beth, spends on the activity.

Next, to treat the MAP rental loss as nonpassive, Ben must materially participate in that activity. Again, Beth's participation can be considered for this test, so Ben and Beth's combined participation in MAP is 610 (90 + 520) hours, which qualifies as material participation. Therefore, Ben and Beth can deduct the $15,000 loss as nonpassive on their tax return since Ben qualifies as a real estate professional and together they materially participate in MAP.

Special Rule for Employees

When applying the 50% and 750-hour tests, the personal services of an employee are not treated as performed in a real estate trade or business unless he has more than a 5% ownership (direct or indirect ownership under the attribution rules of IRC Sec. 318) interest in the employer. If an employee is not a 5% owner in the employer at all times during the tax year, only the personal services performed during the period of 5% ownership are considered. This provision apparently is designed to prevent employers in real estate trades or businesses from compensating employees with tax losses. An employee is considered a more-than-5% owner if he or she owns more than 5% of (1) a corporation's outstanding stock, (2) total combined voting power of all issued corporate stock, or (3) capital *or* profits interest of a partnership.

Election to Combine Rental Real Estate Activities

A taxpayer can elect to treat *all* interests (including limited partner interests) in rental real estate activities as a single activity. This election can be made in any year the special real estate professional rules apply. However, once the election is made, it is irrevocable unless there is a material change in the taxpayer's facts and circumstances. The election must be made by the taxpayer to be effective. Simply grouping activities together and reporting the losses as nonpassive is not sufficient.

If this election is made, material participation is determined for the combined activity as a whole. Generally, if any of the taxpayer's rental real estate activities are held in limited partnership interests, the combined activity is treated as a limited partnership. Accordingly, the taxpayer is considered to materially participate in the combined activity only if he meets one of the three tests applicable to limited partnership interests outlined previously. However, if less than 10% of the taxpayer's share of gross receipts from rental real estate activities comes from limited partnership interests, the combined activity is not treated as a limited partnership interest. In this case, the taxpayer is considered to have materially participated in the combined activity if he meets any one of the seven tests outlined previously.

Example 1H-6 Election to combine rental real estate activities.

George is a general partner in a partnership formed to develop and rent office buildings. He is the sole general partner but employs a staff of full-time accounting, leasing, and construction personnel. During the year, he spent approximately 1,500 hours on the development activity and 400 hours on the rental activity. His share of the loss from the rental activity was $20,000. George also owns three small apartment complexes, each with its own resident manager. George spends approximately 75 hours per year managing each complex. Losses incurred on each of the complexes for the year were $5,000. George performs no other personal services.

With or without this election, George will qualify as a real estate professional eligible for the special relief rules, as his participation in the development activity meets both the 750-hour and 50% tests. However, without the election, George does not materially participate in any of the rental real estate activities because he does not pass any of the seven tests outlined earlier in this lesson. Therefore, all of the rental real estate losses remain passive. If George makes the election, material participation in the rental activities is determined for the combined group. In this case, he will have spent approximately 625 hours [400 hours + (75 hours × 3

complexes)] on the combined rental activity and thus will have materially participated in it. Consequently, George can treat the combined loss of $35,000 [$20,000 + ($5,000 × 3 complexes)] as nonpassive.

The election to combine rental real estate activities may be crucial in allowing some taxpayers to meet the material participation tests or to meet the real estate professional requirements. However, the decision to make the election will need to be made on a case-by-case basis. The following factors should be considered before making this decision.

1. Suspended losses from years before the real estate professional rules apply to the taxpayer are treated as losses from a former passive activity. Any such losses remaining when the entire activity is disposed of in a fully taxable transaction are deductible in the year of disposition. However, if the election is made, the combined rental real estate activity is treated as a single activity for all purposes of IRC Sec. 469, including the disposition rules under IRC Sec. 469(g). Thus, suspended losses cannot be deducted until all (or substantially all) of the activities have been disposed of. Suspended losses related to partial dispositions are generally not deductible until the remainder of the combined group has been disposed of.

2. If the election is made and 10% or more of the taxpayer's share of gross receipts from rental real estate activities comes from limited partner interests, the combined activity is treated as a limited partner interest. The limited partner material participation tests are harder to pass than the regular material participation tests. Thus, it is possible for an electing taxpayer to fail the material participation tests for the combined activity, even though he could have passed the material participation tests for individual nonlimited partnership activities if the election had not been made.

3. If the taxpayer has net income from rental real estate activities in which he or she does not materially participate, keeping the passive status for those activities will allow that passive income to offset other passive losses. However, if the election is made, and the taxpayer materially participates in the combined group, the net income or loss from the combined group (including the otherwise passive income) is nonpassive.

Rental Real Estate Activities Held in Pass-through Entities

When a taxpayer holds rental real estate activities via pass-though entities (partnerships and S corporations), he is bound by the entity's grouping of the activities when he holds less than a 50% interest in the entity. When a taxpayer's interest in the entity is 50% or more, each rental real estate interest held by the entity is treated as a separate interest of the taxpayer regardless of how the entity groups the interests. In either case, if a qualifying taxpayer elects to combine rental real estate activities, the election includes those held through pass-through entities. The election is made at the individual level.

Coordination with $25,000 Allowance for Rental Real Estate

Taxpayers who actively participate in rental real estate activities can potentially offset against nonpassive income up to $25,000 of otherwise passive rental real estate losses from such activities. The $25,000 allowance is reduced by 50% of the amount by which the taxpayers' modified AGI exceeds $100,000. In computing modified AGI for this purpose, rental real estate losses treated as nonpassive under the real estate professional exception are not considered—that is, the losses must be added back to the taxpayers' AGI.

Self-charged Interest Rules

Congress created the passive activity rules to prevent the use of losses and deductions from passive activities to offset unrelated portfolio income and income from other nonpassive activities. Under the general operation of these rules, there can be instances where certain transactions between related taxpayers may give rise to one character of expense and a different character of income for the same item. This can produce an unfair tax result. For example, if an owner makes a loan to the pass-through entity for use in an activity that is passive to the owner, the result is interest income and some allocation of entity-level interest expense to the owner. Under the passive activity rules, the self-charged interest income is treated as portfolio income that cannot be offset by the related interest expense.

In response, the IRS developed the self-charged interest rules addressing this unfair result for lending transactions between a pass-through entity and its owners.

Application of the Self-charged Interest Rules

The following provisions apply to self-charged interest:

1. Taxpayers can recharacterize some or all of self-charged interest income as passive (rather than portfolio) income. This allows interest income to be offset by the taxpayer's passive activity deductions caused by the related interest expense. These rules apply only when passive deductions are generated by the interest expense, which occurs when loan proceeds are expended for use in a passive activity.

2. The self-charged interest rules apply to owner/entity loans when the taxpayer owns any direct or indirect interest in the pass-through entity. The rules also apply to loans between pass-through entities if each owner of the borrowing entity has the same proportionate ownership interest in the lending entity. Interest income from the lending entity is recharacterized as passive if the borrowing entity uses the funds in a passive activity. Under the recharacterization rules, a pass-through entity means a partnership or S corporation. An indirect interest is ownership through one or more partnerships or S corporations.

3. For loans made to a pass-through entity by its owners, the *applicable percentage* (defined below) of the owner's self-charged interest income and passed-through interest expense are treated as passive items from the activity.

4. Interest includes guaranteed payments for the use of capital. It also apparently includes foregone interest under the Section 7872 below-market loan rules, original issue discount described in IRC Sec. 1273, and unstated interest under IRC Sec. 483(b).

To calculate the applicable percentage, the following formula is used for owner loans to pass-through entities. The owner's self-charged interest income from the loan to the entity is multiplied by that owner's passed-through share of the entity's passive interest expense deductions from all owner loans (including loans by other owners) and divided by the greater of (1) that owner's passed-through share of interest expense deductions from all owner loans used for passive activities or otherwise, or (2) that owner's self-charged interest income. Algebraically, this rule can be expressed as follows:

$$A = B \times \frac{C}{\text{Greater of D or B}}$$

A = Owner's self-charged interest income that is recharacterized as passive
B = Owner's self-charged interest income
C = Owner's passed-through share of entity's passive interest expense from all owner loans
D = Owner's passed-through share of entity's interest expense (passive or otherwise) from all owner loans

Under this rule, if all owner loans are used in passive activities, and the loans are made in the same ratio as the entity's interest expense is allocated, 100% of all the owners' self-charged interest income will be characterized as passive. If a particular owner loans "more than his share," less than 100% of his self-charged interest income will be recharacterized as passive. If a particular owner loans "less than his share," 100% of his self-charged interest income will be recharacterized as passive.

Example 1I-1 Recharacterizing interest income when owner loans are not prorata.

Alan and Phil are equal partners in Westside Partnership. Westside is engaged in passive activities. Alan lends the partnership $10,000 and receives $1,000 in self-charged interest income on the loan. Phil lends the partnership $20,000 and receives $2,000 in self-charged interest income on the loan. Thus, Alan loans less than his share while Phil loans more than his share. Alan and Phil are each allocated $1,500 of Westside's interest expense for the year (as shown on their Schedules K-1).

Using the formula previously described, Alan treats 100% ($1,000) of his interest income as passive activity income. The $1,000 represents his interest income ($1,000) multiplied by his passed-through share of passive

interest expense from all owner loans ($1,500) divided by the greater of (1) his passed-through share of Westside's interest expense from all owner loans used for passive activities or otherwise ($1,500), or (2) his self-charged interest income ($1,000).

Phil will treat 75% ($1,500) of his interest income as passive activity income. The $1,500 represents his interest income ($2,000) multiplied by his passed-through share of Westside's passive interest expense from all owner loans ($1,500) divided by the greater of (1) his passed-through share of Westside's interest expense from all owner loans used for passive activities or otherwise ($1,500), or (2) his self-charged interest income ($2,000).

In some cases, taxpayers subject to the self-charged interest rules will recharacterize interest expense as a passive item when the interest would otherwise be investment interest expense. This occurs when a taxpayer borrows money from a third party and lends it to a pass-through entity in which he has an ownership interest and that generates passive income or loss. The interest paid on the money borrowed from the third party may be recharacterized as passive (rather than investment interest expense).

Electing out of the Self-charged Interest Rules

Taxpayers can elect not to apply the self-charged rules. Electing out of the self-charged rules might be appropriate if the taxpayer has sufficient passive income but needs portfolio income to deduct investment interest expense. Electing out might also be beneficial if the taxpayer needs portfolio (nonbusiness) income to increase an NOL by deducting more nonbusiness deductions (which are limited to nonbusiness income). The election out is made at the *pass-through entity level* and, once made, applies to the current and all subsequent years. Revocation is allowed only with IRS consent.

Treatment of Other Self-charged Items

The potentially unfair tax results in self-charged transactions between pass-through entities and their owners can also be experienced in other transactions besides loans. In *Hillman*, the Tax Court allowed the taxpayer to apply the rationale for self-charged interest to self-charged management fees. However, the Fourth Circuit reversed that decision. The appellate court noted that IRC Sec. 469(l)(2) directs Treasury to issue regulations allowing self-charged income items to be treated as passive income "as may be necessary or appropriate." The court did not believe that language *required* Treasury to issue any regulations. Thus, it found that only items specifically addressed in regulations (i.e., self-charged interest) could be recharacterized as passive income to allow deduction of any self-charged passive interest expense.

Despite the directive to issue regulations, final regulations issued in 2002 specifically apply the recharacterization rules only to lending transactions. Moreover, after the appellate court decided that the self-charged rules could not be applied to other transactions without regulations saying so, the *Hillman* case was remanded to Tax Court for an opinion on the taxpayer's alternate argument, which was that the management fees paid by the entity to the owner were incurred in a trade or business separate from entity's rental activities and thus not passive activity losses. The court rejected that reasoning. Thus, it appears that there is no basis for applying the self-charged recharacterization rules to transactions other than loans.

When Former Passive Activities Become Nonpassive

Because the passive loss rules are applied on a year-by-year basis, activities treated as passive in one tax year may be nonpassive in another if the taxpayer's level of participation changes. To accommodate these situations, IRC Sec. 469 includes special rules that apply when an activity with suspended passive losses (because it was a passive activity in a prior year) is not a passive activity in the current year. The Code uses the term *former passive activity* to describe these activities.

General Impact of Former Passive Activities

Suspended losses from a former passive activity are carried forward and deducted first to the extent the taxpayer recognizes income from the same activity. Any remaining suspended passive losses continue to be treated as

passive losses. This means they can be used to offset unrelated passive activity income in the same manner as any other suspended passive losses. The suspended losses are also eligible for the special $25,000 rental realty allowance that applies if the taxpayer meets the requirements described. Otherwise, the suspended losses can only be used when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction.

Real Estate Professionals

As discussed earlier, certain real estate professionals can treat rental real estate losses as nonpassive. Despite this provision, these individuals may have suspended passive losses allocable to their rental real estate activities because of either of the following situations: (1) the special real estate professional rules did not exist for tax years before 1995, so there may be carryforward losses from pre-1995 tax years, or (2) qualifying as a real estate professional is a year-by-year test, so if an individual fails to qualify for any tax year rental real estate losses for that year may be suspended under the PAL rules.

Example 1J-1 Suspended losses from a former passive activity.

Alice is a real estate broker who first qualifies as a real estate professional in 2010. She owns an interest in Axon Apartments, a rental real estate general partnership. Before 2010, Alice had to treat her partnership interest as a passive activity. Her suspended loss carryover to 2010 is $5,000 and is treated as from a former passive activity. Her 2010 Schedule K-1 from Axon reports net rental real estate income of $6,000. She materially participates in Axon's rental activity so the income is nonpassive due to her real estate professional status.

Under the former passive activity rules, Alice can deduct the carryover passive loss to the extent of current-year income from the activity, even though the income is nonpassive. Thus, the entire $5,000 loss carryover is deducted on her 2010 return against the $6,000 of Schedule K-1 income. Form 8582 reporting for this activity is not required for 2010 because the net income of $6,000 exceeds the carryover loss of $5,000. Instead, Alice reports both the $6,000 of income and the $5,000 loss in Part II of Schedule E.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Rental activities are generally deemed passive activities automatically, regardless of whether the taxpayer materially participates. Which of the following is an exception to this rule?

    a. If the average period of customer use or rental is seven days or less.

    b. If property is leased to a corporation in which the property owner has no ownership interest.

    c. If the rental is a long term rental to an individuals.

    d. The property is available during certain hours exclusively for members.

17. Why is it typically difficult for taxpayers to demonstrate active participation in a net lease property?

    a. Because in a net lease the property owner can hire out the maintenance expenses and is not required to spend time maintaining the property.

    b. Because such an arrangement transfers the operating expenses from the owner to the tenant.

18. Residential real property that a taxpayer both uses personally and rents falls into one of three categories for tax purposes: (1) personal residence, (2) vacation home, or (3) rental property with some personal use. Which of the three categories listed below may the property be subject to PAL rules?

    a. The personal residence of a taxpayer in Aspen, Colorado.

    b. The vacation home of a taxpayer in Maine that the taxpayer lives in 4 months of the year, but does not rent.

    c. A ski lodge is frequently rented and used by the taxpayer less than 7 days a year. The property is rented the rest of the year.

    d. A lakeside cabin rented occasionally by the taxpayer, but used 50% of the time for personal or family usage.

19. How are gains and losses treated when a property is rented incidental to a development activity if the renter is the developer and it is rented for less than 12 months?

    a. Gains are recharacterized to business income.

    b. Gains are characterized as passive income.

    c. Losses are recharacterized as business losses.

20. Which of the following is true for net income from a rental property if less than 30% of the unadjusted basis of the property is depreciable?

    a. If the rented property is a rental exception, the income is subject to recharacterization rules.

    b. The income is considered portfolio income and cannot take advantage of PAL rules.

    c. If this rental property generates a loss, the loss is characterized as a portfolio loss.

    d. If the rental property is sold, the gain would not be considered portfolio income to the taxpayer.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Rental activities are generally deemed passive activities automatically, regardless of whether the taxpayer materially participates. Which of the following is an exception to this rule? **(Page 28)**

    a. If the average period of customer use or rental is seven days or less. [This answer is correct. According to Temp. Reg. 1.4691T(e)(3)(ii), if the average period of customer use of the rental is seven days or less (i.e., a vacation condo or motel), the activity is not categorized as a rental activity for PAL purposes.]

    b. If property is leased to a corporation in which the property owner has no ownership interest. [This answer is incorrect. The organizational structure of the lessee or renter does not determine if the activity is passive according to Temp. Reg. 1.469-1T(e)(3)(ii), however an ownership interest can.]

    c. If the rental is a long term rental to an individuals. [This answer is incorrect. There is no exception detailed in Temp. Reg. 1-469-1T-(e)(3)(ii) for PAL purposes for long term rentals to individuals.]

    d. The property is available during certain hours exclusively for members. [This answer is incorrect. As stated in Temp. Reg. 1.469-1T(e)(3)(ii), an exception whereby a property is not categorized as a rental activity for PAL purposes is if the taxpayer customarily make the property available during defined hours for nonexclusive use by various customers (i.e., a golf course). By making the property exclusive, this exception no longer applies.]

17. Why is it typically difficult for taxpayers to demonstrate active participation in a net lease property? **(Page 28)**

    a. Because in a net lease the property owner can hire out the maintenance expenses and is not required to spend time maintaining the property. [This answer is incorrect. In a net lease agreement, the tenant is responsible for all the maintenance, which the tenant can do himself or hire out. It does not require the owner to perform any maintenance, but this is not the main reason that a taxpayer would have a difficult time demonstrating active participation in the activity.]

    b. Because such an arrangement transfers the operating expenses from the owner to the tenant. [This answer is correct. Typically, it will be difficult for taxpayers to demonstrate active participation in a net lease property, since such an arrangement transfers the operating expenses (and thus any related work) from the owner to the tenant. The owner's only obligation is usually to pay the interest and taxes on the property.]

18. Residential real property that a taxpayer both uses personally and rents falls into one of three categories for tax purposes: (1) personal residence, (2) vacation home, or (3) rental property with some personal use. Which of the three categories listed below may the property be subject to PAL rules? **(Page 28)**

    a. The personal residence of a taxpayer in Aspen, Colorado. [This answer is incorrect. Under IRC Sec. 469(j)(10), the passive activity loss (PAL) rules do not apply to a taxpayer's personal residence.]

    b. The vacation home of a taxpayer in Maine that the taxpayer lives in 4 months of the year, but does not rent. [This answer is incorrect. Under IRC Sec. 469(j)(10), the passive activity loss (PAL) rules do not apply to any rental activity that involves the taxpayer's residence and is subject to the Section 280A loss limitation rules (i.e., vacation home).]

    c. A ski lodge is frequently rented and used by the taxpayer less than 7 days a year. The property is rented the rest of the year. [This answer is correct. The only rental property with owner use that are subject to the PAL rules are rental property with some personal use. These properties are rented during the year, and have personal usage by the owner (or attributed to the owner) that does not exceed the greater of 14 days or 10% of rental days.]

d. A lakeside cabin rented occasionally by the taxpayer, but used 50% of the time for personal or family usage. [This answer is incorrect. If a property is rented during the year, and has person usage by the owner that exceeds the rental days, the passive activity loss rules do not apply.]

19. How are gains and losses treated when a property is rented incidental to a development activity if the renter is the developer and it is rented for less than 12 months? (Page **32)**

a. Gains are recharacterized to business income. [This answer is correct. Rental of property by a developer for less than 12 months from property rented incidental to a development activity should be recharacterized from passive income to business income for purposes of the passive activity loss rules as referenced in Reg. 1.469-2(f)(5).]

b. Gains are characterized as passive income. [This answer is incorrect. As stated in Reg. 1.469-2(f)(5), a recharacterization rules applies to income from property rented incidental to a development activity for the purposes of the passive activity loss rules.]

c. Losses are recharacterized as business losses. [This answer is incorrect. Losses are not affected by the recharacterization rule if the the income from property rented incidental to a development activity is rented by a developer for less than 12 months according to Reg. 1.469-2(f)(5).]

20. Which of the following is true for net income from a rental property if less than 30% of the unadjusted basis of the property is depreciable? **(Page 33)**

a. If the rented property is a rental exception, the income is subject to recharacterization rules. [This answer is incorrect. If one of the rental exceptions detailed in Temp. Reg. 1.469-1T(e)(3)(ii) applies, the activity is not subject to the recharacterization rules, but the passive and nonpassive nature of the activity depends on the taxpayer's participation.]

b. The income is considered portfolio income and cannot take advantage of PAL rules. [This answer is correct. According to Temp. Reg. 1.469-2T(f)(3), net income from rental property is not considered passive if less than 30% of the unadjusted basis of the property is depreciable. Instead, it is considered portfolio income. Since less than 30% of the unadjusted basis of the property is depreciable, the income cannot be offset with passive losses.]

c. If this rental property generates a loss, the loss is characterized as a portfolio loss. [This answer is incorrect. The rule of recharacterizing passive income into portfolio income applies only if net income occurs. If the rental activity produces a loss, it retains its passive character.]

d. If the rental property is sold, the gain would not be considered portfolio income to the taxpayer. [This answer is incorrect. If real property is subject to recharacterization to portfolio income in the year it is sold, then the gain from the disposal is also subject to recharacterization. For the recharacterization to apply, the activity must be treated as a rental activity under the Section 469 rules.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TDBTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. In which of the following situations would the taxpayer's income be considered nonpassive?

    a. Joe has a rental house that he rents to college students in the school year. This is his only rental property.

    b. Steven is a silent partner in an art studio. He contributed money to the start-up of the store, but does not share in the management of the facility.

    c. Leslie owns a popcorn store. She works at the store for more than 40 hours a week, 50 weeks a year.

    d. During the ski season, Tom and Sue rent out their house in Colorado close to the ski slopes and go and vacation in Florida for a month.

2. Taxpayers generally may use passive activity losses and deductions to offset income and gains from what type of income?

    a. Salary from the taxpayer's full-time job.

    b. Income from a business in which the taxpayer materially participates.

    c. The taxpayer's portfolio income.

    d. Income from a passive activity.

3. Why is it important to correctly identify passive activities?

    a. To find a business that requires little, if any, effort.

    b. To identify a business that will produce tax-free income.

    c. To determine if the capital gains rates will apple to the income.

    d. To be able to properly apply the passive loss rules to the income and losses from the business.

4. Which of the following statements best describes how a taxpayer can determine whether a group of activities can be treated as a single activity unit for measuring gain or loss and, therefore, be treated as a single activity?

    a. Depends on facts and circumstances. The taxpayer can use any reasonable method to determine whether one or more trade or business activities constitute an appropriate economic unit.

    b. Depends only on ownership and location of business. The taxpayer must own more than a 50% interest in each activity and they must be operated from the same location.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

5. Once activities have been grouped together, the taxpayer cannot change the grouping in subsequent tax years except in certain circumstances. Which of the following circumstances can be used by a taxpayer to change a grouping of passive activities?

   a. Changing the grouping would allow the tax payer to better utilize the passive income of one of the activities.

   b. Changing the grouping would allow the tax payer to offset otherwise passive loss against nonpassive income.

   c. When a material change in the facts and circumstances make the original grouping clearly inappropriate.

   d. If they reflect appropriate economic units, but do not benefit the taxpayer with their grouping.

6. Which of the following determines if an activity is determined to be passive or nonpassive?

   a. The taxpayer's ownership percentage.

   b. The taxpayer's participation the two prior years.

   c. The taxpayer's participation in the prior year.

   d. The taxpayer's material participation.

7. Lucy owns a seasonal pie business with her sister, Leta. Lucy works 125 hours in the holiday season Leta works 90 hours and two helpers work 70 hours each. It is determined that Lucy is a material participant in the pie business. Which of the following tests does she meet?

   a. Substantially all participation test.

   b. Significant participation activity test.

   c. More than 100 hours test.

   d. Personal service activity test.

8. Jane Brown owns a 50% interest in a scrapbooking store. She materially participates in the activity which will show a substantial income for the current year. Jane's husband Bob would like to utilize 50% of Jane's income to offset some passive losses he is expecting in their personal finances. Which of the following statements is correct?

   a. Bob can use 50% of Jane's income which would be passive to him since he did not materially participate in the activity.

   b. Bob can't use any of Jane's income as passive, since he is considered to materially participate in the scrapbooking business, too.

   c. If Bob files a separate return from Jane, he can claim 50% of her income since he did not materially participate in the activity. The income would be considered passive and available to off set his passive losses.

   d. Do not select this answer choice.

9. Wayne is a full-time software developer, but he also owns an interest in two partnerships engaged in a consulting business. Wayne significantly participates in both, performing more than 100 hours during the year in each, but he does not participate in either for more than 500 hours. His partners participate to a greater extent than he does. During 2010, he participated 150 hours in Partnership A and 450 hours in Partnership B. Which of the following statements is true?

    a. If Partnership A and B can be properly grouped together Wayne would be a material participant in B but not in A.

    b. If Partnership A and B can be properly grouped together Wayne would be a material participant in A but not in B.

    c. If Partnership A and B can be properly grouped together Wayne would be a material participant in neither A nor B.

    d. If Partnership A and B can be properly grouped together Wayne would be a material participant in both A and B.

10. Any work done by an individual in an activity in which he owns an interest (when the work is done) generally is treated as participation, without regard to the capacity in which the individual does the work. Under this general rule, menial tasks as well as supervision and management duties qualify in determining whether an individual has met the material participation standards. Which of the following exceptions apply to this rule?

    a. The work of the company is completed by the owner's spouse in an effort to keep the owner from having material participation.

    b. The work is customarily done by the owner of a company and would be a breach in separation of duties if completed by someone else.

    c. The work performed includes work that personally benefits the owner of the company.

    d. The work is not usually done by the owner and the owner is trying to avoid material participation.

11. Passive losses in excess of passive income become suspended. Which of following statements is true?

    a. Suspended passive losses can be carried forward indefinitely to offset future passive activity income.

    b. Suspended passive losses (other than from a publicly traded partnership) can only be offset by future passive income from the activity that generated the passive activity losses.

    c. Suspended passive losses can only be carried forward for ten years, but can be used to offset any passive activity income.

    d. Suspended passive losses can be carried back three years and forward for five years, if the taxpayer so elects.

12. Why are rental real estate activities with active participation separated from all other passive activities?

    a. To determine if the taxpayers can deduct up to $25,000 of passive losses against nonpassive income.

    b. To determine what portion of rental real estate losses can be carryforwarded to another tax year for the taxpayer.

    c. To determine what amount of passive loss can be offset against passive income since rental real estate income cannot be offset.

    d. To determine if the net suspended net passive losses carryforwarded from previous years generate any net passive income for the taxpayer.

13. A limited partner in three partnerships generate for 2010 passive losses of $2,000, $4,000, and $10,000, respectively. A fourth investment produces passive income of $10,000. Taxpayer has no passive loss carryovers to 2010. The taxpayer's form 8562 reports $10,000 of current year passive losses offsetting $10,000 of current passive income, leaving $6,000 of suspended losses. How are the suspended losses allocated to the various activities?

    a. Since there are 4 activities the suspended losses will be allocated 25% to each activity.

    b. Since there were on 3 activities that generated losses the losses will be allocated 33.33% to each of the activities that generated a part of the loss.

    c. The $6,000 suspended losses will be allocated to activity generating the largest loss for year.

    d. The suspended losses will be allocated to each activity based on each activity's loss as a proportion to the total loss.

14. Which of the following is a true regarding losses associated with a passive activity?

    a. Suspended passive losses are deductible in the year following the year the taxpayer disposes of his entire interest in a passive activity.

    b. Both current and suspended losses generated by a passive activity (as well as any loss on disposition) are fully deductible in the year disposition in a fully taxable transaction with an unrelated party.

    c. In the year of disposition of a passive activity, the suspended passive losses are allocated to all other passive activities of the taxpayer and carried forward until the taxpayer generated passive income to offset the losses.

    d. Only current losses generated by a passive activity are fully deductible in the year of disposition.

15. A partial disposition can be treated as a complete disposition if:

    a. Substantially all of the activity is disposed of and the carryover deductions and credits, and the current-year income, deductions, and credits allocable to that part of the activity can be established with relative certainty.

    b. The disposition is at least 42% of the total value of the activity and the taxpayer has kept a separate set of books for the activity.

    c. Substantially all of the activity is disposed of however the taxpayer cannot establish with reasonable certainty the carryover deductions and credits, and the current-year income, deductions, and credits allocable to that part of the activity.

    d. Do not select this answer choice.

16. Which of the following is an exception to the PAL rules in relation to rental activities?

    a. Rental real estate activities by a corporation.

    b. Rental real estate activities owned and materially participated in by real estate professionals.

    c. A rental real estate activity owned and operated by a minor.

    d. Do not select this answer choice.

17. Which of the following requirements must a taxpayer fulfill to be able to utilize the rental real estate exception for passive losses?

    a. A taxpayer actively participates in a rental real estate activity in which he owns a 5% interest. His AGI is less than $100,000 and he is single.

    b. The taxpayer actively participates in a rental real estate activity has an AGI greater than $150,000, owns a 20% interest and files a joint tax return with his spouse.

    c. The taxpayer actively participates in a rental real estate activity, has an AGI of less than $100,000, owns at least a 10% interest in the activity lives with his spouse but files a separate tax return.

    d. The taxpayer actively participates in a rental real estate activity, has an AGI of less than $100,000, owns at least a 10% interest in the activity, and files a joint tax return with his spouse.

18. In which of the following instances would the passive activity loss rules not apply?

    a. When the rental is a long term lease of more than 6 months.

    b. When the property is available for rent but not rented or used by the owner.

    c. When the average period of customer rental is less than seven weeks.

    d. When the average period of customer rental is seven days or less.

19. Which of the following is an eligibility requirement for a taxpayer to qualify as a real estate professional?

    a. They own at least 8 rentals and elect to be treated as a real estate professional as their profession on their tax return at the end of the year.

    b. They buy and sell real estate and perform more than 750 hours of service during the year in real property trades or businesses.

    c. They perform more than 500 hours of service during the tax year in real property trades or businesses in which the taxpayer materially performs.

    d. More than 50% of the personal services the taxpayer performs during the tax year are performed in the real property trades that the taxpayer materially participates.

20. Frank and Melanie are married and file a joint return in 2010. Frank is a real estate professional, working 800 hours in real estate trade and more than 50% of his time. Melanie has a job with a corporation that she works at 30 hours per week and sells real estate for 200 hours per year. Do both Frank and Melanie qualify for the special rule for reclassifying rental real estate income or loss as nonpassive?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

Lesson 2: Pass-through Entities

INTRODUCTION

Reporting an individual taxpayer's share of income, deductions, losses, and credits from pass-through entities is a complex area of tax law. Factors such as at-risk limitations, basis limitations, the passive loss rules, fiscal-year changes, and loan repayments must be considered in reporting Schedule K-1 items. Critical information is often disclosed as supplemental information to Schedule K-1 that requires additional examination by practitioners.

Certain partnerships whose interests are traded on a public market (publicly traded partnerships) may be treated as corporations for tax purposes, or can retain partnership status in certain instances. As partnerships, special rules apply for passive activity purposes.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify basis adjustments required by various pass-through items from a partnership.
- Recognize the at-risk loss limitations and carryforwards for partners and S corporation shareholders.
- Determine the S shareholder basis and the adjustments required by various S corporation pass-through items.
- Apply the reporting rules for unreimbursed expenses and the sale of ownership interests for partners and S corporation shareholders, determine how beneficiaries are tax on income from estates and trusts, and the rules governing partner guaranteed payments.

Limitations on Partner Basis and Loss

Tax practitioners must be able to identify the tax consequences of items and amounts reported to the individual partner on Schedule K-1 and track the partner's adjusted tax basis in the partnership. Tracking a partner's tax basis is important for many reasons, including the determination of (1) gain or loss if the partnership interest is sold or abandoned, (2) gain resulting from cash distributions exceeding basis, (3) basis in property received in partnership distributions or liquidation, and (4) limitations on recognizing losses passed through to a partner.

Adjustments to Partner's Tax Basis for Partnership Items

The analysis of the partner's capital account (item L of Schedule K-1) can be used in both interpreting income and deduction items on Schedule K-1 and in calculating changes to the partner's tax basis. Form 1065 instructions state that the partner's capital account (both on Form 1065, Schedule M-2, and each partner's Schedule K-1) should be prepared on the same basis as the partnership books and records. If a partnership maintains its books on the tax basis, the capital account reconciliation will be useful in verifying the tax impact of items reported on Schedule K-1 and in calculating the partner's basis adjustments. However, if the partnership maintains its books using GAAP or any other basis other than federal tax basis, the Schedule K-1 capital account reconciliation should not be used for tracking a partner's tax basis in his partnership interest.

Even when a partnership maintains its books on a tax basis, a partner's adjusted tax basis in his or her interest (sometimes called his or her outside basis) can differ from the partner's capital shown on the partnership books (sometimes called inside basis). This may occur when the partner purchases his or her interest from another partner since the purchase price becomes the initial outside basis. However, if the partnership makes a Section 754 election (i.e., to adjust the basis of partnership property for the sale or exchange of a partnership interest, or upon a partner's death), the partner's inside basis is adjusted to equal his or her outside basis. Inheriting a partnership interest from a deceased partner also may cause a partner's outside basis to differ from the inside basis. The basis of an inherited partnership interest equals the FMV of the partnership interest at the decedent's date-of-death (or the alternate valuation date, if applicable), reduced to the extent such value is attributable to items constituting income in respect of a decedent. For decedents that die in 2010, the modified carryover basis rules of IRC Sec. 1022 will apply.

Example 2A-1 Using capital accounts to monitor Schedule K-1 data.

Scott is a 5% limited partner in ABC Restaurant. His 2010 Schedule K-1 from ABC has the following entries:

Line	Description	Amount
1	Ordinary business income (loss)	$ 4,881
5	Interest income	1,216
10	Net Section 1231 gain (loss)	154
12	Section 179 deduction	500
13	Cash contributions (50%) (Code A)	194
13	Investment interest expense (Code H)	238
17	Post-1986 depreciation adjustment (Code A)	310
18	Tax-exempt interest income (Code A)	42
18	Nondeductible expenses (Code C)	110
20	Investment income (Code A)	1,216
20	Specially allocated depreciation (Code Y)	762

The capital account information reported to Scott on his Schedule K-1 (line L) is as follows:

Beginning capital account	$ 18,408
Capital contributed during the year	—
Current year increase (decrease)	4,489
Withdrawals & distributions	4,000
Ending capital account	18,897

Scott's share of book income (from Schedule K-1, item L) is reconciled as follows:

Line	Schedule K-1 Items	Amount
1	Ordinary business income	$ 4,881
5	Interest income	1,216
10	Net Section 1231 gain	154
12	Section 179 deduction	(500)
13	Cash contributions (50%)	(194)
13	Investment interest expense	(238)
18	Tax-exempt interest	42
18	Nondeductible expenses	(110)
20	Specially allocated depreciation	(762)
Partner's share of book income		$ 4,489

As a result of this analysis, the practitioner has confirmed that the $762 specially allocated depreciation is an additional deduction to be claimed. Scott's basis adjustments have been confirmed as an overall increase of $489 ($4,489 increase above, less $4,000 distribution). It is apparent that ABC's books are maintained on the tax basis, and the increase and decrease items reported to Scott in his Schedule K-1 capital account analysis also reflect his partnership basis adjustments [although this may not be true in other years if, for example, partnership capital contributions of appreciated or depreciated property are recorded considering precontribution gain or loss under IRC Sec. 704(c)].

Charitable Contributions of Appreciated Property. In Rev. Rul. 96-11, the IRS ruled that when a partnership makes a charitable contribution of appreciated property, a partner reduces his or her basis by the share of the property's adjusted basis, rather than FMV. (See later in this lesson for treatment of contributed property by an S corporation.) This ruling is favorable for taxpayers because it leaves a higher basis than would be available if basis were reduced by the property's FMV.

Example 2A-2 Partner's deduction and basis reduction for partnership's charitable contribution of appreciated property.

During 2010, a calendar-year partnership contributes appreciated securities with an FMV of $10,000 and a $5,000 adjusted basis to a local public hospital. The partnership cannot deduct the contributions when computing its ordinary (i.e., nonseparately stated) income or loss, but instead reports the total contribution in the "Other Deductions" section of Schedule K, line 13. The two 50% partners' respective shares are reported on Schedule K-1, line 13 (Code A) by the partnership. Each partner then combines his $5,000 contribution passed through from the partnership with any other eligible contributions made during the year to compute his contribution deduction allowed on Form 1040. Each partner reduces his tax basis by $2,500 for the respective share of the asset's adjusted basis (50% × $5,000).

The IRS has also ruled that a partner's basis in his interest must be reduced (or increased), but not below zero, by losses (or gains) disallowed (i.e., not recognized) on certain related party sales (Rev. Rul. 96-10). Reducing a partner's basis preserves the intended detriment of disallowing losses from sales or exchanges between partnerships and related persons. If a partner's basis was not reduced by the disallowed loss, he could subsequently recognize the loss (or reduced gain), for example, when he disposes of his interest. [The same concept applies to unrecognized gains; the partner could subsequently recognize the gain (or reduced loss).]

Example 2A-3 Losses disallowed on related party sales reduce partnership basis.

Jane owns a 75% capital and profits interest in both the Zoe partnership, which invests in speculative real estate, and the Moe partnership, which develops commercial real estate. Zoe realizes a $20,000 loss on the sale of property to Moe; the loss is not deductible in computing taxable income because Jane owns more than 50% of the profits interest in both Zoe and Moe.

Even though the loss is disallowed, Jane must reduce her basis in Zoe by her $15,000 share of the $20,000 loss. The disallowed loss will be reflected on Schedule M-1 of Zoe's partnership return and reported to Jane on either line 18 (Code C) or line 20 (Code Y) of Schedule K-1.

Partner Distributions

A partner generally must report capital gain to the extent a distribution of money or marketable securities (valued at FMV on date of distribution) exceeds his or her basis immediately before the distribution. For this purpose, distributions are treated as made on the last day of the tax year if they are advances or draws against the partner's distributive share of partnership income. (A true draw or advance requires the partner to repay any amount in excess of current year income.) Similarly, Rev. Rul. 94-4 provides that a deemed distribution resulting from a partner's reduced share of partnership liabilities is treated as an advance or draw and accounted for on the last day of the tax year. Current distributions (i.e., distributions other than liquidating distributions) that are not draws or advances are measured against the partner's basis at the time of the distribution.

Thus, a partner increases his or her basis by the allocable share of partnership income, increases in partnership liabilities, and contributions *before* accounting for distributions received during the year. Conversely, a partner with an allocable loss from a partnership must reduce basis for distributions before considering allocable loss items. The ordering of these adjustments is important because basis increases may shelter distributions from taxation, and basis reductions attributable to distributions can limit a partner's ability to deduct partnership losses.

Limitations on Losses Passed through to Partner

When a partnership passes a loss through to a partner, it is the partner's, not the partnership's, responsibility to determine the amount of deductible loss. The amount of otherwise deductible loss must be considered in view of three possible limitations: (1) basis, (2) at-risk, and (3) passive loss. The sequence is important because a loss disallowed by one of the limitations is not eligible for deduction under a subsequent limitation. However, when a loss is allowed under one of the limitations, it reduces basis for that purpose even if disallowed by a subsequent limitation. For example, a loss allowed under the basis and at-risk limitations but disallowed under the passive loss limitation reduces the taxpayer's outside basis and at-risk amounts. When interpreting a partnership Schedule K-1, the practitioner must be aware of several factors that determine whether these limitations apply at the partner level.

Effect of Domestic Production Activities Deduction (DPAD) on Partner's Basis in Partnership Interest

A partner can claim the DPAD based on his or her share of the partnership's qualified production activities income and Form W-2 wages. The DPAD is claimed at the partner level rather than at the partnership level. The deduction has no impact on the partner's basis in his or her partnership interest.

If the partner's losses and deductions are limited—for example, due to insufficient basis in the partnership interest, insufficient at-risk basis, or the passive loss rules—the partner's share of expenses and W-2 wages that would otherwise be taken into account in calculating his or her DPAD for the year are proportionately reduced and deferred. Such deferred expenses are not taken into account for DPAD purposes until the limitation no longer applies (i.e., when the expenses become deductible at the partner level in a future year). However, deferred expenses from tax years beginning before January 1, 2005, are never taken into account for purposes of calculating the partner's DPAD, because such expenses predate the effective date of the DPAD.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. When a partnership makes a charitable contribution of appreciated property, how is a partner's basis adjusted?

    a. A partner reduces his or her basis by the share of the property's adjusted basis.

    b. A partner reduces his or her basis by his or her share of the property's FMV.

    c. A partner does not reduce his basis in this type of transaction.

22. When is a partner's distribution to be treated as have been made in the tax year when the capital gain exceeds his or her basis immediately before the distribution and it is an advance or draw against the partner's distributive share of partnership income?

    a. The actual date of the distribution.

    b. The last day of the tax year.

    c. Before the tax return is submitted for the tax year.

    d. The first day of the month following the distribution.

23. When a partnership passes a loss through to a partner, who is responsible for determining the deductible amount of loss?

    a. The Internal Revenue Service.

    b. The partner.

    c. The partnership.

24. A partner can claim the Domestic Production Activities Deduction (DPAD) based on his or her share of the partnership's Form W-2 wages and qualified production activities income. If the partner's losses and deductions are limited due to the basis limitation or the at-risk limitation, which of the following statements best describes the impact of the limitations on the partner's DPAD calculation?

    a. The partner's share of expenses and W-2 wages cannot be used at all in the partner's calculation of his or her DPAD for the year.

    b. The partner's share of expenses and W-2 wages must be proportionately reduced and deferred, based on the amount of the limitation.

    c. The partner's expenses incurred prior to January 1, 2005 can be used in the DPAD calculation regardless of limitations.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. When a partnership makes a charitable contribution of appreciated property, how is a partner's basis adjusted? **(Page 49)**

    a. A partner reduces his or her basis by the share of the property's adjusted basis. [This answer is correct. According to Rev. Rul. 96-11, the IRS ruled that when a partnership makes a charitable contribution of appreciated property, a partner reduces his or her basis by the shares of the property's adjusted basis. This provides the partner with a benefit since it leaves a higher basis.]

    b. A partner reduces his or her basis by his or her share of the property's FMV. [This answer is incorrect. As indicated in Rev. Rul. 96-11, the IRS has ruled that the partner's basis is to be reduced by a lesser amount than the property's FMV.]

    c. A partner does not reduce his basis in this type of transaction. [This answer is incorrect. A partner must adjust his basis in this type of transaction as detailed in Rev. Rul. 96-11.]

22. When is a partner's distribution to be treated as have been made in the tax year when the capital gain exceeds his or her basis immediately before the distribution and it is an advance or draw against the partner's distributive share of partnership income? **(Page 49)**

    a. The actual date of the distribution. [This answer is incorrect. According to Reg. 1.731-1(a)(1)(ii), this is not the appropriate date for the partner's distribution to be recorded.]

    b. The last day of the tax year. [This answer is correct. A partner generally must report capital gain to the extent a distribution of money or marketable securities exceeds his or her basis immediately before the distribution. For this purpose, Reg. 1.731-1(a)(1)(ii) stated distributions are treated as made on the last day of the tax year if they are advances or draws against the partner's distributed share of partnership income.]

    c. Before the tax return is submitted for the tax year. [This answer is incorrect. Most partnership distributions are recorded as occurring on a special day of the tax year, but as detailed in Reg. 1.731-1(a)(1)(ii), this is not the appropriate measurement date for this type of partnership distribution.]

    d. The first day of the month following the distribution. [This answer is incorrect. As explained in Reg. 1.731-1(a)(1)(ii), this is not the appropriate application date of this partnership distribution.]

23. When a partnership passes a loss through to a partner, who is responsible to determining the deductible amount of loss? **(Page 49)**

    a. The Internal Revenue Service. [This answer is incorrect. The IRS is not responsible to determine the deductible amount of the loss for the partner. However if the loss is not properly reported the IRS may challenge the determination.]

    b. The partner. [This answer is correct. When a partnership passes a loss through to a partner, it is the partner's responsibility to determine the amount of deductible loss according to the IRS.]

    c. The partnership. [This answer is incorrect. It is not the partnership's responsibility to determine a the partner's loss, as certain limits are applied at the partner level.]

24. A partner can claim the Domestic Production Activities Deduction (DPAD) based on his or her share of the partnership's Form W-2 wages and qualified production activities income. If the partner's losses and deductions are limited due to the basis limitation or the at-risk limitation, which of the following statements best describes the impact of the limitations on the partner's DPAD calculation? **(Page 49)**

    a. The partner's share of expenses and W-2 wages cannot be used at all in the partner's calculation of his or her DPAD for the year. [This answer is incorrect. As detailed in Reg. 1.199-9(b)(2), the partner may be allowed to use some of the losses and wages in the calculation.]

    b. The partner's share of expenses and W-2 wages must be proportionately reduced and deferred, based on the amount of the limitation. [This answer is correct. The partner's share of the items needed to calculate the DPAD must be reduced or deferred proportionately to the limitations according to Reg. 1.199-9(b)(2).]

    c. The partner's expenses incurred prior to January 1, 2005 can be used in the DPAD calculation regardless of limitations. [This answer is incorrect. Expenses from tax years beginning before January 1, 2005 predate the effective date of the DPAD and are never taken into account for purposes of calculating the partner's DPAD as explained in Reg. 1.199-9(b)(2).]

The Rules of At-risk Limitations and Carryforwards

General Rules

The at-risk rules of IRC Sec. 465 limit the deduction for losses generated by business and investment activities to the amount the taxpayer is *at risk* with respect to that activity. These rules apply at the individual taxpayer level, whether the at-risk activity is held directly (i.e., Schedule C or F) or via an interest in a pass-through entity such as a partnership or S corporation. The effect of the at-risk limitation is to limit the deductible loss from an at-risk activity; it has no effect if the activity is profitable. The at-risk rules apply to all activities, other than the holding of real estate placed in service before 1987. (However, an exception, discussed later, allows a taxpayer holding realty beginning after 1986 to be considered at risk for qualified nonrecourse financing.)

Amounts Considered at Risk

An individual is considered at risk in an activity to the extent of the following:

1. cash contributed to the activity;

2. the adjusted basis of other property contributed;

3. amounts borrowed for use in the activity if the individual is personally liable for repayment of the debt; and

4. amounts borrowed for use in the activity, to the extent of the FMV of the individual's property pledged as security (other than property used in the activity).

For borrowed amounts, one difficult issue involves contingent or deferred obligations. Clearly, the guarantee by a partner of partnership debt does not provide at-risk basis unless the partner is required to actually make payments to the creditor. But, the extent to which contingent liabilities and deferred obligations provide at-risk basis is less certain. If the taxpayer is liable for repayment based only on the occurrence of a contingency, he will be considered at risk if the contingency is considered likely, or if the protection against loss does not cover all likely possibilities.

Certain types of investments in or loans to an activity may not qualify (in whole or part) as at-risk amounts. An individual may be subject to the at-risk limitations if a loss is incurred (either directly or via a partnership or S corporation) in a business or production-of-income activity in which an investment was made in any of the following forms:

1. Nonrecourse loans (either within or to acquire an interest in the activity) that are not secured by the taxpayer's own property (property not used in the activity).

2. Amounts contributed to or used in the activity that are protected against loss by guarantee, stop-loss agreement, or similar arrangement.

3. Amounts borrowed, whether recourse or nonrecourse, for use in, or contribution to, the activity from a person who has an interest in the capital or profits of the activity (other than as a creditor) or who is related to a person (other than the taxpayer) who has such an interest in the activity.

Qualified Nonrecourse Financing

Although nonrecourse loans secured by property used in the activity generally are not considered for at-risk purposes, a special exception applies for realty. A taxpayer holding real property is considered at risk for his share of qualified nonrecourse financing secured by real property used in the activity . The debt must be secured only by the real property; however, property incidental to the activity and other property if less than 10% of the FMV of all property securing the debt are disregarded. *Qualified nonrecourse financing* is any financing that is:

1. borrowed for the holding of real property;

2. borrowed from or guaranteed by a federal, state, or local governmental entity, or borrowed from a person or entity regularly engaged in the business of lending money (e.g., a bank or savings and loan), other than

a person related to the taxpayer, a person or entity from which the taxpayer acquired the property, a person who receives a fee from the taxpayer's investment, or someone related to any such person;

3. debt for which, except as provided in regulations, no one is personally liable for repayment; and

4. not convertible to equity.

Limited Partners

Limited partners often encounter an at-risk limitation because they are generally at risk only for their direct capital investment in the partnership. However, in some cases, the partnership agreement may require capital calls for additional funds from limited partners. This adds to their at-risk basis, but not until the additional capital contributions are actually made. Limited partners may also have guaranteed nonrecourse partnership debts, which also may generate at-risk basis. While guarantees alone generally do not provide at-risk basis, a limited partner who guarantees a partnership nonrecourse note may be able to generate at-risk basis if he or she establishes ultimate economic responsibility for the debt (the limited partner has no right of action against the general partner if required to perform on the guarantee, and the debt is nonrecourse to the extent the general partner is not liable).

Computing At-risk Amount

Form 6198 (At-Risk Limitations) is required for any year an individual's at-risk activity (whether conducted as a sole proprietorship or through a pass-through entity) incurs a loss if the activity includes invested or borrowed funds excluded for at-risk purposes (e.g., nonrecourse financing). If the activity is also subject to the passive loss rules, Form 6198 is completed first, and any allowable loss is carried to Form 8582 (Passive Activity Loss Limitations).

Example 2B-1 Borrowing from a party with an interest in the activity.

Jane and Jill operate a retail sales activity as a partnership. They initially purchase inventory for $5,000 using their own capital. They also borrow $15,000 from their sponsor in this activity, through whom they purchase additional inventory. Jane and Jill are each personally liable on the note. The sponsor/lender receives 8% interest on the note plus 5% of net profit in the activity. If Jane and Jill incur a $6,000 loss, how much of it are they allowed to deduct under the at-risk rules?

Generally, amounts borrowed from a person who has an interest in the profits of the activity are not considered at risk, even if the debt is a recourse liability. Accordingly, Jane and Jill are at risk only for the $5,000 of their own capital. The $15,000 loan is not at risk because of the lender's interest in net profits. They may deduct $5,000 for the current year, in proportion to their partnership interests; the $1,000 disallowed loss carries forward until they have additional at-risk basis.

Variation: If the lender received a percentage of gross receipts (rather than net profits), he or she would not be considered to have an interest in the profits or capital of the activity, and the debt would be considered fully at risk to Jane and Jill.

Example 2B-2 Determining amount at risk via Form 6198.

In 2009, Carl and his brother, Bud, formed a 50/50 partnership (the C&B Partnership) that acquired a small apartment building. Each contributed $5,000 cash, which C&B used as a down payment on the building. In addition, C&B took out a nonrecourse mortgage note for $150,000. This rental property was purchased from, and the mortgage note issued to, a savings and loan association that had acquired it on a foreclosure a year earlier. Because the lender is also the seller of the property, the note does not meet the special qualified nonrecourse financing exception to the at-risk rules. Carl and Bud were each allocated a $5,000 loss in 2009, which was fully deductible. (It did not exceed their at-risk limits and was deductible under the special $25,000 rental realty loss allowance under IRC Sec. 469.)

Each had $75,000 of adjusted basis in his partnership interest as of January 1, 2010 ($5,000 cash contribution plus $75,000 allocable share of partnership debt less $5,000 loss recognized in 2008).

In 2010, Carl and Bud each contributed $3,000 to the partnership. C&B, in turn, used $4,000 to pay down the principal on its debt and the remaining $2,000 for other expenses. For 2010, C&B incurred a loss of $14,000, of which Carl and Bud were each allocated $7,000. Carl's allowable loss of $3,000 for 2010 is computed using Form 6198.

Form 6198, Part II, allows a simplified at-risk computation that refers to adjusted basis in the activity as of the beginning of the tax year. Part III contains a detailed computation of at-risk basis beginning with the acquisition of the activity or, if later, the date it became subject to the at-risk rules.

Here, Carl's at-risk amount is the same whether computed using Part II or III of Form 6198 (which is often the case for most partnership and S corporation investments). In other cases, however, using the detailed Part III computation results in a higher at-risk basis; therefore, the Part III computation should always be considered.

A loss disallowed by the at-risk rules is treated as a deduction allocable to the activity in the first succeeding year, and used against the following year's income from the same activity. If the carryover deduction creates a loss, it is deductible only to the extent of the at-risk amount. Unused losses may be carried forward indefinitely.

Recapture of Negative At-risk Amount

If an individual's at-risk amount in an activity decreases (e.g., recourse debt becomes nonrecourse), all or part of a previously allowed loss may have to be recaptured. If the amount at risk is reduced below zero, the taxpayer must recognize income to the extent of the negative at-risk amount. The recaptured income is offset by the creation of a suspended at-risk loss, equal to the amount of income recognized, that is carried forward to the next tax year. If the partner's amount at risk is subsequently increased, the suspended loss becomes deductible.

Example 2B-3 Recapture of negative amounts at risk.

John purchased commercial real estate in 2008 in partnership with two other individuals. John's investment in the partnership included $15,000 cash; his share of partnership liabilities is $100,000 of recourse debt. In 2008, he deducted a $25,000 loss that was fully at risk. In 2009, the debt was converted to nonrecourse debt that is *not* considered qualified nonrecourse financing. John must recapture $10,000 of the 2008 loss since his at-risk amount became a negative $10,000 ($15,000 at-risk amount − $25,000 loss claimed in 2008). In addition, any loss in 2009 will not be at risk and will be nondeductible.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Which of the following should be considered for an individual when determining the at risk in an activity?

    a. Amounts contributed to or used in the activity that are protected against loss by guarantee, stop-loss agreement, or similar arrangement.

    b. Any amount that the individual borrowed to use in the activity and is personally liable for the repayment of the debt.

    c. Nonrecourse loans that are not secured by the taxpayer's own property (property not used in the activity).

    d. Amounts borrowed from the majority interest holder of the partnership.

26. Why do limited partners often encounter an at-risk limitation?

    a. Because they are generally at risk only for their direct capital investment in the partnership.

    b. Because the partnership may flow through income to the partner.

    c. Because they have no right of action against the general partner.

27. Sue and Julie formed a partnership to operate a retail sales activity. Initially, they purchased inventory for $10,000 using their own capital. They also borrowed $15,000 from their sponsor in this activity, through whom they purchase additional inventory. Sue and Julie are each personally liable on the note. The sponsor/lender receives 8% interest on the note plus 5% of the activity's gross receipts. If Sue and Julie incur a $12,000 loss, how much of it are they allowed to deduct under the at-risk rules?

    a. The full $12,000 loss.

    b. $10,000 of the loss.

    c. None of the loss.

28. If an individual's at-risk amount in an activity decreases (e.g., recourse debt becomes nonrecourse), all or part of a previously allowed loss may have to be recaptured. How is the recapture amount determined?

    a. The taxpayer must recognize income to the extent of the negative at-risk amount if the amount at risk is reduced below zero.

    b. The taxpayer must recognize income equal to the amount of the decrease in the at-risk amount in the activity.

    c. If the amount at risk is reduced, the taxpayer may elect to disregard the decrease and recognize no income until the activity is sold.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Which of the following should be considered for an individual when determining the at risk in an activity? **(Page 56)**

    a. Amounts contributed to or used in the activity that are protected against loss by guarantee, stop-loss agreement, or similar arrangement. [This answer is incorrect. According to IRC Sec. 465(b), these are not considered when determining an individual's at risk in an activity.]

    b. Any amount that the individual borrowed to use in the activity and is personally liable for the repayment of the debt. [This answer is correct. An individual is considered at risk in an activity to the extent that any amount borrowed for use in the activity the individual is personally liable for the repayment of the debt as stated in IRC Sec. 465(b).]

    c. Nonrecourse loans that are not secured by the taxpayer's own property (property not used in the activity). [This answer is incorrect. Nonrecourse loans normally do not provide basis for the at-risk rules for an individual in an activity as detailed in IRC Sec. 465(b).]

    d. Amounts borrowed from the majority interest holder of the partnership. [This answer is incorrect. Any amounts borrowed from anyone with an ownership interest does not provide at-risk basis for the individual in an activity as explained in IRC Sec. 465(b).]

26. Why do limited partners often encounter an at-risk limitation? **(Page 56)**

    a. Because they are generally at risk only for their direct capital investment in the partnership. [This answer is correct. Limited partners are normally only at-risk for their direct capital investment in the partnership. However, in some cases, the partnership agreement may require capital calls for addition funds from limited partners. This adds to their at-risk basis, but not until the additional capital contributions are actually made as explained by Prop. Reg. 1.465-22.]

    b. Because the partnership may flow through income to the partner. [This answer is incorrect. The at-risk limit is reduced by losses rather than income, so this should not affect their at-risk limitation.]

    c. Because they have no right of action against the general partner. [This answer is incorrect. The at-risk determination is not determined on a partner's right of action against the general partner.]

27. Sue and Julie formed a partnership to operate a retail sales activity. Initially, they purchased inventory for $10,000 using their own capital. They also borrowed $15,000 from their sponsor in this activity, through whom they purchase additional inventory. Sue and Julie are each personally liable on the note. The sponsor/lender receives 8% interest on the note plus 5% of the activity's gross receipts. If Sue and Julie incur a $12,000 loss, how much of it are they allowed to deduct under the at-risk rules? **(Page 56)**

    a. The full $12,000 loss. [This answer is correct. If the lender received a percentage of gross receipts (rather than net profits), he or she would not be considered to have an interest in the profits or capital of the activity, and the debt would be considered fully at risk to Jane and Jill according to Reg. 1.465-8(b)(4).]

    b. $10,000 of the loss. [This answer is incorrect. Generally, amounts borrowed from a person who has an interest in the profits of an activity are not considered at risk, even if the debt is a recourse liability. Accordingly, Sue and Julie are at risk only for the $10,000 of their own capital. The $15,000 loan is not at risk because of the lender's interest in net profits.]

    c. None of the loss. [This answer is incorrect. As stated in Reg. 1.465-8(b)(4), the partners would have an amount that was considered at risk in the activity.]

28. If an individual's at risk amount in an activity decreases (e.g., recourse debt becomes nonrecourse), all or part of a previously allowed loss may have to be recaptured. How is the recapture amount determined? **(Page 56)**

    a. The taxpayer must recognize income to the extent of the negative at risk amount if the amount at risk is reduced below zero. [This answer is correct. If an individual's risk amount is reduced below zero, the individual must recognize income to the extent of the negative at risk amount as indicated by the IRS. The recaptured income is offset by the creation of a suspended at risk loss, equal to the amount of income recognized, this is carried forward to the next tax year.]

    b. The taxpayer must recognize income equal to the amount of the decrease in the at risk amount in the activity. [This answer is incorrect. The recapture amount is not determined by the actual reduction in the at risk amount. If the taxpayer's at risk amount is sufficient to absorb the reduction, the taxpayer would not recognize any income as determined by the IRS.]

    c. If the amount at risk is reduced, the taxpayer may elect to disregard the decrease and recognize no income until the activity is sold. [This answer is incorrect. The taxpayer must recognize the income in the year the at-risk amount is reduced below zero as stated by the IRS.]

S Shareholder and Loss Limitations Basis

The net income or loss from an S corporation passes through to the shareholder on Schedule K-1 and increases or decreases his basis accordingly. S corporation losses claimed by the shareholder cannot exceed the sum of the adjusted basis of (1) his stock and (2) any indebtedness the S corporation owes directly to him.

Computing Basis in Stock

A shareholder's basis in S corporation stock usually starts with the initial cost of acquiring the shares. Sometimes, original basis may be determined by other methods, such as:

1. Subject to certain stock ownership tests, the basis of stock issued at incorporation equals the adjusted basis of assets contributed by the shareholder plus any gain recognized on the transfer.

2. Basis of stock acquired by gift is generally the transferor's basis.

3. Basis of stock acquired by inheritance is generally the FMV of the shares at the date of death. For inherited stock received from decedents dying after August 20, 1996, basis must be reduced by the portion of FMV attributable to income in respect of the decedent. For decedents that die in 2010, the modified carryover basis rules of IRC Sec. 1022 will apply.

Stock basis is adjusted when, for example, the shareholder buys or sells stock in the corporation or contributes capital. Also, at each year-end, the shareholder's stock basis must be adjusted under IRC Sec. 1367, as follows:

1. Basis is increased by the shareholder's share of:

    a. nonseparately stated income;

    b. separately stated items of income, including tax-exempt income;

    c. excess of the shareholder's deduction for non-oil-and-gas depletion over the allocable basis in the property subject to depletion; and

    d. recapture of general business credits under IRC Sec. 50(a)(1) when such recapture has caused a corresponding increase to an asset's basis.

2. Basis is decreased by distributions that are not includable in the shareholder's income. Distributions from the corporation to the shareholder reduce stock basis but do not reduce debt basis. (Debt basis is reduced by corporate repayments of the shareholder debt rather than general distributions to shareholders.)

3. Basis is decreased by the shareholder's share of:

    a. nonseparately stated loss;

    b. separately stated items of deduction or loss;

    c. corporation expenses that are not deductible in computing taxable income and not properly chargeable to a capital account (e.g., the nondeductible portion of business meals);

    d. the amount of the shareholder's deduction for depletion for any oil and gas property to the extent such deduction does not exceed his proportionate share of the corporation's basis in the property; and

    e. the reduction in an asset's basis when the general business credit caused such a reduction under IRC Sec. 50(c)(1).

Adjustments are made to stock basis in the following order: (1) increased for income items and excess depletion; (2) decreased by distributions; (3) decreased for nondeductible, noncapital expenses and certain oil and gas

depletion deductions; and (4) decreased for items of loss and deduction [IRC Sec. 1367(a) and Reg. 1.1367-1(f)]. However, a shareholder may elect to reduce basis by items of loss or deduction before reducing basis by nondeductible, noncapital expenses and certain oil and gas depletion deductions. Once this election is made, the shareholder must continue to use these ordering rules in future taxable years unless the Commissioner consents to revocation.

The adjustments to stock basis are allocated to each share owned by the shareholder. When a shareholder has a different basis in different lots of stock, pass-through adjustments generally are allocated prorata to all shares.

Example 2C-1 Using Schedule K-1 data to determine S shareholder's stock basis.

Lyle operated LL Company as a sole proprietorship until January 1, 2010, when the business was incorporated as LL, Inc. LL immediately elected S corporation status. Lyle's beginning stock basis is $49,000. LL is the owner and beneficiary of an insurance policy on his life. LL distributes $75,000 to Lyle during the year. His 2010 Schedule K-1 from LL shows the following items:

Line	Description	Amount
1	Nonseparately stated ordinary income	$ 25,000
4	Interest income	4,000
2	Loss from rental real estate	(3,500)
8a	Net long-term capital gain	5,000
12	Charitable contributions (50%) (Code A)	(2,000)
11	Section 179 deduction	(10,000)
16	Tax-exempt interest income (Code A)	2,500
16	Interest expense on loan used to purchase tax-exempt bonds (Code C)	(900)
16	Nondeductible portion of meals and entertainment expense (Code C)	(5,000)
16	Life insurance premiums in excess of increase in cash-surrender value (Code C)	(2,500)

Lyle's basis in his LL stock is adjusted as follows:

Beginning basis		$ 49,000
Income items:		
Nonseparately stated income	25,000	
Interest income	4,000	
Net long-term capital gain	5,000	
Tax-exempt interest income	2,500	36,500
Stock basis before distributions		85,500
Distributions		(75,000)
Stock basis before items of loss and deduction		10,500
Nondeductible, noncapital expenses:		
Interest expense on loan used to purchase tax-exempt bonds	(900)	
Nondeductible portion of meals and entertainment expense	(5,000)	
Life insurance premiums in excess of increase in cash-surrender value	(2,500)	(8,400)
Subtotal		2,100
Loss and deduction items:		
Loss from rental real estate	(3,500)	
Charitable contributions	(2,000)	
Section 179 deduction	(10,000)	(15,500)
Ending stock basis (not less than zero)		$ -0-

Lyle has $13,400 ($2,100 subtotal less $15,500 of loss and deduction items) of his 2010 losses disallowed due to a basis limitation. The analysis shows that these disallowed losses consist of deductible items, which will

carryover to 2011. If Lyle elects, he can reduce basis by the deductible items before the nondeductible items, which, in this case, would be to his benefit because he could claim more deductible loss items in 2010. Suspended losses retain their character and are treated as incurred in the following tax year. The suspended loss is allocated prorata among the loss items.

Discharge of Indebtedness Income. IRC Sec. 108(d)(7)(A) specifically states that the cancellation of debt (COD) rules are applied at the S corporation level. Thus, when measuring insolvency, it is only necessary to determine the worth of the S corporation. The solvency of the underlying shareholders is not a concern. Income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. This provision generally applies to discharges of indebtedness made after October 11, 2001.

Example 2C-2 Debt discharge of an S corporation.

Zelda forms Zorro, Inc., an S corporation, by contributing $1,000 in exchange for 100% of the stock. Zorro then borrows $20,000 from a third party and ends up incurring this amount in net losses. Because Zelda only has $1,000 of basis in her stock, the pass-through losses from Zorro, Inc. in excess of $1,000 are suspended in Zelda's Form 1040, due to the lack of basis. If the debt is forgiven after October 11, 2001 (and is not part of a plan of reorganization filed with the bankruptcy court before October 12, 2001), the exempt debt relief income does not pass through to Zelda and her stock basis is not increased.

Charitable Contributions of Appreciated Property. In Rev. Rul. 96-11, the IRS ruled that when a partnership makes a charitable contribution of appreciated property, a partner reduces his or her basis by the property's adjusted basis rather than FMV. This ruling is favorable for taxpayers because it leaves a higher basis than would be available if basis were reduced by the property's FMV. It seems as though the rationale of the ruling should apply equally to partners and S corporation shareholders, but the IRS's position has been that an S corporation shareholder reduces basis in stock by the contributed property's FMV rather than its basis.

Example 2C-3 Shareholder's deduction and basis reduction for S corporation's charitable contribution of appreciated property.

Assume the same facts as in Example 2A-2 except the entity contributing the appreciated securities is an S corporation. The S corporation separately reports each shareholder's respective share of the contribution on Schedule K-1; line 12 (Codes A–F). The shareholders (again assuming the S corporation has two 50% shareholders) combine their separately stated charitable contribution with any other eligible contributions made during the year on Schedule A of Form 1040. The shareholders' stock basis amounts are reduced by $5,000 each for their respective shares of the FMV of the contributions (50% × $10,000).

Credits. Credits generally do not affect basis. However, any adjustment to the S corporation's basis of an asset when a credit is generated or recaptured results in a corresponding increase or decrease in a shareholder's basis.

Effect of Domestic Production Activities Deduction (DPAD) on Shareholder's Stock Basis

An S corporation shareholder can claim the DPAD based on his or her share of the S corporation's qualified production activities income and Form W-2 wage expenses. The DPAD is claimed at the shareholder level rather than at the S corporation level. The deduction has no impact on the shareholder's basis in his or her S corporation stock.

If the shareholder's losses and deductions are limited—for example, due to insufficient basis in the S corporation stock (discussed in this lesson), insufficient at-risk basis, or the passive loss rules—the shareholder's share of expenses and W-2 wages that would otherwise be taken into account in calculating his or her DPAD are proportionately reduced and deferred. Such deferred expenses are not taken into account for DPAD purposes until the limitation no longer applies (i.e., when the expenses become deductible at the shareholder level in a future year). However, deferred expenses from tax years beginning before January 1, 2005, are never taken into account for purposes of calculating the shareholder's DPAD because such expenses predate the effective date of the DPAD.

Establishing Debt Basis

An S corporation shareholder receives basis for debt that is owed directly to the shareholder by the corporation. A shareholder's guarantee of a loan made to the corporation by a third party does not provide basis. Also, an S corporation shareholder's basis does not include a participation interest in a third-party loan to his S corporation. While affirming the Tax Court, the Seventh Circuit held that in a loan participation, the lead lender is the only lender; a participant has a contractual relation only with the lead lender. Therefore, the taxpayer's participation interest in the bank loan to his S corporation was equivalent to a guaranty and did not create basis to allow him to deduct corporate losses.

More recently, the courts have focused on whether or not the taxpayer has an economic outlay when claiming a basis increase for guaranteeing a third-party loan. In *Maloof*, even though the taxpayer had pledged his stock in the S-corporation and personally guaranteed the third-party loan, the Tax Court denied any increase in basis. The taxpayer was only secondarily liable and did not have to make any payment on the loan. However, in *Gleason*, the Tax Court allowed an increase in basis when it affirmed the shareholder did have an economic outlay by being the primary obligor on a loan obtained from a third party, and subsequently loaned to the S corporation. All original loan documents listed the taxpayer as the only borrower, demonstrating in form and substance that the loan was from the shareholder to the corporation. In another case, pledged stock did not create any economic hardship to the taxpayer and therefore the taxpayer was not allowed to increase basis. Thus, practitioners should note increases in basis are rarely achieved if the taxpayer has not expended personal resources.

However, if a shareholder-guarantor does satisfy a debt of the corporation or gives a personal note to the lender in full satisfaction of the S corporation liability, additional basis is created.

Example 2C-4 Effect of shareholder's guarantee of third-party debt.

Will expects S Corp (of which he is the sole shareholder) to incur a substantial loss during the year. He currently has little basis remaining in his stock. One of the corporate bank notes has been guaranteed by Will. Can he use this note as additional basis?

For Will to use this loan as basis, he must satisfy the corporate indebtedness in his capacity as guarantor, either by his payment of the corporate debt or by the bank's acceptance of his personal note in satisfaction of the corporate note.

Example 2C-5 Doctrine of subrogation.

Assume the same facts as in Example 2C-4 except the bank issues a note in Will's name and substitutes it for S Corp's note. Here, debt basis will be generated equal to the amount of the substituted note. However, Will's personal note must be accepted in full satisfaction of S Corp's note before year-end and S Corp must be released from its obligation to repay the debt. In many states, substitution of the shareholder's note for the corporation's causes the corporation to be obligated to the shareholder for the note under the doctrine of subrogation. If the subrogation right occurs, the shareholder has basis in the debt.

Example 2C-6 Creating debt basis with borrowed funds.

Another possibility is for Will to borrow the money from the bank, loan it to S Corp, and have S Corp pay off its original note to the bank. The IRS has ruled that this transaction gives the shareholder debt basis if:

1. the shareholder is personally liable for the bank loan to the shareholder,

2. the corporation is not a guarantor or co-maker on the bank loan to the shareholder, and

3. the interest rate on the bank's loan to the shareholder is the bank's current rate.

If all conditions are met, Will has debt basis, even if his bank loan is secured by his stock in S Corp.

Careful planning is necessary when loans are repaid if the basis in the loans has previously been reduced by pass-through losses. Repayment of these loans is a taxable event to the extent a full repayment exceeds the

shareholder's basis in the debt, or to the extent partial repayments exceed a prorata portion of the debt basis. This is determined as of the corporation's year-end after considering net basis increases for current-year pass-through income (see "Restoring Basis" later in this lesson). Income so generated is a capital gain (long-term or short-term depending on how long the shareholder held the note) if the debt is evidenced by a note, or ordinary income if it resulted from an open account indebtedness.

Example 2C-7 Repayment of reduced-basis shareholder loans.

In 2008, Paul loaned Esscorp $60,000, evidenced by a note. A pass-through loss in 2009 reduced the basis of the loan by $15,000, bringing his debt basis to $45,000. Paul understands that a full repayment of the face amount of $60,000 would result in a capital gain of $15,000 ($60,000 payment − $45,000 basis). He is unsure of the effects of a partial repayment of $40,000.

Partial repayment of a shareholder loan that has been used as basis for loss deductions represents income to the shareholder. Here, such income, computed on a prorata basis, is $10,000, determined as follows:

$$\frac{\$60{,}000\ \text{(Face Amount)} - \$45{,}000\ \text{(Basis)}}{\$60{,}000\ \text{(Face Amount)}} \times \$40{,}000\ \text{(Repayment)} = \$10{,}000$$

Debt Basis and Open Account Debt

Open account debt is made up of shareholder advances that are not evidenced by a written instrument and repayments on those advances. In 2005, the Tax Court ruled that shareholder open account loans made late in the year could be netted with repayments on shareholder open account loans made earlier in the year, thus preventing the recognition of income as a result of the debt repayment. The Court determined that the earlier repayments were made on open account debt, and the earlier advances and repayments were not separate transactions (*Brooks*).

In 2008, the IRS issued regulations that effectively reverse the taxpayer-favorable Tax Court decision in *Brooks* by limiting open account debt treatment to shareholder advances of $25,000 or less. Effective for shareholder advances to an S corporation on or after October 20, 2008, open account loans to an S corporation by any shareholder are treated as separate written notes at the beginning of the year following the year in which the ending balance exceeds $25,000. The $25,000 threshold amount applies to each shareholder separately. When the balance of a shareholder's open account debt is $25,000 or less at the *beginning* of the year, advances and repayments are netted during the year, and the increase or decrease in the balance is measured by the difference in the open account balances at the beginning and end of the year.

If the balance of a specific shareholder's open account debt, net of advances and repayments, is more than $25,000 at the *close* of the S corporation's tax year, beginning with the next tax year, the principal amount of the open account debt is no longer considered open account debt. Rather, it is treated as if it were indebtedness evidenced by a separate written instrument for purposes of the debt basis rules. Once a debt is treated as being evidenced by a written instrument, netting of advances and repayments on that loan is no longer allowable. Repayments on the loan reduce the loan's face value and the shareholder's debt basis in the loan. Additional advances are considered to be new loans. If these advances are not evidenced by written instruments, they are additions to open account debt, and will be considered when determining whether the shareholder's $25,000 threshold has been reached.

Pre-1983 reductions in debt basis always result in gain when the loan is repaid. This is inevitable because corporate income increases debt basis only to the extent debt basis was reduced by losses or deductions in tax years beginning after 1982; pre-1983 reductions in debt basis can never be restored by corporate income.

Claiming Losses and Reporting Distributions

While a shareholder's basis in stock is important when the stock is disposed of or redeemed, a primary reason for tracking basis is to determine the extent the shareholder can claim pass-through losses as well as the proper treatment of distributions.

Example 2C-8 Effect of loss on stock and debt basis.

Ed is the sole shareholder in Edco, an S corporation formed on July 1, 2010. Ed originally contributed $10,000 to Edco (which becomes his stock basis), and loaned it $15,000 for start-up costs. During 2010 Edco incurred a $30,000 tax loss. Ed's deductible loss is computed as follows:

Basis in stock	$ 10,000
Loan to corporation	15,000
Total basis (maximum loss deduction)	25,000
2010 loss	(30,000)
Excess loss carryover to 2010	$ (5,000)

At the end of 2010, Ed has an excess loss carryover of $5,000 to 2011. The 2010 loss first reduced his stock basis to zero, and then reduced his debt basis to zero.

Example 2C-9 Effect of distributions on basis.

Assume the same facts as Example 2C-8 except that, during 2010, Edco incurred a $10,000 loss and distributed $15,000 to Ed. The following computation shows Ed's basis and taxable income:

	Stock Basis	Debt Basis	Total Basis
Basis in stock	$ 10,000	$ —	$ 10,000
Loan to corporation	—	15,000	15,000
Totals	10,000	15,000	25,000
2010 distributions	(15,000)	—	(15,000)
Distributions in excess of basis	5,000	—	5,000
Subtotal	—	15,000	15,000
2010 loss	—	(10,000)	(10,000)
Balance at end of year	$ -0-	$ 5,000	$ 5,000

The order of basis adjustments is important because current-year distributions reduce stock basis before current year losses are considered. After stock basis is reduced to zero, losses are applied against debt basis. The 2010 distributions exceed Ed's stock basis so the excess is treated as gain from the sale or exchange of property. Thus, Ed must recognize a short-term capital gain of $5,000. (The gain is short-term because he has held his stock for one year or less.) Because the distributions reduce his stock basis to zero, the $10,000 loss is applied against his debt basis.

Variation: Had the $15,000 been a repayment of the loan from Ed rather than a distribution, he would not have any income as a result of it. Instead, his year-end debt basis would have been reduced to zero, but his stock basis of $10,000 would have been available for claiming the $10,000 loss.

Losses that are currently nondeductible because of insufficient basis carry forward indefinitely. When sufficient stock or debt basis is generated through subsequent corporate profits, shareholder capital contributions, or shareholder loans to the corporation, the carryover losses become deductible. Suspended losses retain their character and are treated as incurred in the following tax year. Carryover losses are personal to the shareholder (i.e., they generally do not transfer with stock). In general, if the shareholder disposes of his stock, he forfeits the carryover losses, and they disappear.

Restoring Basis. When basis in stock or shareholder debt has been reduced by losses occurring in years after 1982, it will be subsequently restored if income is generated. Capital contributions do not restore or increase debt basis. Here, the ordering rules first restore basis in shareholder debt to the extent of prior basis reductions from post-1982 losses, and basis in stock is increased only after debt basis has been restored. If the S corporation passes through a combination of income, gain, losses, and deductions, debt basis is increased by any net amount that pass-through income and gains exceed losses, deductions, and nondividend distributions. In addition, if a debt is disposed of or repaid (either fully or partially) before the end of the corporation's tax year, any net income

restores the debt's basis immediately before the disposition of the debt or the first repayment during the corporation's tax year.

Example 2C-10 Restoration of basis with income.

Assume the same facts as in Example 2C-9. (Ed has zero basis in his stock and $5,000 basis in his debt as of the end of 2009.) If Edco passes through $12,000 of income to Ed for 2010, the basis in Ed's debt will first be increased by $10,000 to the original face amount of $15,000. The remaining $2,000 will then be added to Ed's stock basis. Once the debt basis has been restored with the income, payments on the debt can occur tax-free.

How to Correct Schedule K-1 Data with Form 8082 Disclosure

Generally, a taxpayer reports items in his or her personal return as reported on Schedule K-1 from a partnership, S corporation, estate or trust, or a Schedule Q from a real estate mortgage investment conduit (REMIC). Form 8082 [Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)] must be attached to Form 1040 if the items are not reported consistently.

Form 8082 is filed with the taxpayer's original or amended return for any of the following circumstances:

1. Schedule K-1, Schedule Q, or a foreign trust statement is incorrect, requiring different reporting in either the original or an amended Form 1040 [e.g., the partnership erroneously reports a gain to the partner as a long-term capital gain (portfolio income) rather than a Section 1231 gain, leading to a potential understatement of the partner's passive activity income].

2. The partnership, S corporation, trust, estate, or REMIC has not filed a tax return or issued a Schedule K-1 by the time the individual must file his tax return (including extensions).

3. Taxpayer files an amended return to change an amount previously reported from a pass-through entity on the original tax return (known as an Administrative Adjustment Request or AAR).

Form 8082 *does not* need to be filed in any of the following circumstances:

1. The loss, deduction, or credit is not reported on the individual's tax return because the amount is limited by law, such as a loss limited by the at-risk or passive limitations.

2. The individual is a partner in a partnership (a) with 10 or fewer partners; (b) each partner is either an individual or estate (or for tax years ending after August 5, 1997, a C corporation); (c) for tax years ending before August 6, 1997, no special allocations exist for any item; and (d) the partnership has not made an election under IRC Sec. 6231 to have the consolidated partnership audit rules apply.

3. The individual is a shareholder in an S corporation for a tax year beginning after 1996, except when Form 8082 is used as a notice of inconsistent treatment with the S corporation return. For tax years beginning before 1997, an S corporation shareholder is excepted from filing Form 8082 if the S corporation has five or fewer shareholders, each of whom is an individual or estate, and the S corporation has not made an election under IRC Sec. 6241 to have the consolidated audit rules apply.

4. The individual is a beneficiary of an estate or trust, except when Form 8082 is used as a notice of inconsistent treatment with the estate or trust return.

5. The individual is a residual holder in a REMIC with 10 or fewer residual holders, each of whom is an individual or estate (or for tax years ending after August 5, 1997, a C corporation), and the REMIC has not filed an election under IRC Sec. 6231 to have the consolidated audit rules apply.

Example 2D-1 Schedule K-1 is incorrect.

Jerry is a limited partner in XYZ Oil Company, Ltd. He received a Schedule K-1 from the partnership reporting the following information:

Ordinary income (loss)	$ (13,700)
Section 1231 gain (loss)	(4,000)

Supplemental information included with Jerry's Schedule K-1 reported an additional ordinary loss of $750 due to Section 754 basis adjustments. However, Jerry's records show his loss from the Section 754 basis adjustment should be $1,500. (XYZ inadvertently reported half the adjustment Jerry is entitled to.) The partnership refused to issue Jerry a corrected Schedule K-1.

Example 2D-2 Schedule K-1 not received.

Frank is a 5% limited partner in LTD Limited Partnership. Frank has not received his Schedule K-1 by the October 15 extended due date for his Form 1040. Prior partnership correspondence projected a loss of $2,500 for each 5% limited partner. How is Frank's Form 8082 completed?

Frank should enter the projected $2,500 loss on line 10, column (d), of Form 8082. In Part III, he should enter the notation: "Schedule K-1 or similar statement not received. Reported loss of $2,500 is based on information provided by the partnership."

The IRS conducts a Schedule K-1 matching program for partnerships and S corporations. Income and losses reported by partnerships and S corporations on Schedules K-1 are matched to individual tax returns filed by the partners (shareholders). IRS examiners screen returns manually for such items as passive losses and issue a notice if they cannot determine where information is presented on the individual's return. Significant differences or a failure to respond to a request for information about a discrepancy could lead to further communication from the IRS.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. How is the shareholder's basis in S corporation stock determined?

    a. Based on the FMV of the stock at time of determination.

    b. FMV if the stock is attained through a gift.

    c. At incorporation, the amount the shareholder contributed to the S corporation.

    d. Utilizing the initial cost of acquiring the shares.

30. Which of the following items would increase the shareholder's stock basis?

    i. Nonseparately stated income.
    ii. Separately stated items of income, including tax-exempt income.
    iii. Excess of the shareholder's deduction for non-oil-and-gas depletion over the allocable basis in the property subject to depletion.
    iv. Recapture of general business credits under IRC Sec. 50(a)(1) when such recapture has caused a corresponding increase to an asset's basis.
    v. The amount of the shareholder's deduction for depletion for any oil and gas property to the extent such deduction does not exceed his proportionate share of the corporation's basis in the property.

    a. i, ii, iv, and v.

    b. i, ii, iii, and v.

    c. I, ii, iii, and iv.

31. Adjustments are made to stock basis in a specific order unless a special election is made. In what order are the following items normally made?

    i. Increase for income items and excess depletion.
    ii. Decrease by distributions.
    iii. Decrease for nondeductible, noncapital expenses and certain oil and gas depletion deductions.
    iv. Decrease for items of loss and deduction.

    a. i, iii, ii, iv.

    b. iv, ii, i, iii.

    c. ii, iii, iv, i.

    d. i, ii, iii, iv.

32. What of the following is correct about the Domestic Production Activities Deduction (DPAD)?

    a. It is claimed by the S corporation, not the shareholder, so it affects the S corporation.

    b. The DPAD deduction has no effect on the shareholder's stock basis.

    c. If the shareholder's losses and deductions are limited it does not affect the shareholder's DPAD.

33. Which of the following is true regarding the basis for debt for an S corporation shareholder?

    a. If a shareholder guarantees a loan made to the S corporation by a third party, it will increase the shareholder's debt basis.

    b. If an S corporation has a third party loan, the shareholder's participation will be included in the shareholder's basis.

    c. A shareholder cannot create additional basis by satisfying a debt of the S corporation.

    d. A shareholder's basis can be increased by debt that is owed directly to the shareholder by the corporation.

34. In which of the following situations would a taxpayer need to complete a Form 8082 to file with their Form 1040?

    a. A loss is not reported on the taxpayer's return due to the amount being limited by law.

    b. The taxpayer filing the return is a beneficiary of an estate or trust.

    c. The taxpayer is a shareholder in an S corporation that was founded in 2008.

    d. The S corporation has not filed a tax return or issued a Schedule K-1 by the time the taxpayer must file his tax return.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. How is the shareholder's basis in S corporation stock determined? **(Page 62)**

    a. Based on the FMV of the stock at time of determination. [This answer is incorrect. FMV is not the basis that a shareholder in a S corporation would use when determining basis as the partner may have paid a premium for the shares.]

    b. FMV if the stock is attained through a gift. [This answer is incorrect. According to IRC Sec. 1015, if the S corporation stock is acquired by gift, the basis of the stock is generally the transferor's basis.]

    c. At incorporation, the amount the shareholder contributed to the S corporation. [This answer is incorrect. Subject to certain stock ownership tests, the basis of stock issued at incorporation equals the adjusted basis of assets contributed by the shareholder plus any gain recognized on the transfer as indicated in IRC Sec. 351.]

    d. Utilizing the initial cost of acquiring the shares. [This answer is correct. The cost of acquiring the shares is determined by the initial cost to shareholder if the stock is purchased. There are special rules for determining the "cost" when the stock is acquired by inheritance, gift or other special circumstances.]

30. Which of the following items would increase the shareholder's stock basis? **(Page 62)**

    i. Nonseparately stated income.
    ii. Separately stated items of income, including tax-exempt income.
    iii. Excess of the shareholder's deduction for non-oil-and-gas depletion over the allocable basis in the property subject to depletion.
    iv. Recapture of general business credits under IRC Sec. 50(a)(1) when such recapture has caused a corresponding increase to an asset's basis.
    v. The amount of the shareholder's deduction for depletion for any oil and gas property to the extent such deduction does not exceed his proportionate share of the corporation's basis in the property.

    a. i, ii, iv, and v. [This answer is incorrect. Basis is not increased by the shareholder's deduction for depletion.]

    b. i,ii, iii, and v. [This answer is incorrect. The amount of the shareholder's deduction for depletion for any oil and gas property to the extent such deduction does not exceed his proportionate share of the corporation's basis in the property does not increase the shareholder's stock basis.]

    c. i, ii, iii, and iv. [This answer is correct. The shareholder stock basis is increased by the shareholder's share of items i. thru iv.]

31. Adjustments are made to stock basis in a specific order unless a special election is made. In what order are the following items normally made? **(Page 62)**

    i. Increase for income items and excess depletion.
    ii. Decrease by distributions.
    iii. Decrease for nondeductible, noncapital expenses and certain oil and gas depletion deductions.
    iv. Decrease for items of loss and deduction.

    a. i, iii, ii, iv. [This answer is incorrect. The second adjustment made to stock basis is for distributions.]

    b. iv, ii, i, iii. [This answer is incorrect. The last adjustment made to stock basis is for items of loss and deduction.]

    c. ii, iii, iv, i. [This answer is incorrect. Stock basis is first increased by the income items and then decreased by losses and deductions.]

    d. i, ii, iii, iv. [This answer is correct. According to IRC Sec. 167(a) and Reg. 1.1367-1(f), the specified order for applying the adjustments is: (1) increased for income items and excess depletion; (2) decreased by distributions; (3) decreased for nondeductible, noncapital expenses and certain oil and gas depletion deductions; and (4) decreased for items of loss and deduction.]

32. What of the following is correct about the Domestic Production Activities Deduction (DPAD)? (**Key Issue Page 62)**

    a. It is claimed by the S corporation, not the shareholder, so it affects the S corporation. [This answer is incorrect. The DPAD is claimed at the shareholder level rather than the S corporation level according to IRS regulations.]

    b. The DPAD deduction has no effect on the shareholder's stock basis. [This answer is correct. According to Reg. 1199-9(c)(1), the regulations do not require a shareholder's basis to be reduced by claiming DPAD.]

    c. If the shareholder's losses and deductions are limited it does not affect the shareholder's DPAD. [This answer is incorrect. If the shareholder's losses and deductions are limited, the shareholder's share of expenses and W-2 wages that would otherwise be taken into account in calculating his or her DPAD are proportionately reduced and deferred per IRS regulations.]

33. Which of the following is true regarding the basis for debt for an S corporation shareholder? **(Page 62)**

    a. If a shareholder guarantees a loan made to the S corporation by a third party, it will increase the shareholder's debt basis. [This answer incorrect. According to IRS regulations, a shareholder's guarantee of a loan made to the corporation by a third party will not provide the shareholder with an increase in the shareholder's debt basis.]

    b. If an S corporation has a third party loan, the shareholder's participation will be included in the shareholder's basis. [This answer is incorrect. An S corporation shareholder's basis does not include a participation interest in a third-party loan to his S corporation. While affirming the Tax Court, the Seventh Circuit held that in a loan participation, the lead lender is the only lender; a participation has a contractual relation only with the lead lender. Therefore, the taxpayer's participation interest in the bank loan to his S corporation was equivalent to a guaranty and did not create basis to allow him to deduct corporate losses.]

    c. A shareholder cannot create additional basis by satisfying a debt of the S corporation. [This answer is incorrect. According to Rev. Rules. 70-50 and 75-144, if a shareholder-guarantor does satisfy a debt of the corporation or gives a personal note to the lender in full satisfaction of the S corporation liability, additional basis is created for the shareholder.]

d. A shareholder's basis can be increased by debt that is owed directly to the shareholder by the corporation. [This answer is correct. An S corporation shareholder receives basis for debt that is owed directly to the shareholder by the corporation per IRS regulations.]

34. In which of the following situations would a taxpayer need to complete a Form 8082 to file with their Form 1040? **(Page 68)**

a. A loss is not reported on the taxpayer's return due to the amount being limited by law. [This answer is incorrect. Form 8082 does not need to be filed when the loss, deduction, or credit is not reported on the individual's tax return because the amount is limited by law, such as a loss limited by the at-risk or passive limitations, as indicated by the IRS.]

b. The taxpayer filing the return is a beneficiary of an estate or trust. [This answer is incorrect. According to the IRS, a Form 8082 does not need to be filed when the individual is a beneficiary of an estate or trust. One exception to that is when Form 8082 is used as a notice of inconsistent treatment with the estate or trust return.]

c. The taxpayer is a shareholder in an S corporation that was founded in 2008. [This answer is incorrect. Form 8082 does not need to be filed when an individual is a shareholder in an S corporation for a tax year beginning after 1996, except when Form 8082 is used as a notice of inconsistent treatment with the S corporation return, as indicated by the IRS.]

d. The S corporation has not filed a tax return or issued a Schedule K-1 by the time the taxpayer must file his tax return. [This answer is correct. Form 8082 is filed with the taxpayer's original or amended return when the partnership, S corporation, trust, estate, or REMIC has not filed a tax return or issued a Schedule K-1 by the time the individual must file his tax return (including extensions) per IRC Sec. 6034A, 6037, and 6222.]

Partner or S Corporation Shareholder Incurred Expenses

Although partners and S corporation shareholders each report income or loss from a pass-through entity, their treatment of unreimbursed business expenses differs. Generally, partners receive the more favorable treatment for their unreimbursed expenses.

Partners

A partner cannot deduct expenses incurred on behalf of the partnership if the partnership would have honored the partner's request for reimbursement. However, the IRS has ruled that if, under the partnership agreement or practice, a partner must pay certain partnership expenses out of his or her own funds, he or she can deduct such expenses on the individual tax return. When deductible, these expenses are claimed on Schedule E.

Example 2E-1 Unreimbursed business expenses of a partner.

Donald Smith, an attorney, is a 50% partner in the law firm of Smith & Kearns. The partnership agreement requires partners to pay their own expenses for three items: continuing legal education, dues, and subscriptions. For the current year, Donald's K-1 shows ordinary income from the partnership of $82,490; business expenses for the three items totaled $1,840. How are these reported on his Form 1040?

The instructions for Form 1040, Schedule E, direct that unreimbursed partnership expenses from nonpassive activities are reported on a separate line in column (h) of Schedule E, Part II. This treatment parallels that required for interest expense associated with pass-through entities.

However, if the partnership agreement specifically states that the partnership shall have a nonreimbursement policy when expenses are incurred outside of the partnership or that it does not specifically require partners to pay for certain expenses, the deduction may be disallowed at the partner level. The routine practice of the partnership is also considered if there is no direction provided in the partnership document.

S Corporation Shareholders

S shareholders generally cannot deduct unreimbursed business expenses on Schedule E because they are categorized as employees when performing services for the corporation. These expenses, if not subject to reimbursement from the corporation, are unreimbursed employee business expenses treated as miscellaneous itemized deductions subject to the 2% of AGI floor. When a corporate officer or controlling shareholder incurs unreimbursed business expenses, the IRS has ruled that they are deductible only by the corporation when they relate to corporate business rather than that of the officer or shareholder. Corporate expenses paid by a shareholder cannot be deducted as Section 212 investment expenses.

Example 2E-2 Unreimbursed business expenses of an S corporation shareholder.

Ed is the sole shareholder of Tops, Inc., an S corporation. He personally paid expenses incurred in the corporation's business. Tops and Ed had agreed that the corporation would not reimburse expenses or pay salaries to him until Tops started making a profit. Ed did not request reimbursement of the expenses. He deducted them as ordinary and necessary trade or business expenses on Schedule E of his Form 1040.

Upon audit, the IRS disallowed the deductions. Ed argued that he was entitled to the deductions because, if Tops had paid the expenses, they would have been passed through to him and would have been deducted as business expenses on Schedule E. In a similar case, however, the Tax Court agreed with the IRS and ruled that a corporation and its shareholders are separate and distinct entities, and one entity cannot deduct the expenses of the other. In that case, the corporation could not deduct the expenses because they were paid by the shareholder. The shareholder could not deduct them either, even as employee business expenses, because he had not requested reimbursement for them. However, since the expenditures were on behalf of Tops, they should be treated as capital contributions that increase Ed's basis in stock (*Bautzer*). Thus, the increase in basis could support a larger pass-through loss deduction, if losses would otherwise be limited by basis.

Look-through Capital Gains and Losses on Sales or Exchanges of Partnership and S Corporation Interests

Generally, capital gain attributable to the sale or exchange of a pass-through entity held for more than 12 months is long-term capital gain subject to the regular capital gain rate.

Sale of an S Corporation Interest

The character of gain or loss recognized on the sale or exchange of S stock is capital if the stock is a capital asset. Long-term or short-term classification depends upon the shareholder's holding period, with long-term status being the most favorable because of the lowered tax rates on an individual's long-term capital gains. However, the capital gain or loss reported from the sale may be affected by the following:

1. *Collectibles Gain.* The portion of gain from the sale of S stock that is attributable to unrealized appreciation on collectibles held by the S corporation would be subject to the 28% maximum tax rate that applies to collectibles gain.

2. *Section 1254 Recapture.* The disposition of S stock at a gain presents a trap for the unwary, because a portion of the gain may be subject to Section 1254 ordinary income recapture. The Section 1254 regulations provide guidance on the tax treatment of gain from the disposition of stock in an S corporation that owns natural resource property.

Sale of a Partnership Interest

When a partner sells his partnership interest the resulting gain or loss may consist of the following:

1. *Section 751(a) Ordinary Income.* An amount received in exchange for a partnership interest generally will be ordinary income to the extent attributable to unrealized receivables and inventory (hot assets). Hot assets are deemed sold for their FMV. Ordinary income realized from a deemed sale is allocated to the selling partner in proportion to the interest sold.

2. *Collectible Gains.* The maximum tax rate on collectible gains (i.e., long-term capital gain from the sale or exchange of collectibles) is 28%. A *collectible* is any piece of art, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, or other personal property designated by the IRS that is a capital asset to the taxpayer (i.e., cannot be inventory). Long-term capital gain for this purpose means gain from property held more than one year.

3. *Capital Gain Attributable to Depreciation of Section 1250 Property.* When depreciable real property is sold at a gain, a maximum rate of 25% applies to the gain to the extent depreciation claimed on the property (other than that subject to Section 1250 ordinary income recapture) would apply only if the property were held more than 12 months. Thus, for sales of depreciable real property unrecaptured Section 1250 gain is taxed at a maximum rate of 25% if the property was held more than 12 months.

4. *Residual Long-term Capital Gain or Loss.*

Interaction of IRC Sec. 1250 and IRC Sec. 751. With unrecaptured Section 1250 gain being subject to a 25% tax rate, it is necessary to identify the gain and the applicable tax rates that apply when the property subject to Section 1250 recapture is also subject to recapture under IRC Sec. 751. This can occur when a partnership interest that holds hot assets (unrealized receivables and inventory) is sold or exchanged by a partner. It appears that it can also occur when there is a disproportionate distribution of Section 1250 property made to a partner. Under IRC Sec. 751, Section 1250 recapture is considered an unrealized receivable and is subject to ordinary income tax rates rather than capital gain rates. In this situation, depreciation in excess of straight-line is subject to the taxpayer's ordinary income tax rate (recaptured under IRC Sec. 751). The amount of straight-line depreciation is considered unrecaptured Section 1250 gain and subject to the 25% rate. Any residual gain (the amount in excess of the original purchase price) will be subject to the applicable residual capital gain rate. Note that under MACRS, all depreciation on Section 1250 property is straight-line.

Practitioners must properly identify the components of any gain recognized in such a situation in order for the partner to apply the correct tax rate. This is not necessarily going to be reported directly on the Schedule K-1 since it involves the sale or exchange of a partnership interest as opposed to the sale of a partnership asset. However, if the partnership is aware of any hot assets taxable as ordinary income upon disposition of the partnership interest, it should supply the partner who is disposing of his interest with Form 8308 (Report of a Sale or Exchange of Certain Partnership Interests). This form details the amount of ordinary income that the partner must recognize on disposition.

Example 2F-1 Reporting gain from the disposition of a partnership interest subject to both IRC Secs. 751 and 1250.

Tom sold his 25% interest in the TJ Partnership for $93,000 cash and the assumption of $60,000 of partnership liabilities. Tom realized gain of $81,000 ($93,000 cash plus $60,000 debt relief less $72,000 of adjusted basis).

On the sale date, TJ owned equipment ($4,000 FMV) that had been fully expensed under IRC Sec. 179 and an office building ($500,000 FMV) that originally cost $480,000. Previously, TJ had claimed depreciation on the office building of $280,000 of which $200,000 was straight line.

Unrealized receivables include any recapture amounts under IRC Sec. 1245 or 1250. For equipment, any realized gain is ordinary in character under IRC Sec. 1245. Thus, any potential gain in equipment caused by depreciation or Section 179 expense is Section 751 property. Tom's deemed sale of the equipment resulted in ordinary income of $1,000 ($4,000 FMV × 25%).

Under IRC Sec. 751(a), gain attributable to unrealized receivables is ordinary income when a partnership interest is sold. IRC Sec. 751(c) includes Section 1250 gain in the definition of unrealized receivables. Section 1250 gain occurs when depreciation excess of straight-line is deducted on real property. Tom will have Section 751 ordinary income of $20,000 which is the smaller of Tom's share of the gain realized on the TJ building, $75,000 [($500,000 FMV − $200,000 adjusted basis) × 25%] or the additional depreciation taken $20,000 [($280,000 total depreciation − $200,000 straight-line depreciation) × 25%].

Tom's unrecaptured Section 1250 gain from the deemed sale of the TJ building (subject to a maximum tax rate of 25%) is $50,000 ($200,000 straight-line depreciation × 25%). Tom's remaining $10,000 of gain is a capital gain subject to a 0% or 15% rate (for 2010).

Beneficiaries of Estates and Trusts

Estates and trusts are subject to higher tax rates on lower amounts of income than other taxpayers. They are subject to a 35% tax rate when 2010 taxable income exceeds $11,200. Because these entities generally receive a deduction for income distributed to beneficiaries, fiduciaries often distribute income and shift the tax burden to them.

Reporting information from a Schedule K-1 received from an estate or trust is usually more straightforward than partnership or S corporation K-1s. This is because beneficiaries do not have basis or at-risk computations to make, which could limit the deduction for pass-through losses. Instead, these computations, as well as most other matters requiring special handling or consideration, are made or resolved at the trust or estate level.

The following trust and estate topics include those that may affect how beneficiaries are taxed on income from these entities. For guidance on income tax matters for estates, trusts, and beneficiaries, see *PPC's 1041 Deskbook*.

Simple versus Complex Trust

The terms of a trust instrument determine how much income can be distributed to a beneficiary. In some cases, the trust instrument requires all income to be distributed, while in others, the trustee has the authority to make this decision, generally subject to certain conditions.

Under IRC Sec. 651 and the related regulations, a *simple trust* is one in which the terms governing a particular tax year (1) require all income to be distributed to the beneficiaries currently; and (2) do not require any amounts to be

paid, permanently set aside, or used for charitable purposes. In addition, the trust cannot make distributions from corpus during the year. Trusts that are permitted to make discretionary distributions or accumulate income are classified as *complex trusts*.

A beneficiary of a simple trust will be taxed on trust income whether or not the income is actually distributed. For example, a sole beneficiary of a simple trust with 2010 taxable distributable net income of $15,000 will be taxed on the full $15,000 in 2010, regardless of when the actual distributions occur. Beneficiaries of complex trusts, on the other hand, generally are taxed on the lesser of the amount actually received during the tax year or the taxable portion of the trust's distributable net income (DNI) for the year.

Beneficiaries of estates are taxed similarly to those of complex trusts. They normally are taxed on the lesser of the amount actually received during the *estate's* tax year or the taxable portion of the estate's DNI for the year. However, a specific gift or bequest of money or property that a beneficiary receives under the terms of the governing instrument (i.e., will or trust instrument) is not taxable to the beneficiary, except in some cases where it is received in more than three installments.

Distributions from Complex Trusts and Estates within 65 Days after Year-end

If the trustee or executor so elects, distributions from a complex trust or estate made within the first 65 days following the close of the entity's tax year are considered made on the last day of the prior tax year . Thus, these are treated as prior-year distributions. This can be an effective tax planning technique for avoiding the higher trust and estate tax rates.

Example 2G-1 Consequences of a Section 663(b) election.

Robert is the sole beneficiary of the Robert Smith Trust, a calendar-year, complex trust. In 2010, Robert received a total of $1,000 in trust distributions. In January 2011, the trust made a $9,000 distribution to Robert from income received in late 2010. For 2010, the trust had taxable income of $12,000 before considering the deduction for distributions to Robert. If no Section 663(b) election is made, the trust will pay tax on $11,000 of taxable income, and Robert will be taxed on $1,000, the amount actually distributed to him in 2010. Because of the trust tax rate structure, trust taxable income in excess of $5,350 will be taxed inside the trust at rates of 28% to 35%.

To avoid this harsh tax treatment at the trust level, the trustee makes a Section 663(b) election to treat the $9,000 paid to Robert in January 2011 as having been paid on December 31, 2010. Thus, Robert is issued a 2010 K-1 showing $10,000 as taxable to him in 2010. The trust's return then shows only $2,000 of taxable income for 2009 because the trust deducts actual and Section 663(b) distributions applicable to 2010.

Passive Activity Limitations

An estate or trust with passive activity income reports a beneficiary's allocable amount on line 6 and/or 7 of Form 1041, Schedule K-1. To the extent related depreciation is directly allocated to a beneficiary (i.e., does not reduce trust income), the amount is reported on line 9. Unfortunately, no specific regulatory guidance exists on passive activities for estates, trusts, and their beneficiaries because this portion of the Section 469 regulations has not been issued. Thus, the conclusions stated here are based on tax return forms, IRS return instructions, private letter rulings, and Subchapter J of the Internal Revenue Code.

No regulatory guidance exists for determining whether an activity held by an estate or trust is passive or nonpassive. A district court held that the material participation of a trust operating a ranch should be determined by referring to the persons who conducted the business of the ranch on the trust's behalf, including, but not limited to, the trustee. However, the IRS has privately ruled that the sole means for a trust to establish material participation is for one or more of its fiduciaries (and not those employed by the fiduciary) to meet the qualifications. Time spent by a special trustee who does not possess the capacity to legally bind or commit the trust to any transaction or activity will not count towards the trust's participation and, the legislative history of IRC Sec. 469 indicates that an estate or trust is treated as materially participating in an activity if the executor or fiduciary, in his or her capacity as such, materially participates in the activity in question. Once the determination is made, the income retains its character (passive or nonpassive) if it is distributed to a beneficiary.

When passive income less allocable depreciation results in net passive income to the beneficiary, the net income should be reported on either Form 8582 (Passive Activity Loss Limitations) if the taxpayer also has passive losses or directly on Schedule E of the Form 1040. If, however, the directly allocated depreciation exceeds allocable passive income so a net passive loss results, it appears the beneficiary must include the net loss on Form 8582, making the loss subject to disallowance.

Trust and Estate Tax Years

Trusts generally must use a calendar year, which normally coincides with that of its beneficiaries. Estates, on the other hand, are not restricted to using the calendar year. Thus, it is not uncommon for estates to adopt a year-end other than December 31.

If a beneficiary has a tax year-end that differs from that of an estate, the beneficiary reports income from the estate using the Schedule K-1 for the estate's year-end that ends within the beneficiary's tax year. Thus, if an estate selects a July 31 tax year-end, an income beneficiary reports amounts from the K-1 issued for the estate's year ended July 31, 2010, on his 2010 Form 1040. (This will be a 2009 K-1.) Estate income distributed to the beneficiary between August 1, 2010, and December 31, 2010, will be included in the estate's year ending July 31, 2011, and reported by the beneficiary in 2011 [unless a Section 663(b) election is made].

Grantor Trusts

The grantor (creator) or another person treated as the owner of a portion of a trust is taxed on the income, deductions, and credits attributable to the portion of the trust that the grantor or other person is deemed to own regardless of distributions. Any portion of the trust not deemed owned by the grantor or other person is taxed under the rules normally governing trusts. The grantor will be treated as the owner of the trust if:

1. The grantor retains a reversionary interest in the trust.

2. The grantor or a nonadverse party has the power to control the beneficial enjoyment of the income or principal of the trust without the consent of an adverse party. (A nonadverse party is generally someone without a beneficial interest in the income or corpus of the trust.)

3. The grantor or a nonadverse party retains certain administrative powers over the trust that are exercisable without the consent of an adverse party.

4. The grantor or a nonadverse party has the power to revoke the trust or appoint the corpus to himself or herself without the consent of an adverse party.

5. The grantor or a nonadverse party has the power to distribute income to the grantor or the grantor's spouse without the consent of an adverse party.

Someone other than the grantor can be treated as the owner of a portion of the trust if he or she has the power to vest the trust's income or corpus in himself or herself.

Trust Files Form 1041. Grantor trusts required to file a separate Form 1041 do not report items of income and deduction on the face of Form 1041. Instead, this information is reported on a supporting statement and the trustee must provide the grantor a statement (*not* a Schedule K-1) of income and expense items. The grantor then reports these on his or her appropriate Form 1040 forms and schedules (e.g., Schedule B for interest and dividends, Form 4797 for Section 1231 gains and losses).

Trust Uses Alternative Reporting Method. Certain grantor trusts (e.g., a trust all of which is owned by one or more grantors or other persons) are not required to file Form 1041. Instead, several optional methods (i.e., alternative reporting methods) are available to the trust for reporting information to the grantor and IRS. In each case, the trustee provides the grantor a statement that—

1. shows all items of the trust's income, deductions, and credits attributable to the grantor for the tax year.

2. provides the grantor or other person with information necessary to compute his taxable income.

3. informs the grantor or other person treated as the owner of the trust that all information shown on the statement must be included in computing his taxable income.

In addition, the statement must identify the payer of each income item when the trustee (for a trust with a single grantor) furnished the name and social security number (SSN) of the grantor (as opposed to the trust's tax identification number) to the payer.

Partner Guaranteed Payments

Reporting Issues Associated with Guaranteed Payments

A partner cannot be both an employee and a member of the same partnership. Therefore, a partnership cannot pay a salary to a partner with the same tax consequences as compensation paid to a nonpartner employee. However, the Code gives partners and partnerships a method, through the use of guaranteed payments, to achieve almost the same tax treatment as that accorded salary payments.

The most common type of guaranteed payment is similar to a salary payment to a partner for his or her services to the partnership. However, a guaranteed payment can also be payment for the partnership's use of a partner's contributed capital. A guaranteed payment does not have to be stated as a fixed amount, but it must be determined without regard to the partnership's income. If a payment to a partner acting in his or her capacity as a partner is *not* a guaranteed payment, it is simply treated as a distribution—usually accompanied by an income allocation (i.e., the normal partner-partnership tax rules apply).

Classifying a payment as a guaranteed payment is important because of the following special tax rules that apply to guaranteed payments:

1. The partnership deducts (or capitalizes) the guaranteed payment under the partnership's accounting method when it is paid or accrued.

2. Guaranteed payments are treated as ordinary income to the recipient partner (reported on line 4 of the partner's Schedule K-1), who recognizes the income in his or her tax year that includes the partnership's tax year-end for the year the guaranteed payment was deducted or capitalized.

3. Because guaranteed payments are, in effect, treated as payments to nonpartners, they have no impact on the recipient partner's capital account or tax basis in his interest (except for the effect of the portion, if any, of the partnership's deduction allocable to the recipient partner). The guaranteed payment income does not increase the recipient partner's tax basis in his partnership interest, and the payment itself does not reduce his or her basis. Neither the income nor the payment flows through the recipient partner's Schedule K-1 capital account reconciliation. Obviously, if a payment is *not* a guaranteed payment, the distribution and related income allocation decreases and increases, respectively, the partner's tax basis in his partnership interest, and the amounts will flow through the partner's Schedule K-1 capital account reconciliation.

If a partnership agreement provides for guaranteed payments to a partner and the payments result in a partnership loss, the partner must (1) report the full amount of the guaranteed payment as ordinary income and (2) separately take into account the appropriate distributive share of the partnership loss.

Payment of Health Insurance Premiums

Partnership Treatment. Accident and health insurance premiums (including qualified long-term care insurance premiums) paid by a partnership on behalf of its partners are guaranteed payments, provided the premiums are paid for services rendered as a partner and the payments are determined without regard to partnership income. As guaranteed payments, the premiums are deductible by the partnership and included in the recipient partners' gross income.

The partnership reports the cost of accident and health insurance premiums treated as guaranteed payments as a deduction in arriving at the partnership's ordinary income. The partnership reports each recipient partner's guaran-

teed payment amount (including the health insurance premiums) on line 4 of Schedule K-1. This amount would be considered self-employment income for purposes of SE tax. According to the Form 1065 partnership return instructions, the amount of the premiums *should also be reported* on the recipient partner's Schedule K-1, line 13 (Code M) under "Other deductions." An attached statement should provide the details necessary for the partner to determine the amount eligible for the self-employed's health insurance deduction.

Example 2H-1 Accident and health insurance premiums treated as a guaranteed payment.

Alice and Fran are equal partners in Dreamer Partnership. During 2010, Dreamer paid accident and health insurance premiums of $6,000 ($3,000 each) for the partners. The premiums are for services Alice and Fran rendered as partners and were payable without regard to partnership income. The value of the premiums is equal to the cost of the premiums. These premiums are guaranteed payments. The payment is in connection with services rendered to the partnership and is not determined by reference to partnership income. The premiums are deductible by the partnership and are reported as guaranteed payments to Alice and Fran (on line 4 of their Schedules K-1) and under "Other deductions" on line 13 (Code M) of their Schedules K-1.

S Corporation Treatment. When an S corporation makes payments for accident and health insurance premiums benefiting a 2% shareholder-employee (a shareholder who owns more than 2% of the outstanding stock of the corporation or stock possessing more than 2% of the voting power of all the stock in the corporation) as consideration for services rendered, the payments are also treated as guaranteed payments. There is no FICA tax on these amounts under IRC Sec. 3121(a)(2) if the guidelines in IRS Ann. 92-16 are followed. Therefore, the premiums are deductible by the corporation, and includible in the recipient shareholder-employee's gross income. The shareholder-employee may deduct the applicable amount of the self-employed's health insurance premiums provided the individual has earned income (FICA taxable wages), in excess of the premiums paid, from the corporation.

Self-employment Tax

Guaranteed payments are generally subject to self-employment (SE) tax, even if the partner is a limited partner. However, limited partners owe no SE tax on guaranteed payments unless they provide services to the partnership and the guaranteed payments are in the nature of remuneration for those services.

Domestic Production Activities Deduction

The domestic production activities deduction (DPAD) available under IRC Sec. 199 is available to any qualified taxpayer, including corporations, partnerships, sole proprietors, and limited liability companies. The DPAD is 9% for tax years beginning in 2010 and beyond. However, for taxpayers with oil-related qualified production income, the DPAD will remain at 6%. The DPAD is not allowed in computing self-employment income and the taxpayer can claim the deduction for both regular tax and AMT.

Pass-through Entities—General Rules

The deduction for income attributable to domestic production activities is available to partnerships, S corporations, and other pass-through entities, but the deduction is claimed at the shareholder, partner, or beneficiary level. Each partner, shareholder, or beneficiary is allocated their share of qualified production activities income and Employer's W-2 wages and must compute their deduction separately aggregating their share of items from all pass-through entities and individually owned businesses.

Currently, only Form W-2 wages that are allocable to domestic production gross receipts are counted for purposes of the 50%-of-W-2 wages limitation. Rev Proc. 2006-47 provides guidance on computing the W-2 wage limitation.

Effect of Fiscal-year Pass-through Entities on Owners. In the case of a partnership or S corporation with a non-calendar tax year, the deduction is calculated at the partner or shareholder level based on the pass-through entity's activities. For instance, assume a partnership has a tax year beginning on October 1. With respect to this partnership, any partner-level DPAD calculations are based on the partnership's activities in the tax year beginning on October 1, 2009, and ending on September 30, 2010. Therefore, calendar-year individual partners will calculate their 2009 DPAD based on information provided with their Schedules K-1 for the partnership tax year beginning on October 1, 2009, and ending on September 30, 2010.

Effect of the DPAD on the Pass-through Owner's Basis. The DPAD has no impact on the partner's basis in his or her partnership interest or the shareholder's basis in his or her S corporation stock.

If the partner's or shareholder's losses and deductions are limited—for example, due to insufficient basis in the partnership interest or S corporation stock, insufficient at-risk basis, or the passive loss rules—the partner's or shareholder's share of expenses and Form W-2 wages that would otherwise be taken into account in calculating his or her DPAD is proportionately reduced and deferred. Such deferred expenses are not taken into account for DPAD purposes until the limitation no longer applies (i.e., when the expenses become deductible at the partner or shareholder level in a future year). However, deferred expenses from tax years beginning before January 1, 2005, are never taken into account for purposes of calculating the DPAD because such expenses predate the effective date of the DPAD.

Example 2I-1 Computing the DPAD

Dan owns a 50% interest in Danco, an LLC treated as a partnership, that makes jackets in the U.S. Danco conducts no other activities. Dan's 2010 adjusted gross income [modified for Section 199(d)(2) items] is $350,000 before considering the DPAD.

During 2010, Danco showed the following income and expenses:

Gross receipts	$ 900,000
Cost of goods sold (including $350,000 of W-2 wages)	(600,000)
Other directly allocable expenses	(100,000)
Net income	$ 200,000

Danco provides Dan with a Schedule K-1 and attachments identifying his share of the qualified production activities income as $100,000 (50% partnership interest × $200,000) and his share of W-2 wages as $175,000 (50% × $350,000). These items are reported on Dan's Schedule K-1, line 13 Code U and Code V, respectively. Dan's DPAD for 2010 is $9,000.

The calculation would be similar if Danco were an S corporation and Dan owned 50% of the shares. Danco provides Dan with a Schedule K-1 and attachments identifying his share of the qualified production activities income as $100,000 and his share of W-2 wages as $175,000. These items are reported on Dan's Schedule K-1, line 12, Code Q and Code R, respectively.

Reporting the Deduction

For an individual, the domestic production activities deduction is reported on line 35 of Form 1040.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. When can a partner deduct expenses on their person tax return that are associated with the partnership?

    a. The partnership would have honored the partner's request for reimbursement.

    b. When the partner pays the expenses not detailed in the partnership agreement.

    c. A partner cannot deduct partnership expense in any situation.

    d. If under the partnership agreement or practice, the partner is required to pay certain partnership expenses out of his or her own funds.

36. How is the capital gain attributable to the sale or exchange of a pass-through entity held for more than 12 months treated by the individual owner when there are no components of the sale that require special treatment?

    a. As long-term capital gain subject to the regular capital gain rate.

    b. As ordinary income subject to the passive activity rules.

    c. As long-term capital gain subject to the highest capital gain rate.

    d. As a long-term capital gain subject to the 15% capital gain rate.

37. Due to the different tax rates, a partner must be able to properly identify the components of any gain recognized on the sale of a partnership interest. How does the partner obtain this information when there are hot assets held by the partnership?

    a. All of the information is reported directly on the Schedule K-1.

    b. All of the information will be contained in the partner's basis schedule adjusted annually at year end.

    c. It should be included on the partnership's Form 8308.

38. Stephanie receives income from an estate once a year. The estate has a tax year end of July 31 each year. Stephanie receives her income from the estate on March 1, 2010 for the 2010 year and Stephanie has a tax year end of September 30. When should Stephanie report the income from the estate on her person return?

    a. Stephanie must report the income on a calendar year basis since estates are required to maintain a calendar year.

    b. Stephanie should include this amount in her 2010 Form 1040**.**

    c. Stephanie should include this amount in her 2011 Form 1040 due to the estate's year end.

39. In which of the following situations would the grantor of a trust ***not*** be treated as the owner of the trust?

    a. The grantor of the trust preserves no interest in the trust.

    b. The grantor of the trust has the power to revoke the trust without any consent of an adverse party.

    c. The grantor has the power to allocate income to themselves and their spouse without any consent.

    d. Administrative powers over the trust are held by the grantor without the consent of an adverse party.

40. Which of the following is correct regarding partners in a partnership?

    a. A taxpayer that is a member of a partnership can also be an employee of the partnership.

    b. Any health insurance premiums paid by the partnership for the partner are only expenses of the partnership.

    c. Partners receiving guaranteed payments are required to pay self-employment tax on the payments, unless they are a limited partner.

    d. The payment for a partnership's use of a partner's contributed capital is considered a guaranteed payment.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. When can a partner deduct expenses on their person tax return that are associated with the partnership? **(Page 76)**

    a. The partnership would have honored the partner's request for reimbursement. [This answer is incorrect. If a partnership would have reimbursed the partner, then the partner is barred from claiming a deduction on their individual tax return per the IRS.]

    b. When the partner pays the expenses not detailed in the partnership agreement. [This answer is incorrect. If the partnership agreement does not specifically require partners to pay for certain expenses, the deduction may be disallowed at the partner level.]

    c. A partner cannot deduct partnership expense in any situation. [This answer is incorrect. Under special circumstances detailed in Ltr. Ruls. 9316003 and 933004, a partner can deduct partnership expenses on their personal tax returns.]

    d. If under the partnership agreement or practice, the partner is required to pay certain partnership expenses out of his or her own funds. [This answer is correct. The IRS has ruled that if, under the partnership agreement or practice, a partner must pay certain partnership expenses out of his or her own funds, he or she can deduct such expenses on the individual tax return per Ltr. Ruls. 9316003 and 933004.]

36. How is the capital gain attributable to the sale or exchange of a pass-through entity held for more than 12 months treated by the individual owner when there are no components of the sale that require special treatment? **(Page 77)**

    a. As long-term capital gain subject to the regular capital gain rate. [This answer is correct. According to the IRS, the gain from the sale or exchange of a pass-through entity held for more than 12 is treated as a long-term capital subject to the regular capital gain rate.]

    b. As ordinary income subject to the passive activity rules. [This answer is incorrect. The activity may or may not be subject to the PAL rules, based on the elements associated with the taxpayer. In either case, the gain would not be ordinary due to IRS laws.]

    c. As long-term capital gain subject to the highest capital gain rate. [This answer is incorrect. The sale or exchange of a pass-through entity is subject to the regular capital gain rate as determined at the individual level as indicated by the IRS.]

    d. As a long-term capital gain subject to the 15% capital gain rate. [This answer is incorrect. The capital gain rate is determined at the individual level depending on the individual's income level, not the long-term capital gain.]

37. Due to the different tax rates, a partner must be able to properly identify the components of any gain recognized on the sale of a partnership interest. How does the partner obtain this information when there are hot assets held by the partnership? **(Page 77)**

    a. All of the information is reported directly on the Schedule K-1. [This answer is incorrect. The information is not necessarily going to be reported directly on the Schedule K-1, since it involved the sale or exchange of a partnership interest as opposed to the sale of a partnership asset.]

    b. All of the information will be contained in the partner's basis schedule adjusted annually at year end. [This answer is incorrect. The partner may not have information sufficient to determine the hot assets held by the partnership. This information will have to be supplied by the partnership.]

c. It should be included on the partnership's Form 8308. [This answer is correct. If the partnership is aware of any hot assets taxable as ordinary income upon disposition of the partnership interest, it should supply the partner who is disposing of his interest with Form 8038 (Report on a Sale or Exchange of Certain Partnership Interests). This form details the amount of ordinary income that the partner must recognize on disposition.]

38. Stephanie receives income from an estate once a year. The estate has a tax year end of July 31 each year. Stephanie receives her income from the estate on March 1, 2010 for the 2010 year and Stephanie has a tax year end of September 30. When should Stephanie report the income from the estate on her person return? **(Page 78)**

a. Stephanie must report the income on a calendar year basis since estates are required to maintain a calendar year. [This answer is incorrect. Trust generally must use a calendar year per IRC Sec. 644, which normally coincides with that of its beneficiaries. Estates, on the other hand, are not restricted to using the calendar year.]

b. Stephanie should include this amount in her 2010 Form 1040. [This answer is correct. If a beneficiary has a tax year-end that differs from that of an estate, the beneficiary reports income from the estate using the Schedule K-1 form the estate's year-end that ends within the beneficiary's tax year according to IRC Sec. 662(c).]

c. Stephanie should include this amount in her 2011 Form 1040 due to the estate's year end. [This answer is incorrect. If the money was distributed in 2010, but after the estate's year end of July 31 (i.e. distributed on September 1, 2010), then Stephanie would include it in her 2011 return.]

39. In which of the following situations would the grantor of a trust **not** be treated as the owner of the trust? **(Page 78)**

a. The grantor of the trust preserves no interest in the trust. [This answer is correct. For a grantor to be treated as an owner of the trust per IRC Sec. 673, the grantor must retain a reversionary interest in the trust.]

b. The grantor of the trust has the power to revoke the trust without any consent of an adverse party. [This answer is incorrect. If a grantor or nonadverse party has the power to revoke the trust or appoint the corpus to himself or herself without the consent of an adverse party, then according to IRC Sec. 676, the grantor will be treated as the owner of the trust.]

c. The grantor has the power to allocate income to themselves and their spouse without any consent. [This answer is incorrect. The grantor will be treated as the owner of the trust if the grantor or a nonadverse party has the power to distribute income to the grantor or the grantor's spouse without the consent of an adverse party per IRC Sec. 677.]

d. Administrative powers over the trust are held by the grantor without the consent of an adverse party. [This answer is incorrect. If the grantor or a nonadverse party retains certain administrative powers over the trust that are exercisable without the consent of an adverse party, the grantor will be treated as the owner of the trust as indicated in IRC Sec. 675.]

40. Which of the following is correct regarding partners in a partnership? **(Page 81)**

a. A taxpayer that is a member of a partnership can also be an employee of the partnership. [This answer is incorrect. According to Rev. Rul. 69-184, a partner cannot be both an employee and a member of the same partnership. Therefore, a partnership cannot pay a salary to a partner with the same tax consequences as compensation paid to a nonpartner employee.]

b. Any health insurance premiums paid by the partnership for the partner are only expenses of the partnership. [This answer is incorrect. Health insurance premiums paid by a partnership on behalf of its partners are guaranteed payments, provided the premiums are paid for services rendered as a partner and the payments are determined without regard to partnership income per Rev. Rul. 91-26. As guaranteed payments, the premiums are deductible by the partnership and included in the recipient partners' gross income.]

c. Partners receiving guaranteed payments are required to pay self-employment tax on the payments, unless they are a limited partner. [This answer is incorrect. Guaranteed payments are generally subject to self-employment (SE) tax, even if the partner is a limited partner according to IRS rules.]

d. The payment for a partnership's use of a partner's contributed capital is considered a guaranteed payment. [This answer is correct. The most common type of guaranteed payment is similar to a salary payment for his or her services to the partnership. However, a guaranteed payment can also be payment for the partnership's use of a partner's contributed capital. A guaranteed payment does not have to be stated as a fixed amount, but it must be determined without regard to the partnership's income per IRC Sec. 707(c).]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TDBTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. The partner's capital account (both on Form 1065, Schedule M-2, and each partner's Schedule K-1) should be prepared on what basis?

    a. Cash unless the business does not qualify to use the cash basis.

    b. Tax basis as it provides more information for the partner.

    c. General accepted accounting principles.

    d. The same basis as the partnership books and records.

22. Which of the following statements best describes how a partner's basis is to be adjusted when a partnership enters into a related party transaction?

    a. The basis is increased by gains and decreased by losses.

    b. The basis is increased by gains and decreased by losses recognized**.**

    c. The basis is increased by gains and decreased by losses to the extent of the at-risk amount.

    d. The basis is increased by gains and decreased, but not below zero, by losses disallowed**.**

23. How is a partner's basis to be adjusted by a deemed distribution resulting from a partner's reduced share of partnership liabilities?

    a. As an advance or draw and accounted for on the last day of the tax year.

    b. As a guaranteed payment to a partner.

    c. As an advance or draw and accounted for on the actual date of the deemed distribution.

    d. Do not select this answer choice.

24. A loss from a partnership must be considered in view limitations. The sequence in which these limitations are considered is important. Which of the following order is to be used?

    a. Passive loss, at-risk, and basis.

    b. At-risk, basis, passive loss.

    c. Passive loss, basis, at-risk.

    d. Basis, at-risk, and passive loss.

25. The at-risk rules of IRC Sec. 465 limit the deduction for losses generated by business and investment activities to the amount the taxpayer is at risk with respect to that activity. Which of following statements is true?

    a. The at-risk rules apply to only passive activities.

    b. The at-risk rules apply only to Sub-S corporations.

    c. The at-risk rules apply at the individual taxpayer level.

    d. The at-risk rules apply only to partnerships.

26. Although nonrecourse loans secured by property used in the activity generally are not considered for at-risk purposes, a special exception applies when the property is financed with qualified nonrecourse financing secured by real property. Which of the following is one of the four requirements for qualified nonrecourse financing?

    a. The financing is obtained from general partner or major shareholder.

    b. The financing is obtained from an individual related to the partner.

    c. The purpose of the financing is for the holding of real property.

    d. The financing is obtained from a line of credit held by the partnership from partnership's bank.

27. Certain types of investments in or loans to an activity may not qualify (in whole or part) as at-risk amounts. In which of the forms would an individual be subject to the at-risk limitations if a loss is incurred (either directly or via a partnership or S corporation) in a business or production-of-income activity in which an investment was made?

    a. A nonrecourse loan not secured by the taxpayer's own property.

    b. Contribution of appreciated property to the partnership.

    c. Recourse loans for which the taxpayer is fully liable.

    d. Cash contribution.

28. Bo and Jo form a partnership to operate a retail sales activity. They initially purchase inventory for $5,000 using their own capital. They also borrow $15,000 from their sponsor in this activity, through whom they purchase additional inventory. Bo and Jo are each personally liable on the note. The sponsor/lender receives 8% interest on the note plus 5% of net profit in the activity. If Bo and Jo incur a $6,000 loss, how much of it are they allowed to deduct under the at-risk rules?

    a. Bo and Jo are not allowed to deduct any of the loss.

    b. Bo and Jo are allowed to deduct $5,000 of the loss.

    c. Bo and Jo are allowed to deduction $6,000 of the loss.

    d. Bo and Jo will be able to deduction up to $15,000 of all losses.

29. Robert purchased commercial real estate in 2009 in partnership with two other individuals. Robert's investment in the partnership included $15,000 cash; his share of partnership liabilities is $100,000 of recourse debt. In 2009, he deducted a $25,000 loss that was fully at risk. In 2010, the debt was converted to nonrecourse debt that is not considered qualified nonrecourse financing. How much of the prior year loss must Robert recapture?

    a. $10,000 of the 2009 loss claimed.

    b. $25,000 of the 2009 loss claimed.

    c. $15,000 of the 2009 loss claimed.

    d. Do not select this answer choice.

30. What limits the losses from an S-corporation that can be claimed by a shareholder?

    a. The gross receipts of the S-corporation.

    b. The net profit from the S-corporation.

    c. The sum of the adjusted basis of (1) the shareholder's stock and (2) any indebtedness the S corporation owes directly to the shareholder.

    d. The sum of the adjusted basis of the shareholder's and any indebtedness of the S corporation shareholder to the S corporation.

31. Which of the following is a valid method for determining a shareholder's original basis in S corporation stock acquired by inheritance?

    a. The FMV of shares at the date of death.

    b. The decedent's original value of the stock at the time of purchase.

    c. The decedent's basis of the stock at the time of death.

    d. Do not select this answer choice.

32. When must the shareholder's stock basis in a S corporation be adjusted?

    a. Each time the stockholder attempts to sell the stock.

    b. Each year end of the S corporation.

    c. Each time the stockholder wishes to issue financial statements.

    d. Each time a new shareholder is considered to be admitted to the corporation.

33. Which of the following items would decrease the shareholder's stock basis?

    i. Recapture of general business credits under IRC Sec. 50(a)(1) when such recapture has caused a corresponding increase to an asset's basis.
    ii. Nonseparately stated loss.
    iii. Separately stated items of deduction or loss.
    iv. Corporation expenses that are not deductible in computing taxable income and not properly chargeable to a capital account (e.g., the nondeductible portion of business meals.
    v. The amount of the shareholder's deduction for depletion for any oil and gas property to the extent such deduction does not exceed his proportionate share of the corporation's basis in the property.
    vi. The reduction in an asset's basis when the general business credit caused such a reduction under IRC Sec. 50(c)(1).

    a. i, v and vi.

    b. i, ii, iii iv, v and vi.

    c. ii, iii, iv v, and vi.

    d. i, ii, iii, iv, and v.

34. Which of the following is correct regarding cancellation of debt (COD) in relation to an S corporation?

    a. The COD rules are applied at the individual level.

    b. The COD rules are applied at the S corporation level.

    c. When measuring insolvency, the worth of the shareholder must be determined.

    d. Any discharged income increases the shareholder's basis.

35. How does a partner report a deductible expense on their tax return?

    a. On Form 1040 Schedule E as a non passive loss from a partnership.

    b. On Form 1040 Schedule A as a miscellaneous itemized deduction.

    c. On Form 1040 Schedule C as a business expense.

    d. On Form 1040 Schedule A as an employee business expense.

36. S shareholders can deduct unreimbursed business expenses only if:

    a. Not subject to reimbursement from the corporation.

    b. Incurred by a corporate officer or controlling shareholder.

    c. They can be allowed as unreimbursed employee business expense.

    d. Do not select this answer choice.

37. The character of a gain recognized on the sale or exchange of S corporation stock is determined by which of the following issues?

    i. Long-term or short-term classification.

    ii. Collectibles Gain. The 28% maximum tax rate that applies to any unrealized appreciation on collectibles held by the S corporation.

    iii. Section 751 (a). Gain is reclassed as ordinary Income gain to the extent of unrealized receivable and inventory.

    iv. Section 1254 Recapture. A gain from the disposition of stock in an S corporation that owns natural resources property is subject recapture as ordinary income.

    a. i, ii, iii.

    b. ii. iii, iv.

    c. i. ii, iv.

    d. i, ii, iii, iv.

38. When a partner sells his partnership interest and the resulting gain includes unrealized appreciation on collectibles, how is the gain taxed?

    a. At the maximum tax rate of 28%.

    b. As ordinary income to the extent of the FMV of the collectibles.

    c. As a short term capital gain.

    d. At the maximum tax rate of 25%.

39. When a partner sells his partnership interest and the resulting gain includes capital gain attributable to depreciation of Section 1250 property which was held for more than 12 months, how is the gain taxed?

    a. At a maximum tax rate of 25%.

    b. As ordinary income.

    c. Passive income.

    d. As a long-term capital gain.

40. Which of the following is a characteristic of a simple trust?

    a. A portion of the amounts paid must be set aside for charitable purposes.

    b. Corpus must be distributed each year from the trust.

    c. All income is distributed to the beneficiaries each year.

    d. The trust may make discretionary distributions to the beneficiaries.

GLOSSARY

Basis: The amount assigned to an asset from which gain or loss is determined for income tax purposes. For assets acquired by purchase, basis is cost. Special rules govern the basis of property received by virtue of another's death, by gift, or in an exchange; the basis of stock received on a transfer of property to a controlled corporation; the basis of the property transferred to the corporation; and the basis of property received upon the liquidation of a corporation.

Broker: A person who acts as an intermediary between a buyer and a seller but does not take title to the goods in the transaction.

Capital gain or loss: Derived from the sale or exchange of capital assets. The transaction may result in short-term or long-term gain or loss. Short-term gain or loss results when an asset is held for one year or less. Long-term gain or loss results when an asset is held for more than one year.

Carryforward: A revenue or expense item that is recorded and an asset or liability to be recognized as such in a future period (e.g., deferred revenue or prepaid expense). Carryforward is also the process of recording these revenues and expenses as assets and liabilities in the current period. Carryforward is the process of transferring the balance in an account to another account, or bringing the totals from a column of numbers to a new column or a new page on either a worksheet or within the accounting records.

C Corporation: A corporation organized under subchapter C of the Internal Revenue Code. A C corporation pays an income tax on taxable income at the entity level. A C corporation is sometimes referred to as a regular corporation to distinguish it from an S corporation, which does not pay an income tax at the corporate level and is similar to a partnership from a tax perspective. Shareholders pay taxes on dividends paid out of earnings and profits of the corporation. A C corporation is not limited in the number of shareholders that it may have. There may be as few as one or as many as several million. The stock may be publicly traded on an organized exchange, the over-the-counter market, or held privately.

Distribution: Money a taxpayer withdraws from a retirement plan such as an individual retirement account or an employer-maintained pension plan.

Expense: The outflow or other using up of assets or incurring of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Installment: One payment in a series of payments required over time to settle a debt.

Limited partner: A party who is merely an investor in a partnership. The party's liability is limited to the capital contribution to the partnership. Like a corporate shareholder, a limited partner does not participate in the management of the business.

Limited entrepreneur: A member or owner of a business entity, such as an LLC or partnership, who does not actively participate in the management of that entity. Generally, for tax purposes, a non-management owner is considered to be a *limited entrepreneur.* Similar to a *limited partner* in a limited partnership. If more than 35% of an entity's losses are allocated to limited entrepreneurs, the entity will be deemed to be a *syndicate* for federal tax purposes. One important effect of this designation is that the cash method of accounting is unavailable for entities that are considered to be syndicates.

Material participation: The standard used to define whether a business activity is passive with respect to a taxpayer. If the taxpayer *materially participates* in the activity, it is nonpassive. If the taxpayer fails to materially participate, the activity is passive. Material participation requires regular, continuous, and substantial involvement in the business. It is tested on an annual basis. The regulations list seven separate tests which can be satisfied to meet the material participation standard. Four are quantitative and three are qualitative.

Net lease: A lease arrangement where the tenant pays most or all of the expenses.

Partner's basis: In a partnership interest is commonly referred to as the "*outside basis.*" The adjusted basis of a partner's partnership interest is ordinarily figured at the end of a partnership's tax year. If there has been a sale or exchange of all or part of the partner's interest or a liquidation of his entire interest in a partnership, however, the adjusted basis is figured on the date of the sale, exchange, or liquidation.

Passive activity: For taxable years after 1986, the Tax Reform Act of 1986 divided all income and losses into three categories: passive, active, and portfolio. If a taxpayer materially participates in a trade or business on a regular, continuous, and substantial basis, the income or loss resulting is *active.* If the taxpayer does *not* materially participate in an activity, the income or loss resulting is *passive.* The passive loss rules limit the amount of losses from passive activities that can reduce income from nonpassive sources. Generally, losses from passive activities in excess of passive income may *not* reduce nonpassive income (active income and portfolio income). Passive losses that cannot offset other types of income are suspended losses and must be carried forward to offset future passive income.

Pass-through entity: A nontaxable entity such as a regulated investment company, REIT (real estate investment trust), S corporation, partnership, trust, common trust fund, passive foreign investment company, foreign personal holding company, foreign investment company, and REMIC (real estate mortgage investment company). Usually, the income or expense is passed to the underlying owner and retains its character.

Passive activity income/expense: Involves the conduct of a trade or business in which the taxpayer does *not materially participate.* Material participation means regular, continuous, and substantial participation. This has been interpreted to be 500 hours per year.

Portfolio income: For purposes of the passive loss rules, income must be divided into three categories: active income, passive income, and portfolio income. Portfolio income is income from such sources as dividends, interest, capital gains, and royalties.

Subrogation: Right available to the surety; surety assumes (succeeds to) the rights of (is substituted in the place of) the creditor to the extent the surety contributed to the satisfaction of the obligation, i.e., the surety assumes the contract between the creditor and the debtor and can sue the principal debtor for reimbursement of the amount that the surety paid, or assumes the creditor's position in priority in the bankruptcy of the debtor (e.g., surety pays wages to employees of the bankrupt and then assumes the wage earners' rights to a priority in the bankruptcy).

Suspended loss: A loss or deduction that is realized but not recognized for tax purposes. Suspended losses are carried over to later tax years and may be available for future recognition. In this manner, these deductions or losses may offset any income or gain realized from the activity that created the suspended loss.

Taxpayer: Any person, organization, trade, or business, whether or not subject to any internal revenue tax.

Vacation home: A second residence usually used by taxpayers for short periods of time during the year. It is not the primary personal residence. A vacation home can be any kind of dwelling unit, including houses, apartments, condos, house boats, other boats with sleeping facilities, motor homes, house trailers, and other similar property. A vacation home can also be rented to third parties by the owner. Special rules and restrictions apply to the treatment of income and expenses if the vacation home is also rented.

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V

COMPANION TO PPC'S 1040 DESKBOOK

COURSE 2

The Tax Treatment of Installment Sales, Like-Kind Exchanges, Property Conversions and Personal Residence Transactions (TDBTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the federal tax treatment and reporting for installment sales, like-kind exchanges, property conversions, property transactions and personal residence transactions. Lesson 1 details the availability and requirements of installment sales and how a taxpayer would opt out of the installment method, in addition to the conditions for a like-kind exchange and qualifications for involuntary conversions. Lesson 2 covers how a taxpayer would apply Section 1231 gains and losses, how purchase prices are allocated and the treatment of gain on depreciable property. Lesson 3 explains the tax treatment of the sale of principal residences and the deferral of gain associated with the sale.

PUBLICATION/REVISION DATE: December 2010

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation

CPE CREDIT: 7 QAS Hours, 7 Registry Hours

7 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Installment Sales, Like-kind Exchanges, and Conversions of Property

Completion of this lesson will enable you to:

- Determine the availability of the installment method on transactions, the applicability of installment sales between related parties, the requirements for a taxpayer to elect out of in the installment method and how a taxpayer deals with installment sale purchase price adjustments.
- Identify the effects of a wraparound mortgage and different type of dispositions.
- Recognize the conditions for a transfer to qualify as a like-kind exchange, how gains and losses are recognized and the prerequisites for a deferred exchange.

- Determine the conditions required to qualify for an involuntary conversion under IRC Sec. 1033, the rules for replacement property and how gains and losses are recognized.

Lesson 2—Trade or Business Property Transactions

Completion of this lesson will enable you to:

- Identify abandonment losses and the general rules for reporting and applying Section 1231 gains and loss carryovers.
- Determine purchase prices are allocated, depreciable property gain is computed and reported and the determination of losses for business casualty and with related parties.

Lesson 3—Personal Residence Transactions

Completion of this lesson will enable you to:

- Recognize the requirements for a principal residences and how to exclude the gain on the sale of a residence and on spousal transfers of a residence.

TO COMPLETE THIS LEARNING PROCESS:

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Lesson 1: Installment Sales, Like-kind Exchanges, and Conversions of Property

INTRODUCTION

This lesson discusses issues that may arise for taxpayers with significant real estate and investment property activities. In addition to installment sale issues (including the OID imputed interest rules), practitioners must recognize and deal with like-kind exchanges, wraparound mortgages, and involuntary conversions.

Generally, if property is sold at a gain and at least one payment is received after the close of the tax year of sale, installment reporting is required unless the taxpayer elects out.

Installment reporting does not apply to losses. Also, a number of restrictions and limitations exist on the use of the installment method of reporting gain from the sale of real property. In general, dealers cannot use the installment method except for sales of farm property, timeshares, and residential lots. Nondealers with installment sales in excess of $150,000 are subject to special interest payment and pledge rules (see IRC Sec. 453A).

An installment gain for regular tax and AMT may differ because of a different adjusted basis in the asset sold (due to use of different depreciation methods).

Learning Objectives

Completion of this lesson will enable you to:

- Determine the availability of the installment method on transactions, the applicability of installment sales between related parties, the requirements for a taxpayer to elect out of in the installment method and how a taxpayer deals with installment sale purchase price adjustments.
- Identify the effects of a wraparound mortgage and different type of dispositions.
- Recognize the conditions for a transfer to qualify as a like-kind exchange, how gains and losses are recognized and the prerequisites for a deferred exchange.
- Determine the conditions required to qualify for an involuntary conversion under IRC Sec. 1033, the rules for replacement property and how gains and losses are recognized.

Installment Method Availability

Property Eligible for Installment Reporting

The installment method of accounting is *not* available for dispositions of:

1. real or personal property by dealers,
2. personal property considered inventory,
3. personal property under a revolving credit plan, or
4. stock or securities traded on an established securities market.

Dealer property can be personal property sold by a person who regularly sells property of the same type on the installment plan or real property held for sale to customers in the ordinary course of a taxpayer's trade or business. While not commonly addressed, taxpayers may be able to sell assets such as accounts receivable using the installment sale method.

Certain exceptions apply to dealer sales of timeshares, residential lots, and property used or produced in the trade or business of farming. The farm property exception to the general dealer disposition rule applies only if the seller used the property in farming. It does not apply to dealer property that was merely going to be used in farming by

the buyer. Sales of timeshares and residential lots are eligible for installment reporting (for both regular tax and AMT) only if the taxpayer agrees to pay interest on the tax deferred from using the installment method.

Example 1A-1 Installment sale of residential lots or timeshares.

Arthur, a dealer in residential lots, purchased a six-acre tract of land for $30,000 and intends to sell 12 half-acre lots. In December 2010, he receives an offer to purchase one of the lots for $5,000, with $1,000 down in 2010, and $4,000 payable the following year. No interest is stated in the offer. If Arthur accepts the offer, he has two choices:

1. Recognize the entire $2,500 profit ($5,000 proceeds less $2,500 basis) in 2010.

2. Elect under IRC Sec. 453(l)(2)(B) to use the installment method. (This election and interest calculation only applies to sales of residential lots or timeshares.) To make this election, Arthur must agree to pay interest on the tax attributable to the deferred gain. The interest is calculated at the applicable federal rate (AFR) in effect at the time of the sale (compounded semiannually) and is payable with the tax due for each year gain is recognized on the installment note. [Short-term rates are used if the term of the installment obligation does not exceed three years. Midterm rates are used for obligations with terms exceeding three years but not more than than nine years. Long-term rates are used for obligations with terms exceeding nine years.] The interest period runs from the date of sale to the date of collection. Therefore, assuming the semiannual AFR in December 2010 was 1% and a 28% marginal federal tax rate in 2011, Arthur would owe interest of $26 in 2011, determined as follows:

Amount collected in 2011	$ 4,000
Gross profit percentage	× 50%
Gain recognized in 2011	$ 2,000
Marginal tax rate	× 28%
Tax attributable to gain	$ 560
Interest on deferred tax for one year at 1% compounded semiannually	$ 6

Taxpayers cannot elect to use the installment method for residential lots if they or any related person make any improvements to the lots. Also, installment obligations subject to this election cannot be guaranteed by any person other than an individual. The election is made by properly reporting the interest in the return for the year it is due. The interest is reported on the total tax line of Form 1040 with "Section 453(l)(3) interest" written to the left of the amount shown on that line. This interest charge is not included in regular tax, so it is due even if Arthur is subject to AMT.

The interest due for any year is calculated on the amount of tax attributable to payments received during the year. If the taxpayer has no tax liability for the year, there is no interest charge.

Related Parties and Installment Sales

Sale of Depreciable Property between Related Parties

Installment reporting is not allowed for sales of depreciable property between certain related persons. *Depreciable property* is any property that can be depreciated by the purchaser. When the disallowance rule applies, all payments are deemed to be received in the year the sale occurs. Furthermore, the purchaser cannot increase the basis of the property until the income has been reported by the seller. Under another rule, gain recognized from the sale or exchange of depreciable property between related persons (as defined) is treated as ordinary gain (i.e., IRC Sec. 1231 does not apply).

In this context, a related person includes an individual and all entities controlled by that individual. A controlled entity includes more than 50% owned corporations (based on stock value) and partnerships (based on capital or profits ownership). Other related persons include an individual and a trust in which such person is a beneficiary (other than a remote contingent beneficiary), an estate and a beneficiary of the estate, and two or more partner-

ships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests. Constructive ownership rules apply in determining an individual's ownership in a related entity.

An exception to the prohibition of installment reporting for related persons allows installment reporting if the taxpayer can demonstrate that the principal purpose of the transaction was not the avoidance of federal income taxes. Lack of a significant tax deferral can be used to establish that avoidance of federal taxes was not the principal purpose of the transaction. Conversely, if a significant tax benefit is achieved, the IRS may successfully argue that tax avoidance was a principal purpose of the transaction. In *Guenther*, the Tax Court held that a taxpayer who sold depreciable real estate to an S corporation owned by him and his daughters failed to prove tax avoidance was not one of the principal purposes of the sale. The court looked at, among other items, the depreciation available to the related buyer.

When the sale or exchange involves both depreciable and nondepreciable property, the gain must be allocated between the two. The installment method may be used on the nondepreciable property.

Example 1B-1 Installment sale of depreciable property between related parties.

Mark sold the land and office building that house his medical practice to his professional corporation in 2010 for $190,000. He received $40,000 in cash in 2010 and a 10-year interest-bearing note. The land and building were appraised at $30,000 and $160,000, respectively. The adjusted basis at the time of the sale was $15,000 (land) and $75,000 (building). Mark cannot demonstrate that tax avoidance was not a principal purpose for the transaction. How much gain does Mark recognize in 2010?

The total gain realized from the sale was $100,000 [$190,000 − ($15,000 + $75,000)]. Since the sale was to a related person and involved depreciable property, the installment method cannot be used to report the gain attributable to the sale of the building. Therefore, the entire $85,000 gain ($160,000 − $75,000) attributable to the sale of the building is recognized as ordinary income in 2010. Mark reports this gain on Part II of Form 4797 (Sales of Business Property).

In 2010, Mark must also recognize a portion of the gain attributable to the sale of the land. Since it is nondepreciable property, the installment method is used. The gain realized on the sale of the land is $15,000 ($30,000 − $15,000). Therefore, 50% of the proceeds attributable to the land will be included in Mark's income each year as proceeds are received.

Proceeds received each year will be allocated between the sale of the land and the building, based on their relative fair market value (FMV). Thus, $6,316 [$40,000 × ($30,000 ÷ $190,000)] of the proceeds received during 2010 are allocated to the land sale. Of this amount, $3,158 (50% gross profit percentage) is recognized by Mark and reported on Form 6252 (Installment Sale Income). Because the gain is attributable to land held more than one year, it is carried to Part I of Form 4797. Mark must file Form 6252 for 2010 and any other year payments are received. In addition, he must file Form 6252 for the following two years (i.e., 2011 and 2012) even if no payments are received per the instructions to Form 6252. (See Example 1B-2 regarding second dispositions by related parties.)

Two-year Disposition Rule

Gain recognition on the installment sale of property to a related party is accelerated if the related party disposes of the property within two years of the installment sale (i.e., the first disposition). Under the two-year disposition rule, a related party generally includes a spouse; child; grandchild; parent; sibling; or a related C or S corporation, partnership, estate, or trust. A second disposition includes a sale, exchange, or gift of the property. The initial seller is treated as having received proceeds equal to the excess of the amount realized on the second disposition (or, if less, the contract price on the first disposition) over the actual payments received on the initial sale.

However, gain is not accelerated under any of the following circumstances:

1. The second disposition is the result of an involuntary conversion under IRC Sec. 1033, and the first disposition occurred before the threat of conversion.

2. The second disposition occurs after the earlier of the death of (a) the person making the first disposition or (b) the person who acquired the property in the first disposition.

3. Neither the first nor the second disposition had tax avoidance as one of its principal purposes. Generally, second dispositions that are involuntary (e.g., the result of bankruptcy or foreclosure) are not considered to be tax motivated. In addition, if the terms of payment on the second disposition are substantially equal to or longer than those of the first disposition, the second generally will not be viewed as tax-motivated.

Example 1B-2 Second disposition by related party.

Art owns rare coins (FMV of $50,000, basis $10,000). On June 1, 2009, he sells them to his son Bart for $50,000. Bart makes a $5,000 payment on June 1, 2009, and signs a note to pay $5,000 (plus interest) each June 1 for the next nine years. Bart has cash flow problems and sells the coins to a third party on December 15, 2010, for $60,000. How much income does Art recognize in 2010 as a result of Bart's sale of the coins?

Art's realized gain on the initial sale of the coins was $40,000. Since it qualified as an installment sale, Art recognizes gain on 80% ($40,000/$50,000) of the proceeds received. However, since Bart, a related person, disposed of the coins in 2010 (i.e., within two years of the original sale), Art is treated as having received additional proceeds of $40,000 in 2010 computed as follows:

Initial sales price	$ 50,000 [a]
Less payments received:	
June 1, 2009	(5,000)
June 1, 2010	(5,000)
Deemed payment on December 15, 2010	$ 40,000

Note:

[a] The initial contract price is used instead of Bart's sales price on the second disposition because the second disposition's sales price was in excess of the initial contract price.

As a result of the second disposition, Art realizes total gain of $36,000 in 2010 [($40,000 + 5,000) × 80%]. (In the year of sale, another $4,000 of gain was recognized from the down payment received in that year.)

Art must file Form 6252 with his tax return for the year of sale and any other year payments are received. In addition, since the property was sold to a related party, Art must file Form 6252 for the two years following the sale even if no payments are received. (The form must be filed each year until the entire contract price has been received if the sale involved marketable securities.) Any gain recognized would be reported on Schedule D (or Form 4797 if the property was business property).

Collections from Bart in future years will be nontaxable as Art has reported the entire gain in 2010. If Art had reported less than the entire gain in 2010 (because Bart's sales price was less than the initial contract price), future collections are nontaxable until cumulative collections exceed Bart's sales price.

Electing Out of the Installment Method

An *installment sale* is any disposition of property where at least one payment is received after the close of the tax year in which the sale occurs. Under the installment sale rules, a taxpayer recognizes a portion of each payment as gain when received. These rules are mandatory for eligible sales unless the taxpayer elects out of installment reporting. (Certain sales to related parties and most sales made by dealers are not eligible for installment reporting.) Taxpayers using the installment method normally are taxed on collections based on the tax rules in effect for each collection year. Thus, 2010 collections related to installment sales of capital assets held more than one year are generally taxed at the applicable 2010 tax rate on long-term capital gains (i.e., 0% or 15%) regardless of the year the sale took place.

Maximizing the Benefits of the Election Out

It may be beneficial for a taxpayer to elect out of the installment method and report the entire gain in the year of sale. For example, if a taxpayer has expiring carryovers (e.g., net operating loss, charitable contribution, or business credit), the gain from an installment sale could allow use of these carryovers. A taxpayer who has no carryovers, but has little taxable income or a tax loss, should consider electing out of the installment method and including the total gain in current income to either avoid wasting the tax benefit of exemptions and itemized deductions or to offset a tax loss. A taxpayer who sells a passive activity that contains suspended losses might also find the election to be advantageous. This election may also benefit taxpayers whose social security benefits, without the installment sale income, are not subject to tax. If reported on the installment method, the gain could raise AGI to the point where the Social Security benefits are taxed every year that payments are received. On the other hand, if the taxpayer elects out of installment reporting, AGI would only be boosted in the year the asset is sold and all the gain recognized. Then the benefits are subject to tax in only one year, as opposed to every year that gain is recognized. If a taxpayer knows or believes applicable tax rates will increase in future years, it may be advantageous to elect out of installment sale treatment.

Example 1C-1 Electing out of installment method to use expiring NOL.

The Morgans are retired and living off their pension and investment income. In 2010, they sold a vacant lot for $72,000, receiving $12,000 at closing and a $60,000 note (bearing 8% interest) for the balance. The note will be paid in five annual installments of $12,000, plus interest, in years 2011–2015. The Morgans' basis in the lot was $12,000, so a total gain of $60,000 was realized. Their gross profit percentage is 83.33% ($60,000 gain ÷ $72,000 sales price); thus, $10,000 ($12,000 × 83.33%) of each annual installment will be taxable if installment method reporting is used. They have an NOL carryforward of $60,000 that will expire in 2010.

The following table compares the Morgans' adjusted gross income (AGI) with and without the use of the installment method for 2010 and projected for 2011–2015:

	2010		Each Year 2011–2015	
	Using Installment Method	Electing out of Installment Method	Using Installment Method	Electing out of Installment Method
Interest and dividends	$ 7,000	$ 7,000	$ 7,000	$ 7,000
Pension income	18,000	18,000	18,000	18,000
Gain from land sale	10,000	60,000	10,000	—
NOL carryforward	(35,000)	(60,000)	—	—
AGI	$ -0-	$ 25,000	$ 35,000	$ 25,000

As this example illustrates, electing out of the installment method results in additional income in 2010. However, by electing out, they use all of the NOL expiring in 2010, rather than only being able to use $35,000 of it.

Mechanics of Making the Election Out

An election out of the installment method must be made by the due date, including extensions, for filing the tax return for the year the sale occurred. The election is made transaction by transaction (i.e., a taxpayer can elect out for one sale and use installment reporting for other sales in the same year). Generally, the election is irrevocable unless the IRS consents to a revocation. See Ltr. Ruls. 9511027, 9519014, 200226039, 200230016, 200317014, and 200813019 for situations where taxpayers were allowed to revoke an election out of the installment method when their agent failed to carry out their instructions or elected out based on the erroneous belief that the installment method was unavailable.

An after-the-fact planning idea exists for a taxpayer who has already filed a tax return but decides later that an election out of an installment sale may be beneficial. By amending the return, Reg. 301-9100-2(c) allows an election out of an installment sale as late as the final due date of return with extensions.

Installment Sale Purchase Price Adjustments

When property is sold on the installment method and the buyer and seller later agree to a reduction in the purchase price, both parties must reflect the adjustment for tax purposes. For the seller, this requires a recomputation of the gross profit percentage for the remaining payments.

Example 1D-1 Seller's treatment of purchase price adjustment.

Five years ago, Don sold a parcel of land to Lyle for a $200,000 interest-bearing installment note. His basis in the land was $75,000. Selling expenses were $5,000. Don computed the gain and gross profit percentage as follows:

Selling price	$ 200,000
Basis	(75,000)
Selling expenses	(5,000)
Gain on sale (60% gross profit)	$ 120,000

The sale terms called for Don to receive annual principal payments of $20,000 plus interest over 10 years. During the first five years, Don received $20,000 per year and reported gain of $12,000 each year ($20,000 × 60%) on Form 6252. In the sixth year, Don and the buyer renegotiated the selling price down from the original $200,000 to $175,000. Under the renegotiated deal, Don will receive $15,000 per year for the remaining five years for a total of $175,000 ($100,000 collected before the renegotiation and $75,000 to be collected after). Don incurred legal fees of $2,250 to renegotiate the sale. He must recompute his gross profit percentage as follows:

Reduced selling price	$ 175,000
Basis	(75,000)
Original selling expenses	(5,000)
Renegotiation expenses	(2,250)
Recomputed gain on sale	92,750
Less gain previously reported ($100,000 × 60%)	(60,000)
Gain to be reported over next five years	$ 32,750
Recomputed gross profit percentage ($32,750 remaining gain ÷ $75,000 remaining principal payments)	43.67%

For each of the remaining five years, Don will report gain of $6,550 ($15,000 × 43.67%).

Example 1D-2 Buyer's treatment of purchase price adjustment.

Assume the same facts as in Example 1D-1 except that, instead of purchasing raw land, Lyle purchased land and an office building. Originally, Lyle had allocated $30,000 to the land and $170,000 to the building. In the sixth year, when the purchase price is renegotiated from $200,000 to $175,000, Lyle must reduce his basis in the land and building and reallocate the new purchase price between them. Lyle determines it is appropriate to use the same ratio as in the original transaction (i.e., 15% of the value is allocated to land and 85% to the building). Therefore, $26,250 ($175,000 × .15) of the renegotiated purchase price is allocated to land and $148,750 ($175,000 × .85) is allocated to building. The depreciable basis of the building is therefore reduced by $21,250 ($170,000 − $148,750).

There is no definitive guidance on how to compute depreciation after basis has been adjusted for the reduction in purchase price. Presumably, the rules as provided in the regulations for the former ACRS depreciation apply. Accordingly, the applicable depreciation percentage for the remainder of the recovery period is recomputed and applied to the adjusted basis in the property after the purchase price adjustment. Lyle's depreciation after the purchase price adjustment is computed as follows:

Adjusted basis in building after purchase price adjustment	$ 128,949[a]
Recomputed depreciation percentage (for years 6–39)	× 2.902%[b]
Depreciation in years 6–39	$ 3,742
Proof:	
Depreciation in years 6–39 ($3,742 × 34 years)	$ 127,228
Depreciation in year 40 (final year) [1.177% ÷ (100% − 11.647%)] × $128,949	1,721[c]
Total depreciation claimed	$ 128,949

Notes:

[a] $170,000 original cost − $19,801 total depreciation claimed for first five years − $21,250 purchase price adjustment = $128,949.

[b] Current year recovery percentage divided by (100% − cumulative recovery percentages for years prior to basis redetermination) = 2.564% ÷ (100% − 11.647%) = 2.902%.

[c] Adjusted for rounding.

Repossessing Real Estate Sold on Installment Basis

If a taxpayer sells real property on the installment basis and later repossesses the property, a mandatory rule for reporting gain due to the repossession may apply under IRC Sec. 1038. If so, the FMV of the repossessed property is irrelevant. Generally, the result is that the seller reports all interim installment payments (i.e., principal payments received before repossession) as gain to the extent they exceed the amount of gain reported as income before the repossession. However, the gain that must be reported upon repossession is limited to the seller's gross profit calculated for the original sale less (1) the amount of gain reported as income before the repossession and (2) repossession costs. The gain reported as income before the repossession (in both cases) appears to include both gain from receipt of installment payments and ordinary income recapture in the year of sale. Typically, the limitation on gain does not come into play, and as a result of these rules, the seller's tax basis in the repossessed real estate is the same as when the property was sold (increased by any expenses incurred in repossessing the property). See Example 1E-1.

The Section 1038 rules for calculating repossession gain (no loss is allowed) and tax basis for real property are mandatory. They apply whether the seller realizes a gain or sustains a loss on the original sale of the real property. However, they apply only if all the following conditions are met:

1. The repossession must be by the original seller and be undertaken to protect the seller's security rights in the real estate.

2. The installment obligation that is fully or partially satisfied by the repossession must have been received by the seller in the original sale.

3. The seller cannot pay any additional consideration to the buyer to get the property back, unless (a) the reacquisition and payment of the additional consideration was provided for in the original contract of sale or (b) the buyer has defaulted or default is imminent.

If these conditions are not met, the seller (or other party repossessing the property) cannot calculate the gain on repossession and the new basis in the repossessed property using the Section 1038 rules. Instead, the gain (or loss) on repossession equals the FMV of the repossessed property (at repossession date) less the sum of the adjusted basis of the note and any repossession costs, and the repossessed property's basis equals its FMV at the time of repossession.

Example 1E-1 Repossession of land and building.

Rob sold a commercial building on December 31, 2008 for $300,000. He received $25,000 cash and a note (bearing adequate interest) for $275,000. Semiannual principal payments of $5,000 are to be paid for five years. At that point, a balloon payment for the remaining $225,000 becomes due. Rob received two $5,000 principal payments in 2009 but none in 2010.

Rob's adjusted basis in the building at the time of sale was $200,000, resulting in a 33.333% installment sale gross profit percentage. On December 1, 2010, he repossessed the building after incurring legal fees and other costs of $5,000.

The gain on the repossession and the new basis in the building after repossession are computed as follows:

Taxable gain on repossession:

Cumulative down payment and principal payments received		$ 35,000
Minus: Gain already reported ($35,000 × 33.333%)		(11,667)
Gain on repossession (tentative) (A)		$ 23,333
Gross profit on original sale		$ 100,000
Gain already reported	$ 11,667	
Plus: Repossession costs	5,000	(16,667)
Unreported gross profit less repossession costs (B)		$ 83,333
Taxable gain on repossession [lesser of (A) or (B)]		$ 23,333

Basis of repossessed real property:

Face value of seller's installment receivable at time of repossession ($275,000 − $10,000 payments received)		$ 265,000
Less: Unreported gross profit ($265,000 × 33.333%)		(88,333)
Adjusted basis of receivable on date of repossession		176,667
Plus:		
Taxable gain on repossession	$ 23,333	
Repossession costs	5,000	28,333
Basis of repossessed real property		$ 205,000

After the repossession, Rob is basically back in the same position he was before the sale; his basis in the property is $205,000 ($200,000 original basis + $5,000 repossession costs). Thus, the full amount of payments Rob received from the buyer ($35,000) on the original sale must be recognized as income. Since $11,667 was previously reported as prior-year installment gain, the remaining $23,333 (for a total of $35,000) must be reported in 2010 as repossession gain. [The repossession gain is reported on the same form (e.g., Form 4797) as the previously reported installment gains.] The FMV of the property at the time of repossession does not affect the amount of gain Rob reports.

The repossessed property's holding period (for purposes of any subsequent sale) includes the period when the taxpayer owned the property before the original sale plus the period after the repossession. It does not include the period that the buyer from whom the property was repossessed owned the property. Repossessed property is depreciated as if it had never been sold. The IRS has not issued regulations stating how reacquired MACRS property is to be depreciated. Presumably, the rules will be similar to those for ACRS property, whereby depreciation resumes using the remaining recovery period and applicable rate at the time of disposition. Any basis in excess of the original basis is treated as a new asset.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. A transaction involving the sale of property at a gain, may be subject to installment reporting if there is at least one payment received after the tax year end of the year of the sale. Which of the following transactions are required to be reported under the installment method?

    a. Albert, a real estate dealer, sold real property to an unrelated party. Albert will realize a $300,000 gain on the sale.

    b. Bob a carpet vendor sold inventory from his carpet trade to Charles. Bob will realize a substantial gain and Charles will make payments to Bob of $600 per month for 5 years.

    c. Don, an individual taxpayer (not a dealer), sold land to Edward. Don will realize a substantial loss on the transaction and Edward will make payments to Don over the next 5 years.

    d. Sam a self-employed truck driver sold a semi-truck to Buck. Buck will make payments of $500 a month for the next 2 year. Sam will recognize a gain of $4,000 on the sale.

2. When is an installment sale allowed between related parties?

    a. If the related parties are able to show that the installment sale was not conducted in an effort to avoid paying federal income taxes.

    b. Installment sales are allowed between related parties if the property being acquired is depreciable by the buyer.

    c. The installment method may be used if the related party seller is a corporation that the seller only owns 55% of the company, and not just an individual.

3. In which of the following situations would a taxpayer most likely benefit from using the installment reporting method?

    a. A taxpayer has experienced a significant net operating loss in a prior year and has expiring loss carryovers from the net operating loss.

    b. A taxpayer, who has accumulated a substantial passive loss carryforwards, sells the unprofitable activity in the tax year of the installment sale.

    c. A taxpayer is in a high tax bracket and has no loss carry forward and anticipates that they will be in a lower tax bracket in future years.

    d. Payments received by the taxpayer their Social Security benefits to become subject to income tax every year the payments are received.

4. IRC Sec. 453 requires that certain transactions be reported as installment sales unless the taxpayer elects out of the installment sales rules. Which of the following is correct concerning electing out of the installment method?

   a. The taxpayer must file a notarized election statement disclosing the details of the sale and stating the gain will be recognized in the year of the sale.

   b. If a taxpayer elected out of the installment method in one tax year, the decision can be reversed is advantageous, in the next tax year.

   c. The taxpayer must elect out of the installment method by the due date, including extensions, of the tax return for the year of the sale.

   d. If the taxpayer elects out the installment method for the tax year, it affects all sales conducted in the tax year.

5. Ralph sold property on the installment method to William. The market decreased and William experienced serious financial difficulties. Ralph agrees to settle the contract for a lesser amount. William will continue to make payments but at a lower amount and for a shorter period. Which of the following statements best describes the tax ramifications of the adjustment to the sales price in this case?

   a. Ralph must recalculate the gross profit percentage using the adjusted sale price. He must then amend the prior year returns to report the adjusted gain each year.

   b. William must adjust the basis of the property he purchased. Ralph will continue reporting the gain as originally calculated until the full gain has been recognized.

   c. Both parties must make adjustments for tax purposes. The gross profit percentage for the remaining payments must be recomputed for the seller.

6. Sajon sells real property on a 10 year installment sale contract with adequate interest to Benjamin. After making payments for five years, Sajon was forced to repossess the property when Benjamin defaulted on the contract. On the original contract, Sajon realized a gain of $150,000, resulting in a 33.333% gross profit percentage. Sajon had collected $225,000 on the contract and reported gains of $75,000 prior to the date of repossession. His repossession cost was $5,000. What is Sajon's taxable gain on repossession?

   a. $0.

   b. $75,000.

   c. $70,000.

   d. $150,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. A transaction involving the sale of property at a gain, may be subject to installment reporting if there is at least one payment received after the tax year end of the year of the sale. Which of the following transactions are required to be reported under the installment method? **(Page 101)**

    a. Albert, a real estate dealer, sold real property to an unrelated party. Albert will realize a $300,000 gain on the sale. [This answer is incorrect. The sale of real property by a dealer is excluded from using the installment method by IRC Sec. 453(b)(2), (k) and (l).]

    b. Bob a carpet vendor sold inventory from his carpet trade to Charles. Bob will realize a substantial gain and Charles will make payments to Bob of $600 per month for 5 years. [This answer is incorrect. The sale of inventory is excluded from using the installment method by IRC Sec. 453(b)(2), (k) and (l).]

    c. Don, an individual taxpayer (not a dealer), sold land to Edward. Don will realize a substantial loss on the transaction and Edward will make payments to Don over the next 5 years. [This answer is incorrect. Only property sold at a gain is subject to installment sales rule under IRC Sec. 453.]

    d. Sam a self-employed truck driver sold a semi-truck to Buck. Buck will make payments of $500 a month for the next 2 year. Sam will recognize a gain of $4,000 on the sale. [This answer is correct. The transaction is a sale with a gain involving payments received in more than 1 taxable year. Unless Sam elects out of the installment reporting this transaction must be reported as an installment sale under IRC Sec. 453.]

2. When is an installment sale allowed between related parties? **(Page 102)**

    a. If the related parties are able to show that the installment sale was not conducted in an effort to avoid paying federal income taxes. [This answer is correct. An exception to the prohibition of installment reporting for related persons allows installment reporting if the taxpayer can demonstrate that the principal purpose of the transaction was not the avoidance of federal income taxes as indicated in IRC Sec. 453(g)(2).]

    b. Installment sales are allowed between related parties if the property being acquired is depreciable by the buyer. [This answer is incorrect. According to IRC Sec. 453(g), installment reporting is not allowed for sales of depreciable property between certain related parties.]

    c. The installment method may be used if the related party seller is a corporation that the seller only owns 55% of the company, and not just an individual. [This answer is incorrect. A related person includes an individual and all entities controlled by that individual. A controlled entity includes more than 50% owner corporations and partnerships as stated in IRC Sec. 453(g)(3) and 1239(b).]

3. In which of the following situations would a taxpayer most likely benefit from using the installment reporting method? **(Page 104)**

    a. A taxpayer has experienced a significant net operating loss in a prior year and has expiring loss carryovers from the net operating loss. [This answer is incorrect. A taxpayer with expiring credits from a net operating loss may well benefit from utilizing the loss carryovers and should probably consider not using the installment sales reporting.]

    b. A taxpayer, who has accumulated a substantial passive loss carryforwards, sells the unprofitable activity in the tax year of the installment sale. [This answer is incorrect. If a tax payer can sell a passive activity with passive loss carryforwards in the same tax year as the installment sale the taxpayer may well benefit by offsetting the loss carry forwards with the gain and should consider electing out of the installment method of reporting.]

c. A taxpayer is in a high tax bracket and has no loss carry forward and anticipates that they will be in a lower tax bracket in future years. [This answer is correct. By deferring the gain to years with a lower tax bracket the taxpayer should benefit. A taxpayer in this situation should use the installment method of reporting.]

d. Payments received by the taxpayer their Social Security benefits to become subject to income tax every year the payments are received. [This answer is incorrect. In this situation, the taxpayer may save taxes by recognizing the gain in one year and then receiving their Social Security benefits tax free in the following years. A tax payer in this situation should consider electing out of the install method of reporting.]

4. IRC Sec. 453 requires that certain transactions be reported as installment sales unless the taxpayer elects out of the installment sales rules. Which of the following is correct concerning electing out of the installment method? **(Page 104)**

a. The taxpayer must file a notarized election statement disclosing the details of the sale and stating the gain will be recognized in the year of the sale. [This answer is incorrect. There is no formal election statement required by IRC Sec. 453(d).]

b. If a taxpayer elected out of the installment method in one tax year, the decision can be reversed is advantageous, in the next tax year. [This answer is incorrect. Generally, the election out of the installment method is irrevocable, unless the IRC consents to the revocation.]

c. The taxpayer must elect out of the installment method by the due date, including extensions, of the tax return for the year of the sale. [This answer is correct. According to IRC Sec. 453(d), an election out of the installment method must be made by the due date, including extensions, for filing the tax return for the year the sale occurred.]

d. If the taxpayer elects out the installment method for the tax year, it affects all sales conducted in the tax year. [This answer is incorrect. The election out of the installment method is made transaction by transaction (i.e., a taxpayer can elect out for one sale and use installment reporting for other sales in the same year).]

5. Ralph sold property on the installment method to William. The market decreased and William experienced serious financial difficulties. Ralph agrees to settle the contract for a lesser amount. William will continue to make payments but at a lower amount and for a shorter period. Which of the following statements best describes the tax ramifications of the adjustment to the sales price in this case? **(Page 106)**

a. Ralph must recalculate the gross profit percentage using the adjusted sale price. He must then amend the prior year returns to report the adjusted gain each year. [This answer is incorrect. Ralph is not required to amend any prior year returns pursuant to Rev. Rul. 75-570.]

b. William must adjust the basis of the property he purchased. Ralph will continue reporting the gain as originally calculated until the full gain has been recognized. [This answer is incorrect. It is true that William must adjust the basis of the property but Ralph is not required to continue reporting gain on the original schedule.]

c. Both parties must make adjustments for tax purposes. The gross profit percentage for the remaining payments must be recomputed for the seller. [This answer is correct. When property is sold on the installment method and the buyer and seller later agree to a reduction in the purchase price, both parties must reflect the adjustment for tax purposes. For the seller, this requires a recomputation of the gross profit percentage for the remaining payments as stated in Rev. Rul 72-570.]

6. Sajon sells real property on a 10 year installment sale contract with adequate interest to Benjamin. After making payments for five years, Sajon was forced to repossess the property when Benjamin defaulted on the contract. On the original contract, Sajon realized a gain of $150,000, resulting in a 33.333% gross profit percentage. Sajon had collected $225,000 on the contract and reported gains of $75,000 prior to the date of repossession. His repossession cost was $5,000. What is Sajon's taxable gain on repossession? **(Page 107)**

   a. $0. [This answer is incorrect. Sajon is required to report a gain per IRC Sec.1038.]

   b. $75,000. [This answer is incorrect. Sajon has reported $75,000 of the gain in the prior years. This is not the amount of his repossession gain based on IRC Sec. 1038.]

   c. $70,000. [This answer is correct. The repossession gain is calculated as follows: It is the lesser of the cumulative principal received ($225,0000) less the gain reported ($75,000) which would be $150,000 or the original gain on the contract ($150,000) less any repossession costs and gain reported ($80,000) which would be $70,000. The lesser of the two calculations determines that the gain on repossession would be $70,000 as required by IRC Sec. 1038.]

   d. $150,000. [This answer is incorrect. This amount was the original gain realized, not the gain on repossession based on IRC Sec. 1038.]

The Effect of Wraparound Mortgages on Installment Sales

What Is a Wraparound Mortgage?

A *wraparound mortgage* is a special agreement in connection with an installment sale. Normally, when the seller has an existing mortgage on the property, the buyer either assumes the mortgage, or the seller uses sales proceeds to pay off the existing mortgage with the buyer obtaining a new mortgage (or sometimes both). In some cases, however, it may be beneficial to one or both parties (or required by the original lender) to leave the seller liable on the original mortgage and have him or her pay it off over time, as though he or she still owns the property. Meanwhile, the buyer gives a new mortgage to the seller in an amount equal to the entire purchase price less any down payment. In other words, the buyer's mortgage wraps around the seller's mortgage. The seller receives payments from the buyer, which are used to make payments on his or her own mortgage.

Effect of a Wraparound Mortgage on an Installment Sale

In general, if a buyer assumes a mortgage or takes property subject to a mortgage, the excess of that debt over the seller's basis is treated as a gain-recognized payment received in the year of sale. In addition, this mortgage is not included in the contract price, and the resulting gross profit percentage is increased.

If a wraparound mortgage is used, the contract price is the entire sales price, resulting in a lower gross profit percentage (and thus less gain recognized with each year's collections). Also, since the property is not taken subject to the seller's mortgage, the seller is not taxed on a phantom payment received in the year of sale, even when the mortgage exceeds the seller's basis.

In Reg. 15a.453-1(b)(3)(ii), the IRS defined a *wraparound mortgage* as "an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage encumbering the property (wrapped indebtedness) and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness." Thus, according to the regulation, a wraparound mortgage is deemed to have been taken subject to the seller's mortgage, even though title has not passed and the seller remains liable for payments on the underlying debt.

The conclusion of the regulation is that the gross profit ratio for a wraparound mortgage is a fraction. The numerator is the face value of the obligation minus the taxpayer's basis in the obligation, and the denominator is the face value of the obligation. This treatment, which effectively removes all of the tax benefits of wraparounds, was held invalid by the Tax Court in *Professional Equities, Inc.* (acquiesced to by the IRS). The IRS now states that as long as the wraparound mortgage is valid, it will not be subtracted from the selling price to determine the contract price.

A wraparound mortgage is valid unless the purchaser must discharge the underlying mortgage or the seller has so little control over the proceeds that he or she is essentially acting as a conduit for the mortgagee (e.g., a bank). In such situations, the wraparound is ignored, and the transaction is treated as if the buyer took the property subject to the first-lien note. Therefore, to preserve wraparound treatment, the seller should avoid:

1. payment terms substantially identical to those of the underlying mortgage, and

2. payments directly from the buyer to the underlying mortgagee.

Example 1F-1 Wraparound mortgage.

Murphy owns a parcel of real estate with an adjusted basis of $40,000 and a mortgage against it of $60,000. He enters into a contract to sell the property to John in 2010 for $150,000. The contract consists of a note for the entire amount, payable over several years. In 2010, Murphy receives principal payments of $12,000. In 2011, he receives an additional $24,000.

Assuming a valid wraparound mortgage, Murphy's gain is calculated as follows:

Contract price	$ 150,000
Basis	(40,000)
Gain on sale	$ 110,000
Gross profit percentage ($110,000 ÷ $150,000)	73.33%
Collections in 2010	$ 12,000
Gain in 2010 ($12,000 × 73.33%)	8,800
Collections in 2011	24,000
Gain in 2011 ($24,000 × 73.33%)	17,600

Example 1F-2 Wraparound mortgage requirements not met.

Assume the same facts as in Example 1F-1 except the wraparound mortgage was not valid (e.g., John made principal payments on Murphy's $60,000 mortgage directly to the bank). While Murphy's gain on the sale is still $110,000 ($150,000 sales price − $40,000 basis), his gross profit percentage is calculated as follows:

Sales price	$ 150,000
Mortgage assumed by buyer	(60,000)
Contract price	$ 90,000
Gross profit %	100%

Thus, Murphy will recognize 100% of the installment payments received each year as gain. However, note that although Murphy holds a $150,000 note receivable, $60,000 of that amount (the $60,000 paid directly to the bank by John) was considered to be debt assumed by the buyer and taken into consideration in the year of sale, resulting in a $20,000 gain in that year. Thus, the 100% gross profit percentage is only applied to $90,000 ($150,000 − $60,000) of note collections in later years. Murphy's total recognized gain will be $110,000 ($20,000 in the year of sale plus a $90,000 note from payments received in later years).

Installment Obligations Disposition

An installment obligation may be sold, satisfied at other than face value, or otherwise disposed of before all the gain from the installment sale has been recognized. In such cases, the remaining gain generally must be recognized upon disposition. However, certain transfers do not trigger the unrecognized gain.

Gain or loss on disposition is determined in one of two ways, depending on whether the obligation was (1) satisfied at other than face value, sold, or exchanged; or (2) distributed, transmitted, or disposed of other than by sale or exchange (e.g., by gift, dividend, cancellation, or in any way other than by sale or exchange). Any gain or loss is considered as resulting from the sale or exchange of the property for which the installment obligation was received, so the character of the gain or loss is the same as that of the original sale.

Sale, Exchange, or Satisfaction at Other Than Face Value

The gain or loss on a sale or exchange of an installment obligation (including satisfying the obligation for less than face value) is the difference between the obligation's basis and the amount realized. Basis is the excess of the obligation's face value over the income that would be reported if it had been paid in full.

Example 1G-1 Selling an installment obligation.

Jeff sold a painting for $10,000 that he had bought for $6,000 several years earlier, resulting in a gross profit percentage of 40%. He received a $2,800 down payment and a $7,200 note calling for 36 monthly payments of $200 plus interest. After receiving 10 payments, Jeff sold the note for $4,000.

Jeff's basis in the obligation at the time of sale is calculated as follows:

Initial face value of the note	$ 7,200
Less payments received ($200 × 10)	(2,000)
Face value at time of sale	5,200
Less gain not yet reported ($5,200 × 40%)	(2,080)
Basis of the installment note at time of sale	$ 3,120

The gain on sale of the note is $880 ($4,000 received − $3,120 basis). Assuming the original sale resulted in a capital gain, the gain is reported on Schedule D, Form 1040.

Example 1G-2 Settling an installment obligation at less than face value.

In 2005, Don sold a parcel of land (acquired in 1992) to Jack by taking an installment note for $200,000. Don's basis in the land and his selling expenses totaled $80,000, so his gain was $120,000 (60% gross profit). The note (which had an adequate stated interest rate) called for Don to receive annual principal payments of $20,000 over 10 years. For years 2005–2009, Don received $20,000 per year and reported long-term capital gain of $12,000 each year ($20,000 × 60%) on Form 6252 and Schedule D.

In 2010, Jack approached Don with an offer to settle the balance of the note ($100,000) for $30,000. Because the value of the land had declined, Don accepted Jack's offer. Don reports a 2010 long-term capital gain or loss equal to the difference between the amount accepted in settlement ($30,000) and his remaining basis in the note. Thus, he has a long-term capital loss of $10,000 computed as follows:

Settlement amount		$ 30,000
Basis in installment note:		
Face value at time of settlement	$ 100,000	
Less gain not yet reported ($100,000 × 60%)	(60,000)	(40,000)
Loss from settlement		$ (10,000)

Gain or loss from the settlement retains the same character as that resulting from the original sale of the property. The loss is reported on Schedule D as a long-term capital loss.

Disposition Other Than by Sale

The gain or loss on a disposition other than by sale is the difference between the obligation's basis and its FMV at the time of disposition. If an obligation is canceled or becomes unenforceable, it is considered a disposition other than by sale. In addition, if the canceled or unenforceable obligation is between related parties, the FMV of the obligation cannot be less than its face value.

Example 1G-3 Disposition of installment obligation by gift.

Assume the same facts as Example 1G-1 but, instead of selling the note, Jeff gives it to his sister, Marge. At the date of the gift, the FMV of the note is $4,500.

The gain is the difference between the FMV ($4,500) and Jeff's basis ($3,120) or $1,380.

Example 1G-4 Disposition of installment obligation due to bankruptcy.

Assume the same facts as in Example 1G-1 but, instead of selling the note, the buyer filed for bankruptcy, which caused the note to become worthless.

Jeff reports a loss of $3,120 (his basis in the note at the time of default) as a result of the bankruptcy. Since the original sale resulted in capital gain, the resulting loss is capital.

Transfer at Death. When an installment obligation is transferred at death, no gain or loss is recognized due to the transfer. The estate or heir generally is taxed on installment payments received in the same manner as the decedent would have been, with a possible income in respect of decedent deduction under IRC Sec. 691(c) for estate taxes

paid. However, if the obligation transfers to the buyer (i.e., maker of the note) at death or is canceled at death per the terms of either the original note agreement or the will (i.e., a self-cancelling installment note, or SCIN), the transfer or cancellation is treated as a disposition, and the unreported installment gain is included in gross income of the decedent's estate.

Transfers Incident to Divorce. In a transfer of an installment obligation between spouses during marriage or incident to divorce, no gain or loss is triggered by the transfer. Instead, the same tax treatment will apply to the transferee as would have applied to the transferor.

Transactions Not Considered Dispositions

Certain transactions will not be considered dispositions for purposes of IRC Sec. 453B. In Field Service Advice (FSA) 200125073, the IRS stated that its ruling position in regard to this issue could be summarized as follows:

1. Modification of an installment obligation by changing payment terms (e.g., increasing the rate of interest or deferring or increasing the payment dates) will not be considered a disposition under IRC Sec. 453B. See Rev. Rul. 68-419 in which the IRS ruled that the modification of the terms of a note to defer the payment of principal due under a note for five years and increase the interest from 6% to 7% was not a disposition within the meaning of former IRC Sec. 453(d) (the predecessor to IRC Sec. 453B).

2. When an original installment note is replaced, the substitution of a new note without any other changes will not be treated as a disposition. See Rev. Rul. 75-457 in which the IRS ruled that a substitution of obligors, deeds of trust, and promissory notes, without any other changes, was not considered a satisfaction or disposition of an installment obligation. In that ruling, a taxpayer sold real property for cash, a deed of trust, and a promissory note. Under the terms of the deed and note, the buyer was allowed to resell the property, provided that the subsequent buyer executed a new note under the same conditions and terms as the original deed of trust. Per the IRS, this is not a satisfaction or disposition of an installment obligation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following is correct for a wraparound mortgage?

    a. If a wraparound mortgage is executed, then the buyer will become liable for the remaining payments on the property.

    b. The numerator in the gross profit ratio of a wraparound mortgage is the face value of the obligation.

    c. The seller is taxed on the phantom payment received in the year of sale as a result of completing a wraparound mortgage.

    d. To protect a wraparound mortgage, the seller should not take payments directly from the buyer to the underlying mortgagee.

8. In which of the following scenarios was the disposition of the installment sale handled properly?

    a. George gifts his brother with an installment obligation with a FMV of $8,000. George's basis in the obligation is $6,200. George can claim a loss of $6,200 on his year-end tax return.

    b. Steven sold a delivery truck to John for $10,000, consisting of a $2,500 down payment and a $7,500 3-year installment note, giving Steven a capital gain. After receiving one payment from John, he declared bankruptcy. Steven treated the resulting loss as a capital loss.

    c. Lorna receives the reminder of an obligation on an installment sale from her ex-husband, Tim, as part of the settlement. Tim will recognize a loss for no longer having ownership of the installment obligation.

    d. Sean received an installment obligation through inheritance from his uncle passing away. Sean is obligated to recognize a gain in the amount of the current balance of the note.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Which of the following is correct for a wraparound mortgage? **(Page 114)**

   a. If a wraparound mortgage is executed, then the buyer will become liable for the remaining payments on the property. [This answer is incorrect. According to Reg. 15A453-1(b)(3)(ii), a wraparound mortgage is deemed to have been taken subject to the seller's mortgage, even though title has not passed and the seller remains liable for payments on the underlying debt.]

   b. The numerator in the gross profit ratio of a wraparound mortgage is the face value of the obligation. [This answer is incorrect. The gross profit for a wraparound mortgage is a fraction. The numerator is the face value of the obligation minus the taxpayer's basis in the obligation, and the denominator is the face value of the obligation.]

   c. The seller is taxed on the phantom payment received in the year of sale as a result of completing a wraparound mortgage. [This answer is incorrect. Since the property is not taken subject to the seller's mortgage, the seller is not taxed on a phantom payment received in the year of sale, even when the mortgage exceeds the seller's basis.]

   d. To protect a wraparound mortgage, the seller should not take payments directly from the buyer to the underlying mortgagee. [This answer is correct. A wraparound mortgage is valid unless the purchasers must discharge the underlying mortgage or the seller has so little control over the proceeds that he or she is essentially acting as a conduit for the mortgagee. In such situations, the wraparound is ignored, and the transaction is treated as if the buyer took the property subject to the first-lien note. Therefore, to preserve wraparound treatment, the seller should avoid: (1) payment terms substantially identical to those of the underlying mortgage, and (2) payments directly from the buyer to the underlying mortgagee.]

8. In which of the following scenarios was the disposition of the installment sale handled properly? **(Page 115)**

   a. George gifts his brother with an installment obligation with a FMV of $8,000. George's basis in the obligation is $6,200. George can claim a loss of $6,200 on his year-end tax return. [This answer is incorrect. Since George gifted the installment to his brother, the difference between the FMV and George's basis would be recognized as a gain by George per IRS rules.]

   b. Steven sold a delivery truck to John for $10,000, consisting of a $2,500 down payment and a $7,500 3-year installment note, giving Steven a capital gain. After receiving one payment from John, he declared bankruptcy. Steven treated the resulting loss as a capital loss. [This answer is correct. Per Ltr. Rul. 8136027, since the original sale resulting in a capital gain, the resulting loss would be capital, too.]

   c. Lorna receives the reminder of an obligation on an installment sale from her ex-husband, Tim, as part of the settlement. Tim will recognize a loss for no longer having ownership of the installment obligation. [This answer is incorrect. According to IRC Sec. 453B(g), in a transfer of an installment obligation between spouses during marriage or incident to divorce, no gain or loss is triggered by the transfer. Instead, the same tax treatment will apply to the transferee as would have applied to the transferor.]

   d. Sean received an installment obligation through inheritance from his uncle passing away. Sean is obligated to recognize a gain in the amount of the current balance of the note. [This answer is incorrect. When an installment obligation is transferred at death, no gain or loss is recognized due to the transfer as stated in IRC Sec. 453B(c). The estate or heir generally is taxed on installment payments received in the same manner as the decedent would have been, with a possible income in respect of decedent deduction under IRC Sec. 691(c) for estate taxes paid.]

Like-kind Exchanges

Mandatory nontaxable exchange treatment applies if all of the following requirements are satisfied:

1. The form of the transaction is a sale or exchange.

2. Both the property transferred and the property received are held either for productive use in a trade or business or for investment.

3. The properties transferred and received are like-kind property.

Because the nonrecognition treatment for like-kind exchanges is mandatory, a taxpayer who wants to recognize a realized gain or loss must structure the transaction so that it will fail to qualify as a like-kind exchange. However, when parties to the exchange are related, a two-year holding period exists for IRC Sec. 1031 to apply, as discussed later in this lesson.

What Is Like-kind Property?

The term *like-kind* refers to the nature or character of the property and not to its grade or quality. Although the term was intended to be interpreted broadly, limitations exist. One kind or class of property cannot be exchanged for property of a different kind or class. Real estate can be exchanged only for other real estate, and personal property can be exchanged only for other personal property. Therefore, the exchange of a machine for an office building is not a like-kind exchange.

The exchange of one business for another (each including assets such as cash, accounts receivable, real property, and personal property) cannot be treated as an exchange of a single property for another. Rather, the determination of whether IRC Sec. 1031 applies (or the extent to which it applies) to an exchange of the assets of one business for those of another requires an analysis of the underlying assets exchanged. See lesson 2 for coverage of purchase price allocations when a business is bought or sold.

Real Estate. Real estate includes buildings and land as well as various real estate interests, such as co-op units or producing oil leases. The IRS has held that a condominium and a share in a cooperative are like-kind properties, as are permanent conservation easements in two different pieces of real estate. It does not matter if the real estate is improved or unimproved. Thus, unimproved land can be exchanged for an apartment house. However, an exchange of improved for unimproved real estate may generate recapture income to the owner of the improved realty if accelerated depreciation has been used. See "Computing Gain or Loss" later in this key issue for more on recapture. In *Wiechens*, water rights and a fee-simple ownership interest in land were not like-kind assets because the water rights were limited in quantity, priority, and duration. In Ltr. Rul. 200404044, however, water rights of unlimited duration and farmland were like-kind assets and thus eligible for a tax-deferred Section 1031 exchange. In Ltr. Rul. 200842019, the IRS allowed like-kind exchange treatment for the swap of leasehold interests in office property. In Ltr. Rul. 200901020, IRS ruled that development rights for residential property was like-kind to fee-simple interest in real estate, long-term leasehold interest in real estate, and land development rights for a hotel. Also, the IRS will now issue rulings on whether an exchange of fractional interests in rental real property qualifies for gain deferral under IRC Sec. 1031.

Personal Property. Whether property is like-kind is generally construed more narrowly for personal property than for realty. Under Reg. 1.1031(a)-2, depreciable tangible personal property used in a business or held for investment is exchanged for property of a like kind if it is exchanged for property that is either of a like kind or a like class. Personal property is of a *like class* if the exchanged properties are either within the same General Asset Class or within the same Product Class. However, livestock of different gender do not qualify as like-kind property. Rev. Proc. 87-56 (as modified by Rev. Proc. 88-22) and Reg. 1-1031(a)-2(b)(2) describe 13 General Asset Classes. Examples include:

1. Office furniture, fixtures, and equipment (asset class 00.11).

2. Information systems (asset class 00.12).

3. Automobiles and taxis (asset class 00.22).

For transfers after August 11, 2004, six-digit product classes, based on the North American Industry Classification System (NAICS), generally apply for determining whether tangible personal property is within the same product class. These classes replace earlier four-digit classes based on the SIC Manual.

Property may be of a like-kind even if it is not of the same class. The IRS has ruled that cars, passenger vans, and sports utility vehicles (SUVs) are of a like-kind, even though they are not in the same general asset or product class. The IRS determined that the differences between those vehicles are merely differences in grade or quality. However, the IRS earlier ruled that a light-duty truck and an automobile are different enough in nature to be considered not of a like-kind (Ltr. Rul. 200241013). After Ltr. Rul. 200450005, this earlier ruling appears problematic.

Foreign Property. Real property located in the U.S. and real property located outside the U.S. are not like-kind. A similar rule for personal property provides that personal property used predominately within the U.S. and personal property used predominately outside the U.S. are not like-kind.

Purpose of Holding Property

To qualify for nonrecognition treatment, both the property exchanged and the property received must be held either for the productive use in a trade or business or for investment. Like-kind exchanges can include business for business, business for investment, investment for business, or investment for investment property. Property held for personal use, inventory, and partnership interests do not qualify under the like-kind exchange provisions. Securities (e.g., stocks and bonds), even though held for investment, do not qualify for like-kind exchange treatment. See "Like-kind Exchanges Involving Personal Residences or Rental Vacation Homes" later in this key issue for more information regarding this special topic.

An exchange qualifies only if the taxpayer meets the requisite holding purpose for both the property exchanged and the property received. Whether the other party to the exchange qualifies for nonrecognition treatment is irrelevant.

Example 1H-1 Requirement that property be held for investment or business purposes.

Andy owns a building he uses in his sole proprietorship. He exchanges his building for one owned by JAD Corp., an unrelated corporation. Immediately after the exchange, Andy transfers (in a prearranged transaction) the building he received to a new corporation (Ancorp) he formed. The transfer was a qualified Section 351 exchange for the corporation's stock. Ancorp will use the building in its trade or business. JAD Corp. uses both the building it exchanged and the one received in its trade or business.

For JAD Corp., the exchange is tax-free because it holds both the building exchanged and the one received for use in its trade or business. For Andy, however, the exchange is not tax-free. By immediately transferring the building received in the exchange to Ancorp in a prearranged transaction, Andy fails to meet the requirement that the he hold the property received in the exchange for use in a trade or business or for investment. (Although the building is used in a trade or business by his wholly-owned corporation, Andy was the party to the exchange so he must use the property received in the exchange in a trade or business or for investment.) Andy must recognize gain or loss on the exchange based on the difference between the fair market value of the building received and basis of the one he exchanged.

Variation: Could Andy have received tax-free exchange treatment if he transferred his building to Ancorp just before the exchange and let Ancorp be the party to the exchange? No. Ancorp must hold the property exchanged for use in its trade or business for the exchange to be tax-free. This requirement would not be met if it received the building in anticipation of making the exchange. If, on the other hand, Ancorp uses the building in its business so it meets the held for requirement and then makes the exchange, the exchange should qualify as tax-free.

Note that in Ltr. Rul. 200131014, the IRS stated that an individual transferring replacement properties to a limited liability company (LLC) treated as a disregarded entity (i.e., sole proprietorship) does not violate the Section 1031(a)(1) requirement that the property be used in a trade or business or held for investment.

Exchange Requirement Must Be Met

The transaction must involve a direct exchange of property to qualify as a like-kind exchange. Thus, the sale of old property and the purchase of new property, even though of a like kind, is generally not an exchange. On the other

hand, if the transactions are mutually dependent, the IRS could argue that the two interdependent transactions are a like-kind exchange. For example, according to Rev. Rul. 61-119, if the taxpayer sells an old business machine to a dealer and purchases a new one from the same dealer, a like-kind exchange could result. However, in a similar situation, an Arkansas district court held that transactions involving a sale of property must be reciprocal and mutually dependent. In *C. Bean Lumber Transport, Inc.*, the Court ruled that was not the case. The taxpayer received proceeds from the trade-in of trucks used in a business. However, these proceeds were not used to purchase the replacement trucks from the dealer. The taxpayer received the cash from trading in its trucks, spent it on whatever it desired and financed 100% of the purchase price of the replacement trucks (from the same dealer). The Court distinguished the case from Rev. Rul. 61-119 because the taxpayer simply converted property to cash, with no mutual dependency to use that cash to acquire the replacement trucks.

Computing Gain or Loss

Gain realized is the excess of the fair market value (FMV) of property received over the tax basis of the property given up. *Gain recognized* is the gain reported as taxable income because of the transaction. All, part, or none of the gain realized in a like-kind exchange may be recognized at that time for tax purposes. However, in no case can the gain recognized exceed the gain realized.

Effect of Boot on Exchange. If the taxpayer in a like-kind exchange gives or receives property that is not like-kind property, gain recognition may occur. Property that is not like-kind property (including cash) is called *boot*.

Receiving boot triggers gain recognition if there is realized gain. Gain is realized if the FMV of the property received exceeds the tax basis of the property given. The recognized gain is the lesser of the boot received or the realized gain (i.e., realized gain serves as the ceiling on the amount of gain that can be recognized).

Example 1H-2 Effect of boot received.

Jim and Bill exchange land in a transfer qualifying as a like-kind exchange under IRC Sec. 1031. Since Jim's land (adjusted basis of $20,000) is worth $24,000 and Bill's land is worth only $19,000, Bill also gives Jim $5,000 cash. Jim's recognized gain is $4,000, the lesser of the realized gain ($24,000 − $20,000) or the FMV of the boot received ($5,000).

Example 1H-3 Gain recognized limited to boot received.

Assume the same facts as in Example 1H-2 except Bill's land is worth $21,000 (not $19,000), and he gives Jim $3,000 cash to make up the difference. Jim's recognized gain is $3,000, the lesser of the realized gain ($24,000 − $20,000) or the FMV of the boot received ($3,000).

The receipt of boot does not result in loss recognition if there is a realized loss.

Example 1H-4 Realized loss with boot received.

Assume the same facts as Example 1H-2 except the adjusted basis of Jim's land is $30,000. His realized loss is $6,000 ($24,000 − $30,000). Jim does not recognize a loss on the transaction, whether or not he receives boot.

If the only boot given is cash, any realized gain or loss will not be recognized by the party who gives the cash. If, however, the boot given is appreciated or depreciated property, gain or loss is recognized to the extent of the difference between the adjusted basis and the FMV of the boot. For this purpose, appreciated or depreciated property is defined as property for which the adjusted basis is not equal to the FMV. The effect of this rule is that gain or loss is recognized on the boot given, but no gain or loss is recognized on the like-kind property transfer by the party who gives the boot.

Example 1H-5 Realized gain with cash boot given.

Joan and Beth exchange real property, which qualifies as a like-kind exchange under IRC Sec. 1031. Joan receives property with a FMV of $25,000 and transfers property worth $21,000 (adjusted basis of $15,000) and

cash of $4,000. Joan's realized gain is $6,000 ($25,000 − $15,000 basis of property − $4,000 cash given in the exchange). However, none of the realized gain is recognized because Joan gave cash boot.

Variation: Assume that instead of $4,000 in cash, Joan transferred securities worth $4,000 (basis $3,000) to Beth to equalize the value of the property exchanged. Joan realizes and recognizes gain of $1,000 ($4,000 − $3,000) with respect to the boot (securities) transferred. Her gain relative to the like-kind property exchanged is not recognized because she did not receive boot.

Section 1245 and 1250 Recapture. If property subject to Section 1245 depreciation recapture is transferred, recapture income is triggered to the extent of (1) gain recognized on the exchange determined without regard to Section 1245 recapture plus (2) the FMV of like-kind property received that is non-Section 1245 property and that is not taken into account under item (1). When Section 1250 property is transferred, Section 1250 recapture is recognized to the extent of (1) gain recognized on the exchange or (2) the amount by which potential Section 1250 recapture income exceeds the FMV of the Section 1250 property received in the transaction. However, any Section 1250 recapture that is not recognized carries over to the property received in the like-kind exchange.

Example 1H-6 Section 1245 recapture on like-kind exchange.

Taylor bought an office building (located on land subject to a 50-year lease) for $300,000 in 1983. The building was depreciated under accelerated ACRS. In 2010, when the building was fully depreciated, Taylor traded it for another building (Section 1250 property) in a transaction qualifying as a like-kind exchange. No boot was involved. The building she received was worth $500,000. Taylor realized a $500,000 ($500,000 FMV received less $0 basis given up) gain on the exchange. Because the property given up was Section 1245 property, her previous depreciation deductions are subject to recapture, as follows:

(1) Depreciation subject to recapture	$ 300,000
(2) Section 1245(b) limitation:	
Gain recognized before Section 1245 recapture, plus	$ —
FMV of non-Section 1245 property received (to the extent not included in gain recognized before Section 1245 recapture)	500,000
	$ 500,000
(3) Depreciation recapture [lesser of (1) or (2)]	$ 300,000

Therefore, Taylor recognizes $300,000 of ordinary income (depreciation recapture) and takes a basis of $300,000 in the building received in the exchange.

Section 179 Recapture. Generally, in the year property for which a Section 179 deduction was claimed is no longer predominantly used in the taxpayer's trade or business, the Section 179 expense must be recaptured as income. Although not entirely clear, the authors believe that exchanging an asset in a like-kind exchange does not cause the asset to cease to be used predominantly in the taxpayer's trade or business. Disposing of an asset in a transaction covered by IRC Sec. 1245(a) is specifically excepted from the types of transactions that result in the asset no longer being used predominantly in the taxpayer's business. Like-kind exchanges can result in ordinary income recapture, but the amount of recapture income is determined under IRC Sec. 1245(b). Because it is subject to IRC Sec. 1245(a) [even though recapture income may be limited by IRC Sec. 1245(b)], a like-kind exchange should generate recapture income only to the extent of the Section 1245 recapture described above, but not of the entire Section 179 expense.

Example 1H-7 Recapture income at like-kind exchange.

In 2008, Walter purchased a phone system for his business for $15,000. He expensed the entire cost under IRC Sec. 179 in 2007. In 2010, he traded the system (then worth $10,000) for a new system in a like-kind exchange. The system Walter received in the exchange was only worth $8,000, so Walter also received $2,000 cash (boot) in the exchange. Walter's realized gain on the exchange is $10,000 ($10,000 FMV of property

received less $0 adjusted basis in property given up). However, his recognized gain is limited to the boot received, $2,000. The entire $2,000 gain is ordinary income because the previously claimed Section 179 expense must be recaptured (to the extent of recognized gain).

Basis and Holding Period of Property Received

Basis. If an exchange does not qualify as nontaxable under IRC Sec. 1031, gain or loss is recognized, and the property's basis received in the exchange is its FMV. If the exchange qualifies for nonrecognition, the basis of property received is adjusted to reflect any deferred gain or loss. The basis of like-kind property received in a Section 1031 exchange is computed as follows:

	Adjusted basis of like-kind property given
+	FMV of boot given (if any)
+	Gain recognized on like-kind property given (if any)
−	FMV of boot received (if any)
=	Basis of like-kind property received

Holding Period. The holding period of the property surrendered in a Section 1031 exchange carries over and tacks on to the holding period of the like-kind property received. The boot received has a new holding period (i.e., beginning on the date of exchange) rather than a carryover holding period.

Example 1H-8 Like-kind transactions—comprehensive example.

Glenn, a small-scale vintner, exchanged the following land parcels used for growing grapes for new parcels in five independent like-kind exchanges in 2010:

Exchange	Adjusted Basis of Old Parcel	FMV of New Parcel	Cash Boot Given	Cash Boot Received
1	$ 8,000	$ 18,000	$ —	$ —
2	8,000	18,000	6,000	—
3	8,000	18,000	12,000	—
4	8,000	18,000	—	6,000
5	8,000	7,000	—	600

Glenn's realized and recognized gains and losses and the basis of each of the like-kind properties received are computed as follows:

Exchange	Realized Gain (Loss)	Recognized Gain (Loss)	Old Adj. Basis	Boot Given	Gain Recognized	Boot Received	New Basis
1	$ 10,000	$ —	$ 8,000	$ —	$ —	$ —	$ 8,000
2	4,000	—	8,000	6,000	—	—	14,000
3	(2,000)	—	8,000	12,000	—	—	20,000
4	16,000	6,000	8,000	—	6,000	6,000	8,000
5	(400)	—	8,000	—	—	600	7,400

Depreciating Property Acquired in Like-kind Exchanges

Final regulations issued in 2007 provide rules for depreciating property acquired in a like-kind exchange. These regulations generally apply only to like-kind exchanges of MACRS property if both the property is given up and the replacement property is received after February 27, 2004, when the temporary regulations were originally issued. However, taxpayers can elect to apply the rules in the final regulations to earlier transactions. IRS Notice 2000-4 provides guidance on depreciating property acquired in like-kind exchanges before the effective date of the regulations.

Tax Reporting

Taxpayers who engage in like-kind exchanges of investment or business property must file Form 8824 (Like-Kind Exchanges) for each exchange. Section 1031 exchanges should be reported even when no gain is recognized. If gain or loss is recognized on the exchange, it is reported on Form 4797 (for business property) or Schedule D (for investment property). If a single exchange involves multiple properties, the details of the exchange should be reported on a statement attached to Form 8824. Both real and personal property exchanges are reported on Form 8824.

In most real property transactions, the seller will receive Form 1099-S (Proceeds From Real Estate Transactions). The authors recommend reporting the Form 1099-S sales price on Form 4797 (or Schedule D, if applicable), and plugging basis to result in the gain actually recognized (if any).

Like-kind Property with Liabilities Attached

Like-kind exchanges may involve properties burdened by debt. The assumption of debt by a transferee is treated by the transferor as boot. Whether a liability has been assumed for this purpose is determined under IRC Sec. 357(d), and is generally based upon the facts and circumstances. The taxpayer who assumes the debt gives boot, and the taxpayer whose debt is assumed receives boot. To determine the boot given or received, the boot resulting from liabilities is netted for both parties. However, net boot given in the form of liabilities cannot reduce boot received in the form of cash or other property.

Example 1H-9 Exchange of like-kind properties burdened by liabilities.

Joe exchanged Blue Acres for Chase Downs, a property owned by Stan. Both Joe and Stan assumed the debt on the existing mortgages. The transaction qualified for Section 1031 treatment. Information on the properties includes:

	Blue Acres	Chase Downs
FMV	$ 2,000,000	$ 1,800,000
Mortgage	1,700,000	1,750,000
Basis	1,500,000	1,600,000

Since the equity in Blue Acres is $300,000 (versus $50,000 for Chase Downs), Stan had to pay Joe $250,000 cash to close the deal.

Joe's realized gain is computed as follows:

Blue Acres debt shifted to Stan	$ 1,700,000
+Cash boot received	250,000
+FMV of Chase Downs	1,800,000
−Basis of Blue Acres	(1,500,000)
−Chase Downs debt assumed	(1,750,000)
Gain realized	$ 500,000

Joe's recognized gain is limited to $250,000, the amount of cash received. Because Joe gave more boot (by assuming debt of $1,750,000) than he received (by surrendering debt of $1,700,000), he is deemed to have paid boot of $50,000 in debt. However, net boot given in the form of debt may not be offset against boot received in the form of cash or other property. Therefore, Joe must recognize gain to the extent of the $250,000 of cash received.

Joe's basis in Chase Downs is $1,550,000, calculated as follows:

Adjusted basis of Blue Acres	$ 1,500,000
FMV of boot given (debt assumed)	1,750,000
Gain recognized	250,000
FMV of boot received ($1,700,000 debt transferred + $250,000)	(1,950,000)
Adjusted basis—Chase Downs	$ 1,550,000

Joe has deferred $250,000 of his realized gain on the exchange ($500,000 gain realized less $250,000 gain recognized). However, the FMV of Chase Downs exceeds Joe's adjusted basis in the property by $250,000 ($1,800,000 − $1,550,000). Thus, Joe has a $250,000 built-in gain in Chase Downs.

Line 15 of Joe's Form 8824 is calculated as follows:

Cash and other property (*not* like-kind):		
Cash received		$ 250,000
−Cash given		—
+FMV of other property received		—
−FMV of other property given		—
Net cash and other property received (given)		250,000
Liabilities:		
Liabilities transferred		1,700,000
−Liabilities assumed		(1,750,000)
Net liabilities transferred (not below zero)		—
Excess liabilities assumed	$ 50,000	
Exchange costs		—
Net boot received (not below zero)		$ 250,000
Excess cash and other property given	$ -0-	

Line 18 of Joe's Form 8824 is calculated as follows:

Adjusted basis of property transferred	$ 1,500,000
+Excess liabilities assumed	50,000
+Excess cash and other property given	—
Adjusted basis of like-kind property received	$ 1,550,000

Stan's realized gain is $200,000 (computed the same way as for Joe). Stan will not have to recognize any gain because the boot he is deemed to have received in the form of debt is less than the boot he gave. Stan gave boot of $1,950,000 (assumed $1,700,000 in debt and paid $250,000 in cash), and received (surrendered) boot of $1,750,000. The net boot received in the form of liabilities is offset by the amount of boot paid in the form of cash.

Related Person Exchanges

IRC Sec. 1031(f) provides a special rule for exchanges between related persons. A related person generally includes family members (spouse, sibling, parent, child, etc.), more than 50% controlled corporations and partnerships, and certain fiduciary relationships.

If related taxpayers exchange properties and either of them disposes of their property within two years, gain or loss originally not recognized under the Section 1031 rules will be recognized (i.e., IRC Sec. 1031 will not apply). Any gain or loss so recognized is considered in the year the disqualifying disposition occurs. However, losses are subject to the disallowance rules of IRC Sec. 267 for sales or exchanges between related parties.

A disposition during the two-year period will *not* trigger the unrecognized gain or loss if:

1. the disposition is after the death of the taxpayer or the related person;

2. the disposition is in a compulsory or involuntary conversion, as long as the exchange occurred before the threat or imminence of the conversion; or

3. it is established to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes.

Example 1H-10 Related person exchange.

Max owns a parcel of real estate with a basis of $20,000 and FMV of $50,000. His brother, Loki, owns a similar parcel with a basis of $40,000 and FMV of $50,000. They exchange properties, and afterward their bases in their new property is the same as their bases in their old property—$20,000 for Max and $40,000 for Loki.

If Loki sells his property one year after the exchange and cannot prove that neither the exchange nor disposition had tax avoidance as a principal purpose, IRC Sec. 1031 no longer applies. As of the date of the sale, both Loki and Max must recognize gain on the exchange, to the extent of the excess of FMV of the asset received ($50,000 for both Max and Loki) over the adjusted basis of the asset surrendered in the exchange ($20,000 for Max and $40,000 for Loki). Thus, Max would recognize gain of $30,000 and Loki would recognize a gain of $10,000.

Like-kind Exchanges Involving Personal Residences or Rental Vacation Homes

Taxpayers cannot claim the Section 121 exclusion for a personal residence acquired in a like-kind exchange subject to the rules of IRC Sec. 1031 if the residence is sold during the five-year period after the date the residence was acquired. Consequently, if a taxpayer acquires a personal residence in a like-kind exchange, he or she must wait at least five years after the date of acquisition to take advantage of the $250,000/$500,000 gain exclusion on a sale of the residence. For sales or exchanges after October 22, 2004, the GO Zone Act extended this five-year required holding period for personal residences acquired in a like-kind exchange to any person whose basis in the principal residence is determined in whole or in part by reference to the basis in the taxpayer's hands (i.e., as the result of a gift, divorce, etc.).

Gain deferral on like-kind exchanges under IRC Sec. 1031 is normally not available to homes unless held for the production of income or as investment property. A vacation home does not qualify for like-kind exchange, even if one of the motives in acquiring the home was the prospect of appreciation. However, Rev. Proc. 2008-16 provides a safe harbor for when a second home will qualify as held either for productive use in a trade or business or for investment purposes.

Under Rev. Proc. 2008-16, the IRS will not challenge that a property qualifies for Section 1031 gain deferral if:

1. the relinquished property has been held for at least 24 months immediately preceding the exchange and in each of the two 12-month periods immediately preceding the exchange,

   a. the taxpayer rents the residence to another person at fair market value for at least 14 days, and

   b. the taxpayer does not use the property more than the greater of 14 days or 10% of the total number of days the property was used; and

2. the replacement property is held for at least 24 months immediately after the exchange and in each of the two 12-month periods immediately following the exchange,

   a. the taxpayer rents the residence to another person at fair market value for at least 14 days, and

   b. the taxpayer does not use the property more than the greater of 14 days or 10% of the total number of days the property was used.

For this safe harbor, personal use and fair rental are determined under the same rules as for a vacation home.

Example 1H-11 Like-kind exchange of second residence.

Albert owns a second residence that he has used as a vacation home. He purchased the property in 2006. From September 1, 2008, through August 31, 2009, he personally used the property eight days and rented it

at fair value for 26 days. From September 1, 2009, through August 31, 2010, he personally used the property 24 days and rented it at fair value for 260 days. On September 1, 2010, he exchanged the property for a new vacation home (no boot given or received).

Since for each 12-month period in the 24 months preceding the sale Albert rented the property for at least 14 days (26 for September 1, 2008, through August 31, 2009, and 260 for September 1, 2009, through August 31, 2010) and his personal use did not exceed the greater of 14 days or 10% of total usage [fewer than 14 days for September 1, 2008, through August 31, 2009, and less than 10% (24/284 = 8.45%) for September 1, 2009, through August 31, 2010], the relinquished property qualifies for the safe harbor. As long as Albert continues the same pattern of renting the replacement property for the period from September 1, 2010, through August 1, 2012, this exchange will meet the safe harbor and qualify as a Section 1031 exchange.

Deferred Exchanges

A *deferred exchange* is one in which property received in the exchange (replacement property) is not received immediately upon the transfer of property given up (relinquished property). The deferred exchange rules are the result of the *Starker* case, which first allowed exchanges that were not simultaneous.

Reg. 1.1031(k)-1 provides rules governing deferred exchanges. The two primary requirements to qualify a deferred exchange as a like-kind exchange are that (1) the replacement property must be identified before the end of the 45-day identification period and (2) the identified property must be transferred before the earlier of the 180-day or return due date exchange period.

Identification Period. The identification period begins when the taxpayer transfers the relinquished property and ends 45 days thereafter. During this period, the replacement property must be identified or unambiguously described. The courts require strict adherence to this rule (*Dobrich*). Replacement property is identified if it is received before the end of the period or if it is so designated by a legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building) in the exchange agreement or in a written document signed by the taxpayer and hand delivered, mailed, faxed, or otherwise sent to either (1) the person obligated to transfer the replacement property to the taxpayer, or (2) any other person involved in the exchange other than the taxpayer or a disqualified party (e.g., an intermediary, an escrow agent, or a title company). A disqualified party includes both related parties and someone who acts as the taxpayer's agent (including individuals performing services as the taxpayer's employee, attorney, or broker).

The replacement property received must be substantially the same property identified in the notice, but an original designation can be revoked and a new one made within the 45-day period. Furthermore, the taxpayer may identify (1) up to three properties as replacement properties without regard to FMV; (2) more than three properties provided the aggregate FMV of these properties at the end of the identification period does not exceed 200% of the aggregate FMV of all properties relinquished; or (3) any number of properties of any value provided that 95% of the FMV of all properties identified are received by the end of the exchange period (see below).

Exchange Period. The exchange period also begins on the date of transfer of the relinquished property, and ends on the earlier of (1) 180 days thereafter or (2) the due date, including extensions, of the tax return for the year the relinquished property is transferred. Taxpayers should consider extending their return if the 180-day period straddles year-end and is cut short by the original due date of the return. If more than one property is relinquished, the earliest transfer date controls (also for purposes of the identification period).

The exchange period must be met to qualify as a deferred (like-kind) exchange. An exchange did not qualify when the taxpayer relied on the automatic four-month extension for filing his tax return to complete the exchange, even though he never requested the extension. However, in *Christensen*, the Court allowed the transaction to be treated as an installment sale because the property received in the exchange was received in a tax year subsequent to the tax year in which property was relinquished. Also, if the 45-day or 180-day period ends on a Saturday, Sunday, or holiday, IRC Sec. 7503 does not apply to extend the deadline to the next business day.

Both the 45-day identification period and the 180-day exchange period begin when the taxpayer transfers the relinquished property. Thus, the time prior to the closing (i.e., transfer) date is, in effect, additional time the taxpayer can use to meet these deadlines. The IRS can extend both deadlines in situations involving federally declared

disasters, terrorist attacks, military actions, and cases where taxpayers are serving in combat zones or contingency operations.

Multiple-party Exchanges. Often, when replacement property is located, its owner wants cash (or other property) rather than the property that the taxpayer wants to exchange. A multiple-party exchange can be arranged to result in each party getting the property (including cash) that they want, while preserving Section 1031 treatment for the party who gives up and receives like-kind property in the exchange. Multiple-party exchanges with three or four parties are permitted (IRS Pub. 544, "Sales and Other Dispositions of Assets"). Often, a qualified intermediary (QI) is used to facilitate the exchange by locating the parties to the exchange and holding and eventually disbursing the property and cash transferred between the parties.

Example 1H-12 Exchanges involving three-way swaps.

Ed owns property A, which he wants to exchange for property B, held by Sam. Sam wants cash and is unwilling to exchange B for A. However, Paul wants Ed's property and is willing to pay cash for it. A and B are considered to be like-kind property. Paul buys B from Sam and then exchanges B for A with Ed. Sam receives cash and Paul and Ed wind up with their desired properties.

This transaction can qualify under IRC Sec. 1031 as a like-kind exchange for Ed even though Paul never has title to the property transferred to Ed. This approach alleviates the task and the cost of having to transfer title to the property twice.

Bankrupt or Insolvent Qualified Intermediaries. Because IRC Sec. 1031 does not provide for an extension of the statutorily mandated period to complete a like-kind exchange, a problem has been created in recent years because qualified intermediaries have filed for bankruptcy, jeopardizing the like-kind exchanges they were handling for clients. For a taxpayer whose like-kind exchange fails due to a qualified intermediary (QI) default occurring on or after January 1, 2009, Rev. Proc. 2010-14 provides a safe harbor method of reporting gain or loss for certain taxpayers who initiate deferred like-kind exchanges but fail to complete the exchange because a QI defaults on its obligation to acquire and transfer replacement property to the taxpayer.

Avoiding Constructive Receipt of Cash or Unlike Property. In a typical deferred exchange, the taxpayer transfers property to the transferee (or a qualified intermediate) who promises to acquire replacement property and transfer it to the taxpayer. Normally, the transferor wants some sort of guarantee that the transferee will follow through on this obligation. However, if the guarantee is structured so that the transferor is considered in constructive receipt of cash or unlike property before receiving the like-kind property, the transaction will be treated as a sale rather than a deferred exchange.

Several safe harbors exist so that the transferor will not be considered in constructive receipt of cash or unlike property if the transferee's obligation to transfer replacement property to the transferor is secured by a mortgage, standby letter of credit, third-party guarantee, qualified escrow account, or qualified trust or if the transferor retains a qualified intermediary to facilitate the exchange. Furthermore, a taxpayer's use of these safe harbors will not result in receipts for the installment sale rules. This exception applies only if the taxpayer, at the beginning of the exchange period, had a bona fide intent (based on facts and circumstances) to enter into a deferred exchange. Thus, the installment method remains available to a taxpayer if gain is ultimately recognized on the deferred exchange.

Example 1H-13 Deferred exchange using a qualified escrow account.

Bob owns a parcel of real estate with a basis of $40,000 and an FMV of $100,000 that he wants to exchange for another parcel of real estate. Bill wants to acquire Bob's property, but he does not own any property that Bob is interested in acquiring. Bill is, however, willing to enter into a deferred exchange with Bob.

On October 1, 2010, Bob transfers the property to Bill, and Bill agrees to acquire suitable replacement property and transfer it to Bob. Bill's obligation is secured by $100,000 deposited in a qualified escrow account. Bob has no right to this cash until the earlier of the date the replacement property is delivered or the exchange period ends.

On November 10, 2010, Bob identifies suitable replacement property with an FMV of $80,000. Bill acquires the property and delivers it along with the remaining $20,000 to Bob on January 31, 2011.

All of the requirements of a deferred exchange have been met. Therefore, Bob's receipt of Bill's obligation on October 1, 2010, does not constitute payment. Instead, Bob is treated as receiving payment on January 31, 2011, of $80,000 of like-kind property and $20,000 cash. Therefore, he will recognize a $20,000 gain (the lesser of his $60,000 realized gain on the exchange or the $20,000 boot received) in 2011.

Specific guidance does not currently exist on the reporting requirements for 2010 in this situation. The authors recommend completing the applicable lines of Part I of Form 8824 and attaching a supplement schedule to that form explaining the details of the transaction and stating that it was not completed until 2011. Then in 2011, the Form 8824 should be completed in accordance with the instructions to that form reporting the gain recognized.

Taxation of Earnings Inside Escrow Accounts. In a deferred exchange, funds often are placed in a qualified escrow or trust account by the purchaser until suitable replacement property can be purchased and exchanged with the transferor. Funds held in these types of accounts can generate taxable earnings (i.e., interest, capital gains). In these situations, the exchange facilitator (i.e., the qualified intermediary) is generally treated as owning the qualified escrow or trust account and usually is taxed on the income generated by the account. However, if the taxpayer is paid all the income generated by the escrow account, the taxable income is allocated to that party. These regulations, finalized in 2008, provide transition rules for transfers made after August 16, 1986, and before October 8, 2008. Reg. 1.7872-16(f), also finalized in 2008, provides an exemption from imputed interest rules for transactions of less than $2,000,000 lasting six months or less in which funds are treated as being loaned by the taxpayer to the exchange facilitator.

Example 1H-14 Taxing the earnings of a qualified escrow account.

Assume the same facts as in Example 1H-13. The earnings of the account from October 1, 2010–December 31, 2010, are taxable to Bob in 2010 and the earnings from January 1, 2010–January 31, 2011, are taxable to Bob in 2011.

LKE Programs. Rev. Proc. 2003-39 provides safe harbors with respect to ongoing programs involving multiple exchanges of 100 or more tangible personal properties using a single intermediary. These exchanges are referred to as LKE programs. The revenue procedure outlines the characteristics that must be present in a qualifying program.

Rev. Proc. 2003-39 provides safe harbors for certain aspects of qualification under IRC Sec. 1031 of LKE program property exchanges. However, a transaction must also satisfy the Section 1031 requirements for which safe harbors are not provided in the procedure (e.g., whether property involved in an exchange meets the Section 1031 definition of like-kind property). These safe harbors pertain to (1) treatment of each property exchange as a separate and distinct exchange; (2) treatment of money or other property as actually or constructively received; and (3) determining whether an intermediary is a qualified intermediary or disqualified person.

Reverse Exchanges. The regulations do not address reverse Starker exchanges (a taxpayer first receiving replacement property, then transferring relinquished property). However, Rev. Proc. 2000-37 (as modified by Rev. Proc. 2004-51) provides a safe harbor for reverse like-kind exchanges under a qualified exchange accommodation arrangement (QEAA). If the safe harbor requirements are met, the IRS will not challenge the qualification of the property involved as replacement property or relinquished property. Also, the intermediary's status as the property's beneficial owner will be respected. The IRS has also approved a direct reverse Starker exchange that did not involve a third party.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Transactions that satisfy the requirements of IRC Sec. 1031 must be treated as non-taxable like kind exchanges. Which of the following transactions is a like-kind exchange?

    a. Jim exchanges a building he uses for his law practice for a building owned by Robert. Jim will move his law practice to the new building.

    b. Sam exchanges a fancy sports car for a 50% interest in Sue's dress shop. Sam will become the managing partner and hopes to make the business very profitable.

    c. Slim, who operates a dairy, trades his heifer for Billy Bob's bull. Slim plans to use the bull in his dairy business as a stud.

    d. Ruth decides to exchange her cottage on West Street where she has operated an alterations business for 25 years for a new home on East Street. Ruth will retire and live in the new home.

10. For the purpose of determining if an exchange qualifies for like-kind treatment which of the following statements is **incorrect**?

    a. Like-kind property is property of the same type or class.

    b. Property may be classified as like-kind, even if it is not from the same class.

    c. Unimproved land can be exchanged for improved land.

    d. Real property located in U.S. can be exchanged for property located in Mexico.

11. In reporting the gain from a like kind exchange it is important to differentiate between the gain realized and the gain recognized. Which of the following best describes the gain realized on a like-kind exchange?

    a. The gain reported from a transaction that results in taxable income for the taxpayer.

    b. The excess of the fair market value of all the property received and the tax basis of all the property transferred.

12. Diane and Suzanne exchange real property. The exchange qualified as a Section 1031 exchange. Diane transfers her property with a FMV of $25,000 (adjusted basis of $15,000) to Suzanne for her property with a FMV of $20,000 and $5,000 cash. How much gain should Diane report in the year of the transaction?

    a. $0.

    b. $5,000.

    c. $10,000.

    d. $25,000.

13. If a like-kind exchange qualifies for nonrecognition under IRC Sec. 1031, the basis of the property received must be calculated. When determining basis, which of the following is correct regarding the calculation?

    a. The FMV of the boot given should be subtracted to compute the new basis in the like-kind property received.

    b. The recognized gain on the like-kind property given in the transaction should be subtracted to reach the basis.

    c. The calculation should begin with the adjusted basis of the like-kind property given in the transaction.

    d. The FMV of the boot received from the seller should be added back to reach the basis on the like-kind property received.

14. When property in a like-kind exchange is not received immediately upon the transfer of the property given up, this is referred to as a deferred exchange. Which of the following is correct regarding a deferred exchange?

    a. The two requirements of a deferred exchange is that the replacement property must be identified before the end of the identification period and the property must be transferred before the end of the exchange period.

    b. If the exchange period ends on a Saturday or Sunday, the taxpayer can have the next business day to surrender the property to the other party.

    c. The identification period begins when the taxpayer transfers the relinquished property and ends 180 days after in a deferred exchange.

    d. The exchange period begins when the taxpayer formulate the deal for the deferred exchange with the other party.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Transactions that satisfy the requirements of IRC Sec. 1031 must be treated as non-taxable like kind exchanges. Which of the following transactions is a like-kind exchange? **(Page 121)**

    a. Jim exchanges a building he uses for his law practice for a building owned by Robert. Jim will move his law practice to the new building. [This answer is correct. The transaction was a like-kind exchange. Both the old and the new buildings were held for use in the law firm. The properties are both buildings therefore they are like-kind property. The transaction meets the requirements under IRC Sec. 1031.]

    b. Sam exchanges a fancy sports car for a 50% interest in Sue's dress shop. Sam will become the managing partner and hopes to make the business very profitable. [This answer is incorrect. Sam's sports car was used for personal pleasure with no intent to generate income. IRC Sec 1031 require that both the property received and the property transferred be held for the production of income.]

    c. Slim, who operates a dairy, trades his heifer for Billy Bob's bull. Slim plans to use the bull in his dairy business as a stud. [This answer is incorrect. Although the property transferred and received will both be used in Slim's dairy the IRS has ruled that livestock of different gender do not qualify as like-kind property.]

    d. Ruth decides to exchange her cottage on West street where she has operated an alterations business for 25 years for a new home on East street. Ruth will retire and live in the new home. [This answer is incorrect. Although her cottage and the house are both houses, the cottage was held for productive use in a business while the house will be held for personal use. This transaction does not meet the requirements under IRC Sec. 1031 for a like-kind exchange.]

10. For the purpose of determining if an exchange qualifies for like-kind treatment which of the following statements is **incorrect**? **(Page 121)**

    a. Like-kind property is property of the same type or class. [This answer is incorrect. Generally under the like-kind exchange rules real estate can be exchanged for real estate, personal property can be exchanged for other similar personal property.]

    b. Property may be classified as like-kind, even if it is not from the same class. [This answer is incorrect. Property may be of a like-kind even if it is not of the same class. The IRS has ruled that cares, passenger vans, and sports utility vehicles are of a like-kind, even though they are not in the same general asset or product class.]

    c. Unimproved land can be exchanged for improved land. [This answer is incorrect. IRC Sec. 1031 treats unimproved land and improved land as being like kind. However, an exchange of improved for unimproved real estate may generate recapture income to the owner of the improved reality if accelerated depreciation has been used per IRC Sec. 1250(d)(4).]

    d. Real property located in U.S. can be exchanged for property located in Mexico. [This answer is correct. According to IRC Sec. 1031(h)(1), real property located in the United States and real property located outside the United States are not like-kind.]

11. In reporting the gain from a like kind exchange it is important to differentiate between the gain realized and the gain recognized. Which of the following best describes the gain realized on a like-kind exchange? **(Page 121)**

    a. The gain reported from a transaction that results in taxable income for the taxpayer. [This answer is incorrect. The gain recognized, not realized, is the gain reported as taxable income because of the transaction.]

    b. The excess of the fair market value of all the property received and the tax basis of all the property transferred. [This answer is correct. Gain is only realized when the FMV of property received

exceeds the tax basis of the property transferred. A realized gain may be deferred under IRC Sec. 1031.]

12. Diane and Suzanne exchange real property. The exchange qualified as a Section 1031 exchange. Diane transfers her property with a FMV of $25,000 (adjusted basis of $15,000) to Suzanne for her property with a FMV of $20,000 and $5,000 cash. How much gain should Diane report in the year of the transaction? **(Page 121)**

    a. $0. [This answer is incorrect. Diane received a portion which does not qualify as like-kind, therefore part of the transaction must be reported as income in the year of transaction under IRC Sec. 1031.]

    b. $5,000. [This answer is correct. Diane has a gain of $10,000 and received cash of $5,000. IRC Sec. 1031 requires that if the taxpayer in a like-kind exchange gives or receives property that is not like-kind property, gain recognition may occur. Property that is not like-kind property (including cash) is called boot.]

    c. $10,000. [This answer is incorrect. Diane's total gain on the transaction is $10,000, but under IRC Sec. 1031 only part of that must be recognized in the year of the transaction.]

    d. $25,000. [This answer is incorrect. Diane's total gain realized on the transaction is only $10,000. The recognized gain is the lesser of the boot received or the realized gain (i.e., realized gain serves as the ceiling on the amount that can be recognized) per IRC Sec. 1031(b). Diane did receive boot in this transaction.]

13. If a like-kind exchange qualifies for nonrecognition under IRC Sec. 1031, the basis of the property received must be calculated. When determining basis, which of the following is correct regarding the calculation? **(Page 121)**

    a. The FMV of the boot given should be subtracted to compute the new basis in the like-kind property received. [This answer is incorrect. According to IRC Sec. 1031(d), when calculating the basis of like-kind property received in a nonrecognition transfer, the FMV of the boot given should be added, not subtracted.]

    b. The recognized gain on the like-kind property given in the transaction should be subtracted to reach the basis. [This answer is incorrect. The gain recognized on like-kind property given should be added to the computation to arrive at the new basis of like-kind property received in a nonrecognition IRC Sec. 1031 transaction.]

    c. The calculation should begin with the adjusted basis of the like-kind property given in the transaction. [This answer is correct. To arrive at the basis of the like-kind property received in the transaction, the computation should begin with the adjusted basis of the like-kind property given in the transaction. Then the FMV of the book given should be added, the gain recognized on like-kind property given should be added and finally, the FMV of any book received should be subtracted per IRC Sec. 1031(b).]

    d. The FMV of the boot received from the seller should be added back to reach the basis on the like-kind property received. [This answer is incorrect. To calculate the basis of the like-kind property received, the buyer should subtract the FMV of the boot received from the seller as indicated in IRC Sec. 1031(b).]

14. When property in a like-kind exchange is not received immediately upon the transfer of the property given up, this is referred to as a deferred exchange. Which of the following is correct regarding a deferred exchange? **(Page 121)**

    a. The two requirements of a deferred exchange is that the replacement property must be identified before the end of the identification period and the property must be transferred before the end of the exchange period. [This answer is correct. Reg. 1/1031(k)-1 provides rules governing deferred exchanges. The two primary requirements to qualify a deferred exchange as a like-kind exchange are that (1) the replacement period must be identified before the end of the 45-day identification period and (2) the identified property must be transferred before the earlier of the 180-day or return due date exchange period.]

    b. If the exchange period ends on a Saturday or Sunday, the taxpayer can have the next business day to surrender the property to the other party. [This answer is incorrect. If the 180-day exchange period ends on a Saturday, Sunday or holiday, IRC Sec. 7503 does not apply to extend the deadline to the next business day as indicated in Rev. Rul. 83-146.]

    c. The identification period begins when the taxpayer transfers the relinquished property and ends 180 days after in a deferred exchange. [This answer is incorrect. The identification period begins when the taxpayer transfer the relinquished property and ends 45 days thereafter. During this period, the replacement property must be identified or unambiguously described.]

    d. The exchange period begins when the taxpayer formulate the deal for the deferred exchange with the other party. [This answer is incorrect. Both the identification period and the exchange period begin with the taxpayer transfers the relinquished property. Thus, the time period prior to the closing (i.e., transfer) date is, in effect, additional time the taxpayer can use to meet those deadlines.]

Involuntary Conversions

A taxpayer can elect, pursuant to IRC Sec. 1033, to defer gains realized from involuntary conversions of property resulting from destruction, theft, seizure, condemnation, or threat thereof (see Rev. Rul. 81-180 and Ltr. Rul. 200145001 for guidance on when a sale is deemed to be "under the threat of condemnation"). To completely defer the gain, the taxpayer must purchase property (or stock in a corporation holding similar assets) that is similar or related in service or use to the original property that costs at least as much as the amount realized upon conversion (e.g., insurance proceeds).

To qualify for Section 1033 gain deferral, the property must be so damaged that it cannot be repaired (*C.G. Willis, Inc.*). However, in *Willamette Industries*, the Tax Court allowed the taxpayer to defer gain realized on property (trees) that were damaged by various natural calamities and thus harvested early and processed into paper in the taxpayer's ordinary course of business. Although it was possible to process the trees in the same manner as if they had been harvested at maturity, the Court focused on the fact that the casualty forced the taxpayer to harvest the trees earlier than scheduled to prevent further loss.

It is not necessary that the entire amount of the conversion proceeds received be used to acquire the replacement property rather than the use of a mortgage. IRC Sec. 1033(a)(2) and Reg. 1.1033(a)-2 say only that gain must be recognized if the amount realized exceeds the cost of the replacement property. It does not say that the amount realized has to actually be invested in the replacement property.

Example 1I-1 Using a mortgage to acquire replacement property.

Ted Smith received $50,000 from his insurance company for the destruction of a piece of real estate with an adjusted basis of $20,000. He purchased a replacement piece of property by using $10,000 cash and assuming a $40,000 mortgage on the replacement property. The replacement property's cost is at least equal to the proceeds; therefore, Ted does not have to recognize any gain on the transaction even though he did not use all of the insurance proceeds to purchase the replacement property.

Replacing the converted property with similar use property also includes restoring the converted property to its original condition so it can be used in the same manner as it was used prior to the conversion. Whether expenditures made by the taxpayer are necessary to restore the property to its original usefulness is a question of fact, and any enhancements or improvements to the original property should be *de minimis*.

Similar or Related in Service or Use

IRC Sec. 1033(a)(2) requires that replacement property be similar or related in service or use (hereafter referred to as similar-use property) to qualify for gain deferral. This is a functional rule, meaning the taxpayer-owner's end use of the replacement property must be substantially the same as the replaced property. It is a much more stringent rule than the like-kind requirement for like-kind exchanges. For example, the following would probably not qualify as similar-use replacement property:

1. Unimproved real estate replaced with improved real estate.
2. Mobile home park replaced by a motel.
3. Bowling alley replaced by a billiard center.
4. Rental building replaced with stock in a real estate investment trust.

The following are examples of what probably would qualify:

1. Farmland used to grow crops replaced with farmland used to grow fruit or raise livestock.
2. Residential property in one city replaced with residential property in another city.
3. Two buildings used for a particular purpose replaced with one used for the same purpose.

The gain on an involuntary conversion of a taxpayer's principal residence can also qualify for deferral under IRC Sec. 1033. Under IRC Sec. 121(d)(5), an involuntary conversion of a residence is treated as a sale, eligible for the Section 121 gain exclusion. For Section 1033 purposes, the amount realized from the conversion is reduced by the gain excluded under IRC Sec. 121. Furthermore, when a residence is involuntarily converted and not rebuilt on the existing lot, a later sale of the lot is treated as part of the involuntary conversion (i.e., the residence and land are treated as a single involuntary conversion occurring on the date the dwelling was destroyed). Thus, gain from the sale of the land can be deferred if the Section 1033 deferral requirements are met. Taxpayers may also continue to deduct mortgage interest on a destroyed residence during a reasonable period between the destruction of the residence and its sale or reconstruction and reoccupation. Special rules also apply when a conversion occurs in connection with a federally declared disaster.

Special Like-kind Rule for Condemned Real Property. IRC Sec. 1033(g) contains a special rule for condemned real estate. Real estate used in a business or held for investment that is condemned (or threat or imminence thereof) is deemed to be converted into similar-use property if it is replaced with like-kind property. Consequently, such property may qualify for gain deferral even though the replacement property does not meet the stringent similar-use requirements discussed earlier. For example, unimproved real estate replaced by improved real estate is not similar-use replacement property. It would, however, qualify for gain deferral under IRC Sec. 1033(g) because it is like-kind property. Conversely, replacement of real property not qualifying as like-kind may qualify under the similar-use test. For example, the use of condemnation proceeds (from land or land and building) to construct a building on land already owned by the taxpayer may not qualify as like-kind property, but could qualify under the similar-use test.

Acquiring Corporate Stock. IRC Sec. 1033(a)(2) provides that a taxpayer can replace converted property with either qualifying property or stock in a corporation that owns qualifying property, provided the taxpayer acquires control of the corporation. When corporate stock is purchased as the replacement property, the taxpayer's basis in the stock is its cost, decreased by the amount of gain not recognized. In addition, the basis of the replacement property owned by the corporation must also be reduced by the taxpayer's deferred gain. Thus, basis at both the shareholder and corporate levels is reduced for the same gain deferral.

Replacement Period

The replacement period begins on the earlier of (1) the date the property is disposed of, or (2) the date of the threat or imminence of requisition or condemnation of the property. It generally ends two years (three years for condemned real estate used in a business or held for investment and converted to like-kind property) after the close of the tax year any gain is realized. The replacement period to defer involuntary conversion gains from certain forced early sales of livestock due to drought, flood, or other weather-related conditions is four years, and property other than livestock can qualify as replacement property in certain circumstances. The IRS is authorized to extend the replacement period even longer if regional weather-related conditions persist for more than three years. A four-year replacement period is available for a principal residence or any of its contents located in a federally declared disaster area. The term *federally declared disaster* means any disaster subsequently determined by the president of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. A five-year replacement period applies to property damaged or destroyed (1) after August 24, 2005, that is located in the Hurricane Katrina disaster area, (2) on or after May 4, 2007, that is located in the Kansas disaster area, or (3) on or after the applicable Midwestern disaster date that is located in a Midwestern disaster area. The taxpayer may apply to the IRS for an extension based on reasonable cause. The extension must be requested within the replacement period, unless reasonable cause is shown for a later request.

Replacement Property Acquired from Related Person

Individuals cannot avoid gain recognition if the replacement property is acquired from a related person. However, this related-party rule does not apply if (1) the gain realized from the involuntary conversion is $100,000 or less, or (2) the related party acquired the replacement property from an unrelated party during the taxpayer's replacement period. The Sections 267(b) and 707(b)(1) definitions of related persons apply.

Recognition of Gain

If property is converted only into similar-use property, nonrecognition is mandatory. If a taxpayer receives cash or property that is not similar-use, gain is recognized only to the extent the total of the cash and other nonsimilar property (proceeds) exceeds the cost of the replacement property, provided the taxpayer has timely replaced the property and elected the benefits of nonrecognition. The election is made by including the appropriate portion of gain, if any, in gross income and excluding the deferred portion.

Example 1l-2 Gain on condemnation of real property.

Carol, a calendar-year taxpayer, owns an office building with an adjusted basis of $175,000 on land that cost $30,000. The property was condemned and taken in return for a condemnation award of $250,000. She received the condemnation proceeds on March 18, 2010.

Because her real property was condemned, Carol can replace it with either similar-use or like-kind property. If Carol buys like-kind property costing at least $250,000 by December 31, 2013 (the end of the three-year replacement period), none of the $45,000 realized gain will be recognized. (Alternatively, if the replacement property is not like-kind but is similar-use, the replacement period ends on December 31, 2012.) The basis of the replacement property will be its cost less the deferred gain of $45,000. If she does not reinvest by that date, the entire gain must be recognized.

If Carol acquires like-kind property for $180,000, the excess of the conversion amount ($250,000) over the cost of the replacement property is $70,000, and the entire $45,000 realized gain is recognized. The basis of the replacement property is $180,000 because there was no gain deferred. If she acquires like-kind property for $230,000, the excess of the condemnation award over the cost of the new property is $20,000. In this situation, she recognizes only the $20,000, and the basis of the replacement property will be $205,000 ($230,000 cost − $25,000 deferred gain).

Alternately, if the award had been only $180,000, the loss of $25,000 (basis of $205,000 less award of $180,000) is recognized regardless of any replacement. Section 1033 deferral applies only to gains.

If the taxpayer fails to replace the converted property within the allowable period or does so at a lower cost than anticipated at the time of the election, an amended return reporting the recognized gain must be filed for the tax year the gain was originally realized. Interest is owed on any additional tax resulting from the gain recognition.

Special Rules for Property Damaged by Federally Declared Disasters

Taxpayers with property destroyed in federally declared disaster areas are subject to special relief provisions that broaden the scope of the normal involuntary conversion rules. In addition, for taxpayers affected by disasters in federally declared disaster areas or by certain terrorist or military actions, the IRS can extend the normal deadline for many actions, including replacing damaged or destroyed property under IRC Sec. 1033. Note, however, that postponements under IRC Sec. 7508A are not automatic when a disaster occurs. Generally, the IRS will publish a Notice or issue other guidance (including an IRS News Release) authorizing the postponement. Such guidance will describe the acts postponed, the duration of the postponement, and the location of the covered disaster area.

Trade or Business or Investment Property. No gain is recognized if property held for use in a trade or business or for investment is involuntary converted as a result of being in a location that the president declares a disaster area (i.e., a federally declared disaster) and is replaced with tangible property used in a trade or business. This rule applies even if the replacement property is not similar-use to the converted property.

Example 1l-3 Gain deferral for dissimilar and unrelated-use property.

Sue's Diner was destroyed by a flood in 2010. The president declared the location a disaster area. Sue decides not to reopen the diner and uses the insurance proceeds to purchase a bowling alley. She recognizes no gain on the transaction because the new property is trade or business property (treated as being similar-use to the property destroyed in the federally declared disaster).

Property lost in the involuntary conversion can be either business or investment property, but the replacement property must be "of a type held for productive use in a trade or business."

Example 1I-4 Gain deferral denied for investment replacement property.

Assume the same facts as in Example 1I-3 except Sue uses the insurance proceeds to purchase valuable works of art for investment. She cannot defer the gain on the conversion of the diner.

Variation: If Sue had lost the artwork in a federally declared disaster and purchased the diner with the insurance proceeds, the gain deferral provisions should apply because she replaced investment property with business property.

Principal Residences. The involuntary conversion rules for a disaster in a federally designated disaster area also apply to a taxpayer's principal residence. When a taxpayer's principal residence (or any of its contents) is involuntarily converted:

1. No gain is recognized on the receipt of insurance proceeds for unscheduled personal property that was part of the contents of such residence. This rule applies regardless of the taxpayer's basis in the unscheduled personal property or how the insurance proceeds are used.

2. Any insurance proceeds for the residence or its separately scheduled contents can be treated as a common pool of funds. The taxpayer can elect to recognize gain only to the extent that the funds exceed the cost of replacing the residence and its contents. Any type of replacement contents (whether separately scheduled or unscheduled) qualify for this purpose. Insurance proceeds for separately scheduled property (e.g., jewelry, art) do not have to be used to purchase the same type of property.

3. The taxpayer must make the replacement within four years (as opposed to the normal two-year period for involuntary conversion replacements) after the close of the year gain is first realized [IRC Sec. 1033(h)(l)(B)]. (See also the discussion earlier in this lesson on the interaction of the Section 121 residence gain exclusion rules and the Section 1033 involuntary conversion rules.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. IRC Sec. 1033 provides for the deferral of gains realized from numerous involuntary conversions. In which of the following scenarios will the gain **not** qualify for deferral under IRC Sec. 1033?

    a. Bill's barn that was insured for 80% of its FMV of $50,000 burns. Bill's basis in the barn is only $10,000. His insurance proceeds will be $30,000.

    b. Sam sold his vacant land valued at $10,000 to Roy for $12,000. Sam really didn't want to sell but Roy offered more than FMV, so he felt compelled to sell the property.

    c. Ralph owns a parcel of the land with a house on it that is needed by the city to build a new school. Ralph does not want to sell his land. The city finally has the property condemned and pays Ralph $100,000 for the land.

    d. Cattle rustlers stole 3 prize bulls John had raised as a cattle breeder. The bulls were insured for $80,000.

16. Sam Jones owned a small piece of property with an adjusted basis of $40,000. After severe storm damage, Sam received $100,000 from his insurance company. He purchased replacement property in a timely manner. He paid $30,000 and signed a $70,000 mortgage on the replacement property. How much gain must Sam report in the year he acquires the new property?

    a. $0.

    b. $60,000.

    c. $70,000.

    d. $100,000.

17. The replacement property rules for involuntary conversion property and like-kind exchanges are very similar. Which of the following is true for replacement property?

    a. To defer gain in an involuntary conversion, the replacement property must be similar or related in service or use. The gain deferral rules are more stringent than those employed under like-kind transactions.

    b. The replacement period for an involuntary conversion requires the replacement property transaction be completed within two years after the close of tax year in which the property was condemned, lost, or destroyed.

    c. An example of a replacement property that would qualify for gain deferral under IRC Sec. 1033 is replacing a mobile home park with a motel due to total loss from tornado if the owner can show that a motel would be more stable in another disaster.

    d. A taxpayer's farm was condemned. The taxpayer replaced it by buying a family member's farm that has been in the family for 75 years. The gain on the transaction will be over $250,000 and can be deferred under IRC Sec. 1033.

18. Which of the following statements best describes a special rule for condemned real property?

    a. Condemned real property must be replaced by qualifying similar use property.

    b. Condemned real property must be replaced with qualifying like-kind property.

c. Condemned real property that is replaced does not have to meet the stringent similar-use requirements of IRC Sec. 1033.

19. If taxpayer received cash as part of the replacement in an involuntary conversion, timely replace the property with similar-use property and chose an IRC Sec. 1033 election, how would this be reported?

a. An amended return will have to be filed by the taxpayer later in the year to highlight the deferral.

b. Including the appropriate portion of the gain from the cash in gross income and excluding the deferred portion.

c. No recognition is required to since the property is an involuntary conversion and all the gain is deferred.

20. Janelle receives a condemnation award of $250,000 for property she held with an adjusted basis of $125,000. She acquires like-kind property for $200,000. How much gain will Janelle report for the replacement?

a. $0.

b. $50,000.

c. $125,000.

d. $250,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. IRC Sec. 1033 provides for the deferral of gains realized from numerous involuntary conversions. In which of the following scenarios will the gain **not** qualify for deferral under IRC Sec. 1033? **(Page 138)**

    a. Bill's barn that was insured for 80% of its FMV of $50,000 burns. Bill's basis in the barn is only $10,000. His insurance proceeds will be $30,000. [This is incorrect. Bill's gain resulting from the destruction of the barn would qualify for Section 1033 treatment since it qualifies an in involuntary conversion under destruction.]

    b. Sam sold his vacant land valued at $10,000 to Roy for $12,000. Sam really did not want to sell but Roy offered more than FMV, so he felt compelled to sell the property. [This answer is correct. Sam's gain does not qualify for Section 1033 treatment. It was not an involuntary conversion resulting from destruction, theft, seizure, condemnation or threat of condemnation.]

    c. Ralph owns a parcel of the land with a house on it that is needed by the city to build a new school. Ralph does not want to sell his land. The city finally has the property condemned and pays Ralph $100,000 for the land. [This answer is incorrect. An involuntary conversion that qualifies for IRC Sec. 1033 gain deferral is condemnation. Since Ralph's house was condemned, he would qualify.]

    d. Cattle rustlers stole 3 prize bulls John had raised as a cattle breeder. The bulls were insured for $80,000. [This answer is incorrect. John's gain resulted from theft, which is considered an involuntary conversion, and would qualify for deferral under Section 1033.]

16. Sam Jones owned a small piece of property with an adjusted basis of $40,000. After severe storm damage, Sam received $100,000 from his insurance company. He purchased replacement property in a timely manner. He paid $30,000 and signed a $70,000 mortgage on the replacement property. How much gain must Sam report in the year he acquires the new property? **(Page 138)**

    a. $0. [This answer is correct. The replacement property's cost is equal to the proceeds from the insurance so Sam has no gain to recognize under IRC Sec. 1033.]

    b. $60,000. [This answer is incorrect. Although Sam realizes a gain of $60,000 the gain is deferred under section 1033.]

    c. $70,000. [This answer is incorrect. Sam is not required the use the cash he received. He is just required to replace the property so the regulations allow Sam to use a mortgage to replace the property.]

    d. $100,000. [This answer is incorrect. Sam had a $40,000 adjusted basis in the property. His total gain would be $60,000 which is fully deferred under the IRC Sec. 1033.]

17. The replacement property rules for involuntary conversion property and like-kind exchanges are very similar. Which of the following is true for replacement property? **(Page 138)**

    a. To defer gain in an involuntary conversion, the replacement property must be similar or related in service or use. The gain deferral rules are more stringent than those employed under like-kind transactions. [This answer is correct. The term similar or related in service require that the end use of the replacement property must be the same as replaced property. IRC Sec. 1031 for like-kind exchanges requires only that both properties be held either for productive use in a trade or business or for investment.]

    b. The replacement period for an involuntary conversion requires the replacement property transaction be completed within two years after the close of tax year in which the property was condemned, lost, or destroyed. [This answer is incorrect. The replacement period begins on the earlier of (1) the date the

property is disposed of, or (2) the date of the threat or imminence of requisition or condemnation of the property. It generally ends two year after the tax year any gain is realized, but is three years for condemned real estate, and four years for certain forces early sales of livestock due to drought, flood, or other weather-related conditions.]

c. An example of a replacement property that would qualify for gain deferral under IRC Sec. 1033 is replacing a mobile home park with a motel due to total loss from tornado if the owner can show that a motel would be more stable in another disaster. [This answer is incorrect. Replacing a mobile home park with a motel would probably not satisfy the similar-use replacement property rules under IRC Sec. 1033 since they are not the same type of structure.]

d. A taxpayer's farm was condemned. The taxpayer replaced it by buying a family member's farm that has been in the family for 75 years. The gain on the transaction will be over $250,000 and can be deferred under IRC Sec. 1033. [This answer is incorrect. According to IRC Sec. 1033(l), individuals cannot avoid gain recognition if the replacement property is acquired from a related person. The related-party rule does not apply is (1) the gain realized from the involuntary conversion is $100,000, or less, or (2) the related party acquired the replacement property from an unrelated party during the taxpayer's replacement period. Neither of these exception apply in this case.]

18. Which of the following statements best describes a special rule for condemned real property? **(Page 138)**

a. Condemned real property must be replaced by qualifying similar use property. [This answer is incorrect. This is the general rule under IRC Sec. 1033, but there is an exception allowed for condemned real property.]

b. Condemned real property must be replaced with qualifying like-kind property. [This answer is incorrect. Condemned real property can fall under IRC Sec. 1033 and not like-kind exchanges so it requires similar-use property.]

c. Condemned real property that is replaced does not have to meet the stringent similar-use requirements of IRC Sec. 1033. [This answer is correct. IRC Sec. 1033(g) contains a special rule for condemned real estate. Real estate used in a business or held for investment that is condemned is deemed to be converted into similar-use property if it is replaced with like-kind property. Consequently, such property may qualify for gain deferral even through the replacement property does not meet the stringent similar-use requirements.]

19. If taxpayer received cash as part of the replacement in an involuntary conversion, timely replace the property with similar-use property and chose an IRC Sec. 1033 election, how would this be reported? **(Page 138)**

a. An amended return will have to be filed by the taxpayer later in the year to highlight the deferral. [This answer is incorrect. An amended return only has to be filed in a IRC Sec. 1033 conversion when the taxpayer fails to replace the converted property within the allowable period or does so at a lower cost than anticipated at the time of the election. This is done so that the gain can be recognized.]

b. Including the appropriate portion of the gain from the cash in gross income and excluding the deferred portion. [This answer is correct. According to IRC Sec. 1033, if a taxpayer receives cash or property that is not similar-use, gain is recognized only to the extent the total of the cash and other nonsimilar property exceeds the cost of the replacement property, provided the taxpayer has timely replaced the property and elected the benefits of nonrecognition. The election is made by including the appropriate portion of gain in gross income and excluding the deferred portion.]

c. No recognition is required to since the property is an involuntary conversion and all the gain is deferred. [This answer is incorrect. If the property is converted into only similar-use property, nonrecognition is mandatory per IRC Sec. 1033(a)(1), but in this case, the taxpayer received cash.]

20. Janelle receives a condemnation award of $250,000 for property she held with an adjusted basis of $125,000. She acquires like-kind property for $200,000. How much gain will Janelle report for the replacement? **(Page 138)**

a. $0. [This answer is incorrect. Janelle received more than she reinvested. She must report some gain under condemnation rules.]

b. $50,000. [This answer is correct. Janelle realizes a $125,000 gain on transaction. She must recognize gain on condemnation award in excess of the cost of the replacement property but only to the extent of the realized gain. Under IRC 1033, Janelle will recognize $50,000 of gain.]

c. $125,000. [This answer is incorrect. Janelle realizes a gain of $125,000 but part of that gain is deferred under the involuntary conversion rules.]

d. $250,000. [This answer is incorrect. Janelle is not required to report the total proceeds as a gain since she had basis and she reinvested in replacement property.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TDBTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Property sold by dealers is normally not eligible for installment sale reporting. However, there is an exception to the rule that dealers may elect under IRC Sec. 453(l)(2)(B) to report the sale of residential lots, or timeshares under the installment reporting. How is this election made?

   a. The dealer must petition the IRS for permission to elect the use of the installment method of reporting. Once the permission is received the dealer may use the installment method or reporting.

   b. The dealer makes the election by paying the interest on the tax deferred at the rate in effect at the time of the sale with the tax due from the gain on each tax return.

   c. The dealer must file a notarized election statement with the return for the year in which the gain was first realized. The dealer is required to pay the appropriate IRS service fee for each year.

   d. The dealer must file an IRS form 6252 and pay the tax due each year. The dealer is also required to pay the appropriate IRS service fee for each year.

2. Stan purchased a 10-acre tract of land for $100,000. As a dealer Stan hopes to sell 20 half-acre lots. He receives an offer on one of the lots for $10,000 with $5,000 down in 2010 and the balance of $5,000 due in 2011. Stan's gain on the lot will be $5,000. His gross profit percentage will be 50%. Assume that Stan's tax rate for 2011 will be 28% and the applicable short-term federal interest rate for 2010 is 5%. How much tax and interest will Stan pay in 2011 as a result of the transaction?

   a. Tax will be $500 and interest will be $25.

   b. Tax will be $600 and interest will be $30.

   c. Tax will be $700 and interest will be $35.

   d. Tax will be $1,400 and interest will be $70.

3. Dr. Taylor sells his office building and land to his professional corporation, a related party, in 2010 for $200,000. He receives a 10 year interest bearing note and $50,000 cash. The professional corporation is owned 100% by Dr. Taylor. The land and building were appraised at $50,000 and $150,000, respectively. Dr. Taylor's tax basis in the land and the building were $25,000 and $100,000 respectively. The gain on the transaction is $75,000 [$200,000 sales price − ($25,000 tax basis on land + $100,000 tax basis on property)]. The gain attributable to the building is $50,000 ($150,000 appraised value − $100,000 tax basis on property). The gain attributable for the land is $25,000 ($50,000 appraised value on the land − $25,000 tax basis on land). Which of the following statements best describes how the gain on the property and the land will be treated by Dr. Taylor in 2010?

   a. Dr. Taylor can report the total gain attributable to the transaction by using the installment method of reporting. The gross profit ratio will be 37.50% ($75,000 ÷ $200,000). Dr. Taylor will report $18,750 (37.50% × $50,000) of gain as long term capital gain for 2010.

   b. Dr. Taylor owns 100% of the professional corporation, therefore the transaction is between related parties and the installment reporting cannot be used. Dr. Taylor must report the full $75,000 gain in the year of the sale.

   c. Dr. Taylor can not use the installment method of reporting for the sale of the building. He will report the $50,000 gain on the building as ordinary gain. The land is not a depreciable asset. Dr. Taylor can report the $25,000 gain on the land as an installment sale.

d. Do not select this answer.

4. An installment sale occurs when a property transfer requires at least one payment to be made in a future tax year. Which of the following statements best describes the options a taxpayer has in relation to the installment method?

   a. A taxpayer can decide after filing a tax return to opt for the installment method by amending the return as late as the final due date of the return with extensions.

   b. A taxpayer files a special notarized election to defer the total gain until the final payment on the contract is received. The election must be filed with tax return for the year the first payment is received.

   c. A taxpayer must file an election to defer gain on an installment sale by filing an IRS election form no later than the third year of the contract. The gain is then recognized as future payments are received.

   d. A taxpayer can only use the installment method. The taxpayer must recognize the first dollars received on the contract as gain until the realized gain on the transaction has been fully recognized.

5. Joe sold real property to Moe five years ago and received a $300,000 interest-bearing note. Moe was to pay $30,000 a year plus interest for 10 years. Joe's basis in the property was $90,000. His selling expenses were $10,000. The realized gain was $200,000 and the gross profit was 66.66%. Joe received $30,000 per year in each of the first five years of the contract. Joe reported $100,000 of the gain in the first five years. Moe renegotiated the contract. For the remaining five years Joe will receive $20,000 a year plus interest. How much gain will Joe recognize in each of the five remaining years?

   a. $5,000.

   b. $10,000.

   c. $15,000.

   d. $20,000.

6. Which of the following is correct regarding repossessed property sold under the installment method?

   a. Repossessed property's depreciation will start over when the seller reacquires the property after the repossession.

   b. The property's holding period now includes the time period the buyer owned the property since the property was repossessed.

   c. Any additional basis acquired due to a repossession is added to the original asset for tax purposes.

   d. The property's holding period is the amount time the seller held owned the property before the sale plus the period after the repossession.

7. Gavin owns a piece of land that Andrew would like to purchase. Gavin's adjusted basis in the land is $50,000 and Gavin has a mortgage for $70,000. He enters into a contract with Andrew to sell him the piece of land for $120,000, by assuming Gavin's existing mortgage and paying the remaining directly to Gavin over the next three years. Andrew will pay the existing mortgage payments directly to the bank. What is Gavin's gain on the sale of the land?

   a. $0.

   b. $50,000.

   c. $70,000.

   d. $120,000.

8. John sold a parcel of land to Mark. John received a down payment and a contract for payments plus interest. John's gross profit percentage on the sale to Mark is 50%. Mark made the scheduled payments until the balance on the contract was reduced to $200,000. John has recorded the sale on the installment method but now needs the cash. He offers to settle the contract for $100,000 if Mark will pay it off immediately. How much gain or loss will John recognize on the transaction?

    a. John will recognize no gain or loss.

    b. John will recognize a loss of $50,000.

    c. John will recognize a gain of $100,000.

    d. John will recognize a loss of $100,000.

9. There are three requirements that must be satisfied for the mandatory nontaxable exchange treatment of IRC Sec. 1031 to apply. Which of following is *not* a requirement for nontaxable exchange treatment?

    a. The properties transferred and received must be like-kind property.

    b. The properties transferred and received must be held either for productive use in a trade or business or for investment.

    c. The properties must be transferred either in a sale or an exchange.

    d. The properties transferred and received must be similar or related in service or use.

10. A taxpayer enters into a transaction which meets the requirements of IRC Sec. 1031 as a like-kind exchange. Which of the following statements best describes the application of IRC Sec. 1031?

    a. Section 1031 requires that a transaction that is a sale or exchange, where both the property transferred and the property received are like-kind property held either for business or investment, be treated as a taxable exchange, unless, the taxpayer formally elects to defer the gain on the transaction.

    b. Section 1031 requires that a transaction that is a sale or exchange, where the properties transferred are like-kind property held either for business or investment, be treated as a nontaxable exchange transaction. There is no provision to elect out of Section 1031 treatment.

    c. Section 1031 requires that a transaction that is a sale or exchange, where both the property transferred and the property received are held either for business or investment, be treated as a nontaxable exchange unless both taxpayers elect out of the gain deferral.

    d. Section 1031 allows a taxpayer to defer the gain on transaction where real property is exchanged with personal property provided and that both parties agree to deferral of the gain.

11. Sean enters into a like-kind exchange with Jonathan for a parcel of land. Sean's land has an adjusted basis of $50,000 and a fair market value (FMV) of $70,000. Jonathan's parcel has a FMV of $60,000 so Jonathan will give Sean $10,000 cash. Sean will realize a $20,000 gain on the transaction and a gross profit percentage of 28.6%. How much gain must Sean recognize if the transaction is a qualified like-kind exchange?

    a. $0.

    b. $5,720.

    c. $10,000.

    d. $20,000.

12. Will enters into a like-kind exchange with Lauren for a parcel of land. Will's land has an adjusted basis of $40,000 and fair market value (FMV) of $30,000. Lauren's parcel has a FMV $25,000. She agrees to pay will an additional $5,000 of cash to be fair about the swap. How much gain or loss must Will recognize in the year of the exchange?

    a. $0.

    b. $5,000 gain.

    c. $5,000 loss.

    d. $10,000 loss.

13. MacKenzie enters into a like-kind exchange with Kristy. MacKenzie will transfer Blue Mesa to Kristy. Blue Mesa has a FMV of $2,500,000 and a mortgage of $1,000,000. MacKenzie's tax basis in Blue Mesa is $100,000. Kristy will transfer Green Meadows with a FMV $2,200,000, a mortgage of $1,500,000 and $800,000 in cash to MacKenzie. As the results of this transactions how much gain will MacKenzie recognize in the year of the transaction?

    a. $0.

    b. $800,000.

    c. $1,000,000.

    d. $2,400,000.

14. A tax payer can elect to defer gains realized in an involuntary conversion. In IRC Sec. 1033 there are very specific types of conversions given that are eligible for the election to defer gain. Which of the following does not qualify as an involuntary conversion?

    a. The theft or seizure of property.

    b. The condemnation or threat thereof.

    c. The sale of property due to financial hardship.

    d. The destruction of property.

15. Leroy owns an office building and land with a tax basis of $300,000 and $30,000 respectively. The property is condemned in 2010. The condemnation award is $375,000. Leroy realized a gain of $45,000 on the transaction. The cost of the replacement property is $345,000. The property is similar use property and the replacement is timely made within the replacement period allowed. The replacement cost is $30,000 less than the condemnation award. What is Leroy's adjusted tax basis in the replacement property?

    a. $300,000.

    b. $330,000.

    c. $335,000.

    d. $375,000.

16. James owns an office building and land with an adjusted tax basis of $250,000 and $50,000 respectively. The property has been condemned and taken in 2010. James receives a condemnation award of $275,000. How will James treat the transaction?

    a. James will realize a loss on the transaction ($300,000 basis less award of $275,000). He will replace the property and defer the loss under Section 1033.

    b. James will realize a loss of $25,000 on the transaction ($300,000 basis less award of $275,000). He will not replace the property and therefore forego the deferral.

    c. James will realize a loss of $25,000 on the transaction ($300,000 basis less $275,000). The loss will be recognized in 2010 regardless of whether James replaces the property.

    d. Do not select this answer choice.

17. Roy's barn was destroyed by fire. He planned to rebuild the barn with the insurance proceeds. In the year he received the insurance, Roy reported no gain. He was anticipating the costs to replace the barn to be greater than the insurance proceeds. The new barn was completed before the end of the required replacement period. That was when Roy realized that he had been able to replace the barn for much less than the insurance proceeds. Which of the following statements best describes how Roy should report his gain?

    a. Roy will calculate the difference between the insurance proceeds and the total cost to replace the barn. He will report the gain in the year the barn is completed and pay interest on the amount of tax due as though it had been due in the year the barn burned.

    b. Roy will calculate the gain as the difference between the insurance proceeds and the total cost to replace the barn. He will amend his return and recognize the gain in the year it was originally realized. He will pay both the tax due and the interest owed.

    c. Roy will calculate the gain as the difference between the insurance proceeds and tax basis of the barn that burned. He must report the full gain realized in the year he completes the barn and forgo all gain deferral available pursuant to IRC Sec. 1033.

    d. Roy will calculate the gain as the difference between the insurance proceeds and the total cost to replace the barn. He will amend his return and recognize the gain in the year it was originally realized. He will pay the tax due but will owe no interest on the unpaid taxes.

18. Special provisions apply for property destroyed in a federally declared disaster area. Which of the following is one of the special provisions?

    a. A loss on investment property located in a federally declared disaster area can be replaced with other investment property and no gain will be recognized.

    b. Either business or investment property lost in a federally declared disaster area can be replaced with other investment property and no gain will be recognized.

    c. Either business or investment property lost in a federally declared disaster area can be replaced with business property and no gain will be recognized.

    d. No gain will be recognized from property used in a trade or business and destroyed in a federally declared disaster area even if no replacement is made.

19. Shawanna's coffee shop was destroyed in a major storm. The coffee shop was located in a presidentially declared disaster area. Shawanna received $300,000 in insurance proceeds and promptly invested the total proceeds in valuable Santa Clara pottery. Shawanna realized a gain of $50,000 on the transaction. Which of following statements best describes Shawanna's tax situation relative to any gain deferral or recognition as a result of the destroyed coffee shop?

    a. Shawanna has reinvested the total amount received so she can defer total the gain.

    b. Shawanna has reinvested in investment property. She can not defer any of the gain.

    c. Shawanna has reinvested in investment property. She will need to reduce the basis of the investment property.

    d. Do not select this answer choice.

20. Bill and Sue lost their home and all its content in a violent storm. The home was located in a federally declared disaster area. They will receive $300,000 for the house, $5,000 for unscheduled personal property and $3,000 for separately scheduled jewelry. What is the best approach for Bill and Sue to avoid all taxes on the replacement?

    a. They can buy another home for at least $300,000 within 5 years after the close of the year gain is first realized.

    b. They can buy another home for $200,000 and spend $100,000 to replace the contents within 4 years after the close of the year gain is first realized.

    c. They can recognize no gain by spending at least $308,000 to replace the home and its content within four years after the year the gain is first realized.

    d. They can replace the home for $250,000 and the contents for $8,000 within 2 years after the close of the year gain is first realized.

Lesson 2: Trade or Business Property Transactions

INTRODUCTION

This lesson discusses some of the special issues and problems regarding sales, exchanges, and losses of business property. Section 1231 gain or loss treatment, purchase price allocations, various recapture rules, and related-party loss issues are included in the discussion.

Under IRC Sec. 1231, net gains from the disposal of real (whether or not depreciable) or depreciable personal property used in a trade or business and held more than one year generally are treated as long-term capital gains (unless the depreciation recapture or Section 1231 loss recapture rules apply). Such gains may qualify for installment sale reporting and may be taxed at favorable rates. On the other hand, net Section 1231 losses are treated as ordinary losses (unless the related-party sale rules apply) and are deductible against ordinary income.

Learning Objectives

Completion of this lesson will enable you to:

- Identify abandonment losses and the general rules for reporting and applying Section 1231 gains and loss carryovers.
- Determine purchase prices are allocated, depreciable property gain is computed and reported and the determination of losses for business casualty and with related parties.

Business Property Abandonments

When a taxpayer owns and abandons property used in a business or in a transaction entered into for profit, a loss deduction generally may be claimed. Abandonment losses attributable to business property generally are deductible in the year sustained without regard to any capital loss limitations.

Distinguishing Various Types of Abandonment Losses

No single set of rules covers abandonment loss deductions. The following summarizes the kinds of losses allowed and where they are covered in the Code and regulations.

1. *Depreciable Property.* Abandonment results in a loss deduction allowable under the depreciation and cost recovery regulations. The loss equals the adjusted basis of the property when it is irrevocably discarded by the taxpayer. (It will never be used again or retrieved for sale, exchange, or other disposition.) An actual disposition apparently is not required if the property is placed in a supplies or scrap account or the loss is attributable to an abnormal retirement (i.e., a loss arising from sudden, unexpected termination of the usefulness of the property as through a casualty or extraordinary obsolescence). Even though they may ultimately become the lessor's property under the terms of the lease, depreciable leasehold improvements may give rise to an abandonment loss by the lessee (see Example 2A-1).

2. *Nondepreciable Property (e.g., land).* A loss deduction will be allowed under IRC Sec. 165(a) for the abandonment of nondepreciable property if (a) the loss is incurred in a business (or transaction entered into for profit), (b) the loss arises from the sudden termination of the property's usefulness in the business, and (c) the business is discontinued or the property is permanently discarded. The loss is deductible in the year sustained, which may not be the same year in which the overt act of abandonment or passage of title occurs.

3. *Mineral Property (e.g., oil or gas lease or a well).* A taxpayer is allowed a deduction under IRC Secs. 165 and 612 for mineral property that becomes worthless. To deduct the loss, the taxpayer must permanently cease using the property. Whether an oil or gas (or other mineral) property is worthless in a particular year is a question of fact.

   Special rules apply to intangible drilling and development costs (IDC); a taxpayer may either expense or capitalize them. If the taxpayer elected to capitalize IDC, and a well becomes nonproductive, such costs

may be deducted as an ordinary loss at the election of the taxpayer. This election is made by including a statement in the first return in which a nonproductive well (dry hole) is completed.

4. *Leased Property.* The cost of improvements made to leased property by a lessee is recovered under the MACRS depreciation rules without regard to the term of the lease. If, upon termination of the lease, there is unrecovered cost and the property is lost to the lessee, an abandonment loss is computed with reference to the remaining adjusted basis of the improvements and as though the property had been sold for a zero sales price in the year it was abandoned.

5. *Partnership Interest.* A partner can take a deduction upon abandoning an interest in a partnership or if the partnership interest becomes worthless. Two cases (*Echols* and *Citron*) establish the criteria for determining the date of an abandonment or worthlessness loss and the nature (capital or ordinary) of the loss.

Identifying an Abandonment Loss

A loss is deductible in the year sustained, which generally is the year the identifiable event occurs [Reg. 1.165-2(a)]. The taxpayer bears the burden of proof in establishing that the loss was sustained in the same year the loss was claimed on the return.

A loss deductible under IRC Sec. 165 must be evidenced by a completed transaction that is established by an identifiable event. For an abandonment loss, the taxpayer must also show (1) the owner's intent to abandon the asset and (2) an affirmative act of abandonment (*Allen*). Intent to abandon normally is determined by the related facts and circumstances, and the subjective judgment of the taxpayer is given great weight (*A.J. Industries, Inc.*). Thus, identifiable events such as plugging an oil well, scrapping machinery, and discontinuing a line of business generally would be considered affirmative acts that constitute property abandonments. Another common abandonment situation arises upon termination of a lease when leasehold improvements are abandoned.

Example 2A-1 Abandonment of leasehold improvements.

Sam, a self-employed attorney, signed a five-year lease for office space beginning March 1, 2005. Shortly thereafter, he placed in service $15,000 of leasehold improvements. Sam did not renew his lease when it expired in February 2010. All improvements will remain with the leased property. Therefore, Sam effectively abandoned all the leasehold improvements when the lease terminated.

Because leasehold improvements are depreciated using real property recovery periods, Sam's adjusted basis in the improvements at the time of abandonment was $13,076 ($15,000 − $1,924 accumulated depreciation). Thus, he may claim a $13,076 abandonment loss on Part II of his 2010 Form 4797.

Lessors are subject to the same abandonment loss rules as lessees for leasehold improvements. Thus, if leasehold improvements made by the landlord are abandoned or disposed of at the end of a lease, the landlord can deduct the unamortized or undepreciated basis of the improvements in the year of abandonment or disposition [IRC Sec. 168(i)(8)]. If the lessor purchased the building after the leasehold improvements were already in place, an allocation of the purchase price must have been made to the leasehold improvements before the lessor could deduct an abandonment loss on the improvements. However, if the new tenant continues to use the improvements, no loss is available to the landlord. In *Standard Commodities Import and Export Corp.,* the Tax Court determined a transfer of leasehold improvements to a majority shareholder did not constitute a factual abandonment because both parties received consideration in exchange of the leasehold property for the release of liability; thus, any abandonment loss was disallowed under IRC Sec. 267. In addition, see Key Issue for a discussion regarding related party transactions.

Reporting the Loss. Losses on abandonment of business property are reported on Form 4797 Part II as an ordinary loss (IRS Pub. 544). However, if the property was abandoned due to a casualty, the loss is reported on Form 4684. Reg. 1.1402(a)-6 states that gain or loss from the disposition of business property (other than inventory) is excluded in determining net earnings from self-employment. According to Prop. Reg. 1.168-2(l)(1), the term *disposition* includes abandonment.

Carryovers from Nonrecaptured Section 1231 Losses

General Rules

Real or depreciable property used in a trade or business or for the production of rental income and held more than one year is Section 1231 property. Net gains from Section 1231 property are treated as long-term capital gains while net losses are treated as ordinary losses. When reporting the disposition of depreciable property, the practitioner first calculates ordinary gain (if any) resulting from depreciation recapture. Any remaining gain is Section 1231 gain. Both are reported on Form 4797.

If Section 1231 losses exceed gains, the net Section 1231 loss for the year is ordinary. If Section 1231 gains exceed losses, the net Section 1231 gain is treated as a long-term capital gain if no nonrecaptured Section 1231 losses exist from prior years. If there are nonrecaptured prior-year Section 1231 losses, Section 1231 net gains in subsequent years are taxed as ordinary income to the extent of those unexpired prior-year nonrecaptured Section 1231 losses.

Applying the Rules

Nonrecaptured Section 1231 losses are the aggregate net Section 1231 losses deducted in the five preceding tax years that have not offset Section 1231 gains. These losses are considered recaptured in chronological order (i.e., FIFO) and expire if they have not been recaptured after five years. Nonrecaptured Section 1231 losses cannot be carried back to affect the character of prior-year Section 1231 gains; they can only be carried forward.

A nonrecaptured Section 1231 loss carryover schedule is helpful for keeping the information necessary to apply these rules.

Example 2B-1 Tracking nonrecaptured Section 1231 loss carryovers.

Leona, a calendar-year taxpayer who owns several partnership interests, has the following net Section 1231 gains and losses:

Year	Gain	Loss
2003	$ 15,000	$ —
2004	—	20,000
2005	8,000	—
2006	5,000	—
2007	—	—
2008	6,000	—
2009	—	—
2010	5,000	—

Leona had no Section 1231 gains or losses before 2003. The 2003 gain is not affected by the 2004 loss since nonrecaptured losses cannot be carried back. In 2005 and 2006, the $8,000 and $5,000 gains are taxed as ordinary income due to the $20,000 nonrecaptured Section 1231 loss carryover from 2004. In 2008, the $6,000 gain is taxed as ordinary income due to the remaining $7,000 ($20,000 − $8,000 − $5,000) nonrecaptured Section 1231 loss carryover. Since no Section 1231 transactions occurred in 2009, the $1,000 remaining nonrecaptured Section 1231 loss carryover originating in 2004 expires at the end of the 2009 tax year. In 2010, the $5,000 gain is treated as a long-term capital gain because no nonrecaptured Section 1231 losses remain.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. David sold depreciable real property held for twelve months or longer and used in a business to William. David realized a total gain for $40,000 on the sale including straight-line depreciation of $10,000 which is subject to recapture. David has no 1231 loss carryovers. Which of the following answers best describes the tax treatment of David's gains and how he should report the gains?

    a. David should report the total gain of $40,000 as ordinary income on the form 1040 as a miscellaneous income item.

    b. David should report $30,000 of the gain from the sale of the land as long term capital gain He should report it on IRS Schedule D.

    c. David should report $10,000 as ordinary gain and $30,000 as long term capital gain to be reported on an IRS Form 4797.

    d. David should report the $40,000 gain from the sale of the property as short term capital gain. He should report the gain on Schedule D.

22. Edward sells Section 1231 real property he has owned and used in his business for 15 years to Lawson. Edward has $50,000 Section 1231 loss on the sale and a Section 1231 nonrecaptured loss carryover from last year of $10,000. Prior depreciation on the property is $20,000. Edward has no other Section 1231 transactions for this year. Which of the following answers best describes the tax treatment of Edward's loss and how he will report the loss?

    a. $50,000 ordinary loss to be reported on Form 4797.

    b. $10,000 as ordinary gain on Schedule D.

    c. $20,000 as ordinary gain on Form 4797.

23. Randal had never experienced any losses before 2006. He has purchased 3 partnership interests that have passed through both Section 1231 gains and losses. Based on the following Section 1231 loss carryover schedule, which of the following is true?

Year	Gains	Losses
2006	$ 15,000	$ —
2007		20,000
2008	5,000	—
2009	7,000	—
2010	10,000	—

    a. The $10,000 Section 1231 gain for 2010 was taxed as a long term capital gain.

    b. The $10,000 gain for 2010 was taxed as $8,000 ordinary income and $2,000 as capital gain.

    c. $8,000 of the gain was taxed as ordinary income and $2,000 was taxed as long-term capital gain in 2010.

    d. The $20,000 loss in 2007 can be carried back to 2006 to offset the gain from that year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. David sold depreciable real property held for twelve months or longer and used in a business to William. David realized a total gain for $40,000 on the sale including straight-line depreciation of $10,000 which is subject to recapture. David has no 1231 loss carryovers. Which of the following answers best describes the tax treatment of David's gains and how he should report the gains? **(Page 157)**

    a. David should report the total gain of $40,000 as ordinary income on the form 1040 as a miscellaneous income item. [This answer is incorrect. The IRS instructions do not support this type of reporting but rather direct the taxpayer to a Form 4797.]

    b. David should report $30,000 of the gain from the sale of the land as long term capital gain He should report it on IRS Schedule D. [This answer is incorrect. According the IRS filing instructions, David must first report the gain on Form 4797 where the amount is combined with other items and then the adjusted total flows through to the Schedule D.]

    c. David should report $10,000 as ordinary gain and $30,000 as long term capital gain to be reported on an IRS Form 4797. [This answer is correct. Section 1231 treats the gain in excess of any depreciation recapture and 1231 loss carryovers as long term capital gain.]

    d. David should report the $40,000 gain from the sale of the property as short term capital gain. He should report the gain on Schedule D. [This answer is incorrect. The IRS instructions do not support this type of reporting but rather direct the taxpayer to a Form 4797.]

22. Edward sells Section 1231 real property he has owned and used in his business for 15 years to Lawson. Edward has $50,000 Section 1231 loss on the sale and a Section 1231 nonrecaptured loss carryover from last year of $10,000. Prior depreciation on the property is $20,000. Edward has no other Section 1231 transactions for this year. Which of the following answers best describes the tax treatment of Edward's loss and how he will report the loss? **(Page 157)**

    a. $50,000 ordinary loss to be reported on Form 4797. [This answer is correct. According to the IRS filing instructions, all net losses are treated as ordinary losses and should be reported on Form 4797.]

    b. $10,000 as ordinary gain on Schedule D. [This answer is incorrect. Nonrecaptured loss carryovers are not reported as ordinary gain instead they determine the amount of Section 1231 gain that is to be treated as ordinary income.]

    c. $20,000 as ordinary gain on Form 4797. [This answer is incorrect. The depreciation recapture rules of Section 1245 convert Section 1231 gains into ordinary income. Edward does not have a gain so the depreciation recapture rules do not apply.]

23. Randal had never experienced any losses before 2006. He has purchased 3 partnership interests that have passed through both Section 1231 gains and losses. Based on the following Section 1231 loss carryover schedule, which of the following is true? **(Page 157)**

Year	Gains	Losses
2006	$ 15,000	$ —
2007		20,000
2008	5,000	—
2009	7,000	—
2010	10,000	—

a. The $10,000 Section 1231 gain for 2010 was taxed as a long term capital gain. [This answer is incorrect. Randal's total gain had to be adjusted for any nonrecaptured 1231 losses reported in the 5 prior years as required by the Nonrecapture section of Section 1231.]

b. The $10,000 gain for 2010 was taxed as $8,000 ordinary income and $2,000 as capital gain. [This answer is incorrect. The gain had to be adjusted according to IRC Sec. 1231 for nonrecaptured 1231 losses reported in the 5 prior years.]

c. $8,000 of the gain was taxed as ordinary income and $2,000 was taxed as long-term capital gain in 2010. [This answer is correct. IRC Sec. 1231 requires that gain be taxes as ordinary income to the extent of any nonrecaptured Section 1231 losses. Randal had recaptured $5,000 of the $ 20,000 in 2003 and another $7,000 in 2004 leaving a balance of $8,000 of nonrecaptured 1231 losses to carry over to 2005.]

d. The $20,000 loss in 2007 can be carried back to 2006 to offset the gain from that year. [This answer is incorrect. Nonrecaptured 1231 losses cannot be carried back to affect the character of prior-year Section 1231 gains; they can only be carried forward.]

Form 8594—Purchase Price Allocations

When a taxpayer transfers (either directly or indirectly) assets that constitute a trade or business, and the transferee's basis in the assets is determined wholly by reference to the consideration paid for the assets, specific allocation rules under IRC Sec. 1060 must be applied to determine the transferee's basis in the assets acquired and the transferor's gain or loss on the transfer. In addition, buyers and sellers are mutually bound by any purchase price allocations and FMV determinations specified in any written buy/sell agreement, unless the parties can refute the allocation or valuation under the standards set forth in *Danielson*. A party wishing to challenge the tax consequences of an agreement must show proof that "in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc."

Factors indicative of the sale of a trade or business include:

1. total consideration in excess of the aggregate book value of the tangible and intangible assets purchased (other than goodwill or going concern value); or

2. related transactions, such as lease agreements, management contracts, noncompete agreements, or other similar agreements between the buyer and seller made in the transfer.

Reporting Requirements

The IRS requires both the buyer and seller to attach a completed Form 8594 (Asset Acquisition Statement) to their tax returns in the year the transaction occurs. Form 8594 requires the parties to disclose how the purchase price is allocated to seven asset categories. A revised Form 8594 must be filed if the purchase price allocated to any asset is increased or decreased after the tax year that includes the purchase date. Form 8594 expands the tax return disclosures required for sales and purchases of businesses and increases the IRS's ability to monitor allocations of purchase price to ensure the buyer and seller use the same allocation.

Effect of Like-kind Exchanges. Under the like-kind exchange rules of IRC Sec. 1031, the exchange of one business for another (each including assets such as cash, accounts receivable, real property, and personal property) cannot be treated as an exchange of a single property for another single property. Instead, the determination of whether IRC Sec. 1031 applies (or the extent to which it applies) to that exchange requires an analysis of all the underlying assets exchanged.

To the extent the like-kind exchange rules apply, IRC Sec. 1060 does not apply, and disclosure on Form 8594 is not required. However, the application of IRC Sec. 1031 to some of the assets transferred does not exclude the transfer of other nonlike-kind assets from Section 1060 requirements. Form 8594 disclosure is required for such assets. [In addition, Form 8824 (Like-Kind Exchanges) will be required to the extent IRC Sec. 1031 applies to the assets.] Also, all assets transferred (including any like-kind assets not subject to the Section 1060 rules) are considered for determining whether a trade or business was acquired.

Procedures for Allocating Purchase Price

Reg. 1.338-6 provides the rules for allocating purchase price to the basis of the business assets acquired. The assets constituting a trade or business are separated into seven classes:

I. Cash and cash equivalents (other than CDs).

II. Actively traded personal property as defined in IRC Sec. 1092(d) (e.g., readily marketable stock or securities) and certificates of deposit and foreign currency, even if not actively traded.

III. Accounts receivable, mortgages, and credit card receivables arising in the ordinary course of business and any assets that the taxpayer marks to market at least annually for federal income tax purposes.

IV. Stock in trade or other property of a kind that would ordinarily be included in inventory if on hand at the close of the tax year, or property held for sale in the ordinary course of business.

V. All assets not in Classes I, II, III, IV, VI, or VII. (This category includes land and buildings.)

VI. All Section 197 intangibles except goodwill or going concern value.

VII. Goodwill and going concern value (whether or not qualified as a Section 197 intangible).

When making this allocation, the purchase price is first reduced dollar for dollar by Class I assets (if any). The price is then reduced by the FMV of assets in Classes II–VI, in ascending order. The remaining purchase price, if any, is allocated to Class VII assets. Once the purchase price is allocated to these classes, the allocation within a particular class to individual assets is based on the relative FMV of the assets in that class.

This method of purchase price allocation is known as the residual method because the amount allocated to each class of assets is determined by the residual left after allocation to the preceding class. The use of the residual method means that an allocation of purchase price to an asset cannot exceed FMV—except for Class VII assets.

Example 2C-1 Form 8594 for asset acquisition including goodwill.

Tom sold the assets in his proprietorship business to John on July 1, 2010. The purchase price was $325,000 ($100,000 cash plus assumption of a $225,000 mortgage). The assets Tom sold have the following FMV:

Cash (Class I asset)	$ 1,000
Accounts receivable (Class III asset)	25,000
Inventory (Class IV asset)	25,000
Land (Class V asset)	30,000
Building (Class V asset)	195,000
Equipment (Class V asset)	25,000
Covenant not to compete—three years (Class VI asset)	15,000
	$ 316,000

John and Tom agreed on this allocation prior to sale, and it was written into the agreement. After allocating $1,000 to Class I assets, $25,000 to a Class III asset, $25,000 to a Class IV asset, $250,000 to Class V assets and $15,000 to a Class VI asset, John allocates the remaining purchase price (the residual) of $9,000 to Class VII. This becomes the value of the goodwill for the business.

Example 2C-2 Form 8594 for asset sale—bargain purchase.

Assume the same facts as in Example 2C-1 except the purchase price is $275,000 ($50,000 cash plus assumption of the $225,000 mortgage) and there is no covenant not to compete.

The FMV of the tangible business assets is $301,000. The $275,000 purchase price is first reduced by $1,000 cash (Class I) then by $25,000 (Class III), and again by $25,000 (Class IV). The remaining $224,000 is allocated to Class V; there is no value allocated to Class VI or VII. The $224,000 is allocated between Class V assets based on their relative FMV. The allocation to Class V assets will be (1) $26,880 ($30,000/$250,000 × $224,000) for the land, (2) $174,720 ($195,000/$250,000 × $224,000) for the building, and (3) $22,400 ($25,000/$250,000 × $224,000) for the equipment.

Effect of Debt on Asset Allocation. FMV, for allocating the purchase price to individual assets, is determined without regard to mortgages, liens, or other debt to which the asset is subject. However, in determining a seller's gain or loss, the FMV of property subject to nonrecourse debt is deemed to be at least the amount of the nonrecourse debt.

Postsale Adjustments to Purchase Price

If an increase in purchase price occurs after the sale date, it is allocated to the assets purchased based on the original purchase price allocation. The FMV of assets as of the purchase date must still be used to allocate any postsale increase in purchase price. Generally, the purchasing taxpayer will be unable to show that an increase in the FMV of assets in Classes II–VI caused the increase in the purchase price. Accordingly, the postsale increase in

purchase price, (to the extent the original purchase price equaled or exceeded the purchase date FMV), usually results in an increased allocation to Class VII intangibles only.

Postsale reductions in purchase price are allocated in reverse order, starting with Class VII intangibles. Decreases in the allocation to an individual asset cannot exceed the original purchase price allocated to it. The FMV as of the purchase date must be used to allocate any postsale price decrease. This means that negative postsale price adjustments usually affect only the allocations to Class VII intangibles.

Depreciation Recapture Computation

A gain on the disposition of Section 1231 business property qualifies for preferential capital gain treatment. This is important because gains of this character may be eligible for the installment method of reporting. They are also taxed at rates that are typically lower than the taxpayer's rate on ordinary income.

However, for personal property, Section 1245 depreciation recapture converts Section 1231 gains into ordinary income to the extent of depreciation claimed on the property. Similarly, Section 1250 recapture potentially converts capital gain from sale of depreciable real property into ordinary income. To the extent Section 1231 gain is converted into ordinary income, it is taxed at the taxpayer's ordinary income rate and is not eligible for installment reporting. Only gain in excess of ordinary income recapture can be reported on the installment method.

In addition to depreciation recapture, Section 1231 gains can be taxed as ordinary income if the taxpayer has nonrecaptured Section 1231 loss carryovers from the five previous tax years. Also, gain from the sale or exchange of depreciable real property between certain related persons is treated as ordinary income rather than Section 1231 gain.

When a single transaction involves the disposal of a combination of Section 1245, Section 1250, and nondepreciable property (e.g., land), the sales price must be allocated to each class to determine the gain or loss with respect to each class. This should be based on the FMV of each property and the agreement of the buyer and seller. For example, the sale of land and building requires an allocation of sales price between the building (which may be subject to recapture) and land (which is not subject to recapture).

Related-party Sales Losses

General Rules

Losses on sales or exchanges of property, directly or indirectly, between certain related parties are disallowed. The loss-disallowance rules prevent taxpayers from manipulating recognition of losses for tax purposes when an economic loss has not been realized. Exceptions to the rules apply to complete corporate liquidations and transfers of property between spouses or incident to divorce. The rules apply to any sale or exchange, even if it is bona fide and the terms are determined on a fair market basis. These rules have also been applied to involuntary sales.

What Is a Related Party?

Related parties include:

1. Individuals and their spouse; siblings (including half-brothers and half-sisters); parents and grandparents (or any other ancestor); and children, grandchildren, or any other lineal descendants.

2. An individual and a corporation (C or S corporation) in which the individual owns more than 50% in value of the outstanding stock.

3. A partnership and a person who either directly or indirectly owns more than 50% of either a capital or profits interest.

4. A tax-exempt organization and an individual that directly or indirectly controls the organization.

5. A fiduciary of a trust and (a) a grantor, (b) a beneficiary of that trust, (c) a fiduciary or beneficiary of another trust if both have the same grantor, and (d) a corporation in which more than 50% of the stock is owned by either the trust or an individual who is a grantor of the trust.

6. An executor of an estate and an estate beneficiary, except for sales or exchanges in satisfaction of a pecuniary bequest.

Constructive Ownership. Indirect ownership of corporate stock is also considered in determining whether parties are related. Stock owned by one person is considered owned by another in the following situations:

1. Stock owned by a corporation, partnership, estate, or trust is considered owned proportionately by the shareholders, partners, or beneficiaries.

2. Individuals are considered to own the stock owned directly or indirectly by other family members (as described in item 1 under "What Is a Related Party").

3. An individual who is a partner in a partnership and who owns stock in a corporation (other than stock attributed from a family member) is considered to own all the stock owned by his partners.

Stock attributed to an individual from a family member or a partner cannot be reattributed to someone else. Stock owned directly by related family members can be owned indirectly by multiple family members. Stock owned indirectly through a corporation, partnership, or trust can be attributed to another individual.

Example 2E-1 Indirect ownership of corporate stock.

Jan owns 25% of the outstanding stock of Essco, Inc. Her son, Bob, and her daughter, Jane, each own 12.5% of the stock. The remaining 50% is owned by an unrelated person. Jan sold a parcel of land to Essco for its FMV of $62,000; her basis in the land was $70,000. Jan realized a loss of $8,000.

Jan must include the stock owned by her children to determine whether the Section 267 loss limitations apply. Thus, Jan is considered to own 50% of the Essco stock. However, under IRC Sec. 267(b)(2), an individual must own more than 50% of the stock for the limitation to apply. Therefore, Jan can deduct the loss, since her direct and indirect ownership of Essco stock was not more than 50%. Essco's basis in the land is its cost of $62,000.

Applying the Related-party Rules

If several properties are sold in one transaction to a related party, gain or loss must be computed separately for each item. Gains on some items cannot offset losses on others. As a result, gains are recognized and losses are disallowed even if the items are sold at one time. Because of this, the allocation of the sale proceeds to the various assets sold is critically important. If possible, the taxpayer should attempt to allocate the proceeds in a way that will not generate losses which cannot currently be deducted. However, the guidelines for purchase price allocations must be considered.

Example 2E-2 Nonaggregation of related party gains and losses.

Jack owns a 60% interest in Woodlands II, a partnership. As of January 1, 2010, Jack owed $72,000 to Woodlands from loans in prior years. To pay off the loans, Jack transferred $72,000 of marketable securities to Woodlands in 2010, resulting in realized gains to Jack on some of the securities and losses on others.

Jack must compute gains and losses separately (without offset) on the transfer of securities in satisfaction of the debt. He must recognize the gains for tax purposes. However, Jack may not deduct the losses under IRC Sec. 267.

A disallowed loss may reduce the related buyer's gain on a subsequent sale. However, if the related buyer subsequently sells the property for a loss, the loss disallowed on the original sale to the related party is never recognized.

Example 2E-3 Gain on subsequent sale.

Several years ago, Stan sold an asset to his grandson, Dan, resulting in a realized yet unrecognized loss of $10,000. In 2010, Dan sold the asset for a $15,000 profit. (His basis was his purchase price when he bought the asset from Stan.) In 2010, Dan must recognize a gain of $5,000 from the sale, which is the $15,000 realized gain offset by Stan's previously disallowed $10,000 loss. Presumably, Dan would increase his original basis on Form 4797 or Schedule D of Form 1040 by the $10,000 previously disallowed loss. If, instead, Dan had sold the asset for a $5,000 profit, he could eliminate his realized profit by offsetting it with $5,000 of Stan's disallowed loss. The remaining $5,000 disallowed loss is never recognized.

Business Casualty Losses

A deduction for business casualty losses is allowed under IRC Sec. 165(c)(1). A *casualty loss* is defined as the damage, destruction, or loss of property resulting from a sudden, unexpected, or unusual identifiable event (e.g., car accidents, storms, floods). The amount of the loss is generally the lesser of the adjusted basis in the property or the decrease in the FMV due to the casualty.

Three important differences exist between business and personal casualty losses:

1. No percentage of AGI or $100 ($500 for 2009) per casualty threshold applies to limit the amount deductible for business casualty losses.

2. For real property, a business casualty loss or involuntary conversion gain is calculated separately for each identifiable piece of property. For example, if a casualty damages or destroys an office building and its landscaping, the properties are taken into account separately to determine the casualty loss or conversion gain attributable to each.

3. If business property is totally destroyed in a casualty and the fair market value of the property is less than its adjusted basis immediately before the casualty, the loss is calculated solely by considering the adjusted basis and the insurance proceeds. The decrease in FMV is not considered.

The deductible amount of a casualty loss is determined after reduction for any insurance proceeds or other reimbursement a taxpayer receives or expects to receive on the casualty. If insurance proceeds exceed the casualty loss, taxable gain results unless those proceeds are used to acquire qualifying property under the involuntary conversion rules.

If property is used partly for business and partly for personal purposes, basis must be allocated between the two components. A loss is then computed for each component based on either the business or personal casualty loss rules. The $100 per casualty and 10% of AGI limitations are only applied to the personal portion of the loss.

Example 2F-1 Computing a business casualty loss.

Jack, a self-employed contractor, drives a pickup truck that he uses 60% for business purposes and 40% for personal purposes. His adjusted basis in the pickup truck is $5,250 for the business use portion ($12,000 cost less $6,750 of accumulated depreciation) and $8,000 for personal use. Jack's adjusted gross income for 2010 is $25,000.

In July 2010, Jack was involved in an auto accident. His insurance company reimbursed him for the cost to repair the truck, subject to his $1,000 deductible. It cost Jack $6,000 to have his pickup repaired. [This is assumed to be the decrease in FMV.] Because the pickup was used partly for business and partly for personal purposes, a separate casualty loss is calculated for each.

	Business Loss	Personal Loss	Total
(1) Adjusted basis in truck before accident	$ 5,250	$ 8,000	$ 13,250
(2) Decrease in FMV	3,600	2,400	6,000
(3) Amount of loss (lesser of line 1 or 2)	3,600	2,400	6,000
(4) Less insurance reimbursement	(3,000)	(2,000)	(5,000)
(5) Loss after reimbursement (line 3 minus line 4)	$ 600	$ 400	$ 1,000

The $600 business loss is reported in Part 1, Section B, of Form 4684 (Casualties and Thefts). This loss is deductible without limitation in arriving at AGI (i.e., not an itemized deduction). The $400 loss related to the personal-use portion of the pickup is reported in Section A of Form 4684 and is deductible subject to the limitations placed on personal-use property casualty losses. Also, Jack's basis in the pickup is reduced by the amount of insurance reimbursement and by the casualty losses deducted and is increased by the cost of the repairs.

The rationale for increasing the basis of the damaged property by the cost of the repairs appears to be that such a cost is capitalized under IRC Sec. 263(a)(2) because it is incurred to restore a property or make good any exhaustion for which an allowance has been (or will be) made. Thus, the property's condition after the casualty is considered to determine whether the cost incurred is a capital expenditure. But in Ltr. Rul. 199903030, the IRS took a more taxpayer-favorable approach, looking at the property's condition immediately before the casualty to determine whether repair costs are capitalized. Because the taxpayer's costs merely brought the property back to its pre-casualty condition but did not enhance or improve it beyond that condition, repair costs after a casualty were found to be deductible rather than capital expenditures.

Gains from the Sale of Depreciable Real Property

Reporting Unrecaptured Section 1250 Gain

Under IRC Sec. 1(h)(6)(A), unrecaptured Section 1250 gain is the excess of (1) gain to the extent of depreciation claimed on the property, other than gain treated as ordinary income because of Section 1250 recapture or nonrecaptured Section 1231 loss carryovers, over (2) the excess of 28% rate loss [the sum of (a) loss from the sale of collectibles, (b) net short-term capital loss, and (c) the amount of any long-term capital loss carryover coming into the tax year] over 28% rate gain [the sum of (a) gain from the sale of collectibles and (b) the 50% gain exclusion from the sale of qualified small business stock under IRC Sec. 1202].

A maximum 25% rate applies to the unrecaptured Section 1250 gain if the real property has been held more than 12 months. Any remaining gain in excess of the amount subject to Section 1250 recapture and the unrecaptured Section 1250 provisions is classified as Section 1231 gain, subject to the regular capital gains rate.

The following table summarizes the maximum tax rates that apply to sales of Section 1250 real property in 2010:

Holding Period	Character of Gain	Maximum Tax Rate
12 months or less	Ordinary gain	35%
More than 12 months	Section 1250 recapture	35%
	Unrecaptured Section 1250 gain	25%
	Section 1231 gain	15%

When real property is sold or exchanged, the total amount realized must be allocated among the Section 1250 property and the non-Section 1250 property (i.e., Section 1245 personal property or nondepreciable land). Thus, a sale of depreciable real property typically requires an allocation of the sales price between the land and building. The allocation should be based on the relative fair market values of each component. Due to the different tax effects to the buyer and seller (it is more beneficial for the seller to allocate a greater portion to land due to the tax rate differential and more beneficial for the buyer to allocate a greater portion to the depreciable building), both parties should execute a written agreement allocating the total proceeds to each component of the sale.

Example 2G-1 Analyzing gain from the sale of depreciable real property.

On December 1, 2010, Allen sold a rental building that he has owned since 1997. His original cost basis in the building was $500,000 and he has taken straight-line depreciation deductions of $200,000, leaving an adjusted basis of $300,000. His basis in the land is $100,000. The sales price of the property was $850,000, of which $650,000 was allocable to the building and $200,000 to the land. He has no unrecaptured Section 1231 loss carryovers.

Allen's gain from the sale of the building is computed as follows:

		Building	Land	Total
Selling price		$ 650,000	$ 200,000	$ 850,000
Adjusted basis:				
Cost	$ 500,000			
Accum. depr.	(200,000)	(300,000)	(100,000)	(400,000)
Gain from sale		$ 350,000	$ 100,000	$ 450,000

There is no Section 1250 ordinary income recapture because the building was always depreciated using the straight-line method. Thus, the $350,000 gain attributable to the building is taxed as follows: (1) $200,000 (the amount of depreciation claimed) of the gain is unrecaptured Section 1250 gain taxed at a maximum rate of 25%, and (2) the remaining $150,000 of gain is a Section 1231 gain eligible for the 15% maximum capital gain rate. The $100,000 gain attributable to the land is a Section 1231 gain eligible for the 15% maximum capital gain rate.

Installment Sales of Depreciable Real Property

As Example 2G-1 illustrates, the sale of depreciable real property can result in gain being taxed at more than one capital gain rate. Thus, installment gains of depreciable real property may be taxed partly at 25% and partly at the applicable capital gain rate if the total gain exceeds the unrecaptured Section 1250 gain.

Reg. 1.453-12 takes a front-loaded approach to the installment recognition of unrecaptured Section 1250 gain. According to the regulation, if gain from an installment sale includes both unrecaptured Section 1250 gain (25% gain) and adjusted net capital gain (15% gain in 2010), the unrecaptured Section 1250 gain is reported before the adjusted net capital gain. The regulation applies to installment payments received after August 23, 1999.

Example 2G-2 Reporting unrecaptured Section 1250 gain.

Colleen owns a building that she purchased several years ago for $500,000. In 2010, she sold the building for $1 million, to be paid in five annual installments beginning June 1, 2010. Assume Colleen has no other gains or losses. Through the date of the sale, Colleen has claimed $300,000 of straight-line depreciation on the building. The deferred installment gain is $800,000 [($1,000,000 − $500,000) + $300,000].

The unrecaptured Section 1250 gain ($300,000) is recognized as income before the net capital gain ($500,000). The $200,000 installment payment received in 2010 will result in unrecaptured Section 1250 gain of $160,000 [$200,000 × ($800,000 ÷ $1,000,000)]. The installment payment received in 2011 will recognize the remaining $140,000 of unrecaptured Section 1250 gain with the other $20,000 ($160,000 − $140,000) being recognized as long-term capital gain subject to the applicable tax rate. For each of the remaining three installments, Colleen will recognize $160,000 of net capital gain subject to the applicable tax rate.

Variation: Assume that Colleen had a $70,000 unrecaptured Section 1231 loss in 2010. Her recognized gain would then be as follows:

	2010	2011	2012	2013	2014	Total
Sec. 1231 Ordinary	$ 70,000	$ —	$ —	$ —	$ —	$ 70,000
25% LTCG	90,000	140,000	—	—	—	230,000
Applicable LTCG rate		20,000	160,000	160,000	160,000	500,000
Total	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 800,000

The front-loading rule creates a tax friendly position for installment sales that occurred before the date that the 25% tax rate became effective (May 7, 1997). Therefore, even though the 25% rate was not applicable to gain recognized from payments received before May 7, 1997, that gain is treated as unrecaptured Section 1250 gain to the extent it does not exceed the total amount of unrecaptured Section 1250 gain recognized on the sale.

Example 2G-3 Installment sale before May 7, 1997.

Assume the same facts as Example 2G-2 except Colleen sold the building in 1995 for a 20-year installment note. She received annual payments of $50,000 on December 31, 1995, 1996, 1997, 1998, 1999, 2000, 2001, and 2002. As in Example 2G-2, Colleen's gain from the sale is $800,000, of which $300,000 is unrecaptured Section 1250 gain. Because the gain recognized on the sale prior to May 7, 1997, totaled $80,000 ($40,000 × 2 years), Colleen is deemed to have recognized that much unrecaptured Section 1250 gain prior to the effective date of the 25% tax rate. Therefore, all of the $40,000 gain recognized in 1997, 1998, 1999, 2000, and 2001 was deemed to be taxed at the 25% rate. Only $20,000 of the $40,000 gain recognized in 2002 was deemed to be taxed at 25%. The remaining 2002 gain of $20,000 and all gain recognized on the remaining installment payments received in subsequent tax years is taxed at the applicable capital gain rate for that year.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. Alice decides to retire and sell her quilt shop to Mary, an unrelated friend. Alice will transfer to Mary an operating bank account balance of $5,000, the accounts receivable, the inventory, the land and building, the equipment, and her Section 197 intangibles. Mary has offered $200,000 for everything. Which of the following statements best describes how Alice will determine the allocation of the sales price to each of the various classes of assets so she can determine the various types of gains to be reported?

    a. Alice decides to allocate the purchase price mainly to the land as she wants to have capital gain on as much of the sale proceeds as possible. Mary decides to allocate the purchase price mainly to the building as she wants to have as much depreciable property as possible.

    b. Alice and Mary agree on the allocation as part of the sales agreement. The assets involved in the sale are separated into classes and the sales price is allocated according IRC Sec. 1060. The transferor and transferee must use the same schedule to report the transaction.

    c. Alice and Mary divide the assets into seven classes according to IRC Sec. 1060, determine the fair market value for each group of assets and allocate the purchase price proportionately to the fair market value of each class of assets included in the transactions.

    d. Alice and Mary divide the assets into seven classes according to IRC Sec. 1060. After they determine the fair market value of each group they allocate the purchase price to the land and building. The remaining purchase price is allocated proportionately to the FMV of the remaining assets.

25. In 2010, Scott has a gain of $15,000 on the disposition of Section 1231 property. He has a nonrecaptured Section 1231 loss carryover of $2,000. The basis of the property has been adjusted for straight-line depreciation of $5,000 which is subject to Section 1245 recapture. Which of following statements best describes the application of the IRS code and the taxation of Scott's gain?

    a. In 2010, Scott's gain on the disposition will be taxed as ordinary income of $7,000 and long term capital gain of $8,000.

    b. In 2010, Scott's gain from the disposition will be taxed as $2,000 ordinary income and $13,000 of long term capital gains.

26. Darrell sells a small parcel of land with a building built on it. He has no carryover Section 1231 loss. What is the first step to determining his gain from the sale of depreciable real property?

    a. Allocate the proceeds among the Section 1250 and the non-Section 1250 property.

    b. Separate the transaction into asset classes according to Section 1060 and allocate the proceeds to each class of assets.

    c. Separate the assets into IRC Section 1245 property and non-Section 1245 property.

    d. Allocate the proceeds among the Section 1250, 1245, and 1231 properties.

27. Samantha sells for $800,000, real property consisting of land with a tax basis of $100,000, a building with an original cost of $400,000, with accumulated depreciation of $200,000. The depreciation has been calculated using the straight-line depreciation method. Samantha does not have any nonrecaptured Section 1231 loss carryover. The $800,000 sales price has been allocated as $200,000 for the land and $600,000 for the building. Which of the following statements best describes how Samantha's gain on the transaction will be taxed in 2010?

    a. The $400,000 gain on the building is taxed as $200,000 of unrecaptured Section 1250 gain and $200,000 as Section 1231 gain eligible. The remaining gain of $100,000 is a Section 1231 gain.

b. The $400,000 gain on the building is taxed as Section 1231 gain. The $100,000 gain on the land is taxed as Section 1231 gain and should be reported on Form 4797.

c. The $400,000 gain on the building transferred by Samantha and the $100,000 of the gain on the land would be reported on a Form 4794 and taxed at the maximum tax rate of 15%.

28. Sandra sold depreciable real property in 2010, on a five year contract for $1,600,000 with stated interest of 10%. The transaction consisted of land and a building. The basis of the building has been adjusted for $200,000 of straight-line depreciation. Sandra will report the gain proportionately to the principal received on the contract each year. Her gross profit percentage is 50% Sandra has a total realized gain of $800,000 of which $200,000 is unrecaptured Section 1250 gain to be taxed at a higher rate than the $600,000 of Section 1231 gain will be taxed. How will the gain be recognized in the first year of the contract if Sandra receives 20% of the contract principal amount in the first year?

a. $160,000 of gain is allocated: $40,000 to unrecaptured Section 1250 gain, taxed at the higher rate and $120,000 is be Section 1231 gain, taxed at the lower rate.

b. $160,000 of gain, all of which is recognized as Section 1231 gain and taxed at the lower rate. There will be no IRC Sec. 1231 gain reported in 2010.

c. $160,000 of gain from the sale is recognized as a Section 1250 gain and taxed at the higher rate.

d. $160,000 of gain is allocated: $80,000 as Section 1250 gain, taxed at the higher rate and $80,000 to Section 1231 gain, taxed at the lower rate.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. Alice decides to retire and sell her quilt shop to Mary, an unrelated friend. Alice will transfer to Mary an operating bank account balance of $5,000, the accounts receivable, the inventory, the land and building, the equipment, and her Section 197 intangibles. Mary has offered $200,000 for everything. Which of the following statements best describes how Alice will determine the allocation of the sales price to each of the various classes of assets so she can determine the various types of gains to be reported? **(Page 162)**

    a. Alice decides to allocate the purchase price mainly to the land as she wants to have capital gain on as much of the sale proceeds as possible. Mary decides to allocate the purchase price mainly to the building as she wants to have as much depreciable property as possible. [This answer is incorrect. Alice and Mary must agree on the allocation of the purchase price so Alice can determine her gain correctly and Mary can determine her tax basis in the property received in the transaction. The IRS requires both parties to attach to their returns a completed Form 8594 to report the agreed upon allocation.]

    b. Alice and Mary agree on the allocation as part of the sales agreement. The assets involved in the sale are separated into classes and the sales price is allocated according IRC Sec. 1060. The transferor and transferee must use the same schedule to report the transaction. [This answer is correct. The classifications and the allocation method must be in agreement with IRC Sec. 1060. The IRS requires both the buyer and seller to attach a completed Form 8594 to their tax returns in the year the transaction occurs and disclose how the purchase price is allocated to seven asset categories.]

    c. Alice and Mary divide the assets into seven classes according to IRC Sec. 1060, determine the fair market value for each group of assets and allocate the purchase price proportionately to the fair market value of each class of assets included in the transactions. [This answer is incorrect. It does not comply with the allocation method required by IRC Sec. 1060. The purchase price is to be allocated by the actual amount of the fair market value of each class of assets. The allocation is to be done in a specific order and any excess is allocated to goodwill.]

    d. Alice and Mary divide the assets into seven classes according to IRC Sec. 1060. After they determine the fair market value of each group they allocate the purchase price to the land and building. The remaining purchase price is allocated proportionately to the FMV of the remaining assets. [This answer is incorrect. The allocation method does not comply with the order and manner required by Section 1060.]

25. In 2010, Scott has a gain of $15,000 on the disposition of Section 1231 property. He has a nonrecaptured Section 1231 loss carryover of $2,000. The basis of the property has been adjusted for straight-line depreciation of $5,000 which is subject to Section 1245 recapture. Which of following statements best describes the application of the IRS code and the taxation of Scott's gain? **(Page 164)**

    a. In 2010, Scott's gain on the disposition will be taxed as ordinary income of $7,000 and long term capital gain of $8,000. [This answer is correct. The total gain of $15,000 must be reduced by any nonrecaptured Section 1231 losses from the prior 5 years. In this case a carryover of $2,000 must be reported as ordinary income. IRC Sec. 1245 converts Section 1231 gains to ordinary income to the extent of any depreciation required to be recaptured. In this case the depreciation to be recaptured under Section 1245 is $5,000. Therefore $7,000 must be taxed as ordinary income and the remaining gain of $8,000 is to be taxed as long term capital gain.]

    b. In 2010, Scott's gain from the disposition will be taxed as $2,000 ordinary income and $13,000 of long term capital gains. [This answer is incorrect. The total gain of $15,000 will be reduced by any nonrecaptured Section 1231 losses from the prior 5 years. In this case $2,000 will be taxed as ordinary income due to the carryover of the nonrecaptured gains. Scott must also consider IRC Sec. 1245 to determine if there is any depreciation that must be recaptured as ordinary income.]

26. Darrell sells a small parcel of land with a building built on it. He has no carryover Section 1231 loss. What is the first step to determining his gain from the sale of depreciable real property? **(Page 167)**

    a. Allocate the proceeds among the Section 1250 and the non-Section 1250 property. [This answer is correct. According to Reg. 1.125-1(a)(6), when real property is sold or exchanged the total amount realized must be allocated amount the Section 1250 property and the non-Section 1250 property.]

    b. Separate the transaction into asset classes according to Section 1060 and allocate the proceeds to each class of assets. [This answer is incorrect. This describes the first step in allocating the proceeds in an IRC Sec. 1245 transaction.]

    c. Separate the assets into IRC Section 1245 property and non-Section 1245 property. [This answer is incorrect. Darrell did not have any Section 1245 property included in his transaction.]

    d. Allocate the proceeds among the Section 1250, 1245, and 1231 properties. [This answer is incorrect. Darrell's transaction only included land and a building, neither of which is Section 1245 property.]

27. Samantha sells for $800,000, real property consisting of land with a tax basis of $100,000, a building with an original cost of $400,000, with accumulated depreciation of $200,000. The depreciation has been calculated using the straight-line depreciation method. Samantha does not have any nonrecaptured Section 1231 loss carryover. The $800,000 sales price has been allocated as $200,000 for the land and $600,000 for the building. Which of the following statements best describes how Samantha's gain on the transaction will be taxed in 2010? **(Page 167)**

    a. The $400,000 gain on the building is taxed as $200,000 of unrecaptured Section 1250 gain and $200,000 as Section 1231 gain eligible. The remaining gain of $100,000 is a Section 1231 gain. [This answer is correct. The depreciation was calculated using the straight-line method, so the $200,000 gain due to the depreciation is treated as an unrecaptured Section 1250 gain and is taxed at the maximum 25% rate. This treatment is in agreement with Sections 1231 and 1250.]

    b. The $400,000 gain on the building is taxed as Section 1231 gain. The $100,000 gain on the land is taxed as Section 1231 gain and should be reported on Form 4797. [This answer is incorrect. Section 1250 requires that the part of the gain resulting from the depreciation be taxed at a different rate. In this case, the depreciation has been calculated using the straight-line method depreciation and is not required to be recaptured but should be reported as unrecaptured Section 1250 property, with a maximum tax rate of 25%. The transaction would not be reported on a Schedule D.]

    c. The $400,000 gain on the building transferred by Samantha and the $100,000 of the gain on the land would be reported on a Form 4794 and taxed at the maximum tax rate of 15%. [This answer is incorrect. The transaction involves both Section 1250 and 1231 gains, which are taxed at different rates.]

28. Sandra sold depreciable real property in 2010, on a five year contract for $1,600,000 with stated interest of 10%. The transaction consisted of land and a building. The basis of the building has been adjusted for $200,000 of straight-line depreciation. Sandra will report the gain proportionately to the principal received on the contract each year. Her gross profit percentage is 50% Sandra has a total realized gain of $800,000 of which $200,000 is unrecaptured Section 1250 gain to be taxed at a higher rate than the $600,000 of Section 1231 gain will be taxed. How will the gain be recognized in the first year of the contract if Sandra receives 20% of the contract principal amount in the first year? **(Page 167)**

    a. $160,000 of gain is allocated: $40,000 to unrecaptured Section 1250 gain, taxed at the higher rate and $120,000 is be Section 1231 gain, taxed at the lower rate. [This answer is incorrect. The gain recognized would be $160,000. The allocation between the Section 1250 and Section 1231 gain recognized in accordance with Reg. 1.453-12. This allocation does not follow the IRS regulations.]

    b. $160,000 of gain, all of which is recognized as Section 1231 gain and taxed at the lower rate. There will be no IRC Sec. 1231 gain reported in 2010. [This answer is incorrect. The gain recognized would be $160,000. The allocation between the Section 1250 and Section 1231 gain recognized in not in accordance with Reg. 1.453-12 and would not all be taxed at the lower rate.]

c. $160,000 of gain from the sale is recognized as a Section 1250 gain and taxed at the higher rate. [This answer is correct. Reg. 1.453-12 takes a front-loaded approach to the installment recognition of unrecaptured Section 1250 gain. According to the regulation, if gain from an installment sale includes both unrecaptured Section 1250 gain and adjusted net capital gain, the unrecaptured Section 1250 gain is reported before the adjusted net capital gain.]

d. $160,000 of gain is allocated: $80,000 as Section 1250 gain, taxed at the higher rate and $80,000 to Section 1231 gain, taxed at the lower rate. [This answer is incorrect. The gain recognized would be $160,000. The allocation between the Section 1250 and Section 1231 gain recognized is not in accordance with Reg. 1.453-12.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TDBTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. Jim has several Section 1231 losses and a few section 1231 gains for 2010. The losses exceed the gains by $10,000. Jim has no nonrecaptured Section 1231 losses from prior years. How is Jim's $10,000 loss treated?

    a. Jim's $10,000 loss is treated as an ordinary loss in 2010.

    b. Jim's loss is treated as a capital loss in 2010.

    c. Jim's loss must be adjusted by the recapture of any depreciation.

    d. Jim's loss should be treated as ordinary and his gain should be treated as a long-term capital gain.

22. Robert has several Section 1231 losses and one large Section 1231 gain for 2010. His losses total $5,000 and his gain is $15,000. Robert also has $2,000 of nonrecaptured Section 1231 losses from 2008. Which of the following statements best describes the taxation of Robert's Section 1231 gains and losses for 2010?

    a. Robert will recognize $5,000 of ordinary loss $15,000 of capital gain.

    b. Robert will realize $2,000 of ordinary income and $8,000 of capital gains income.

    c. Robert will recognize $3,000 of ordinary loss and $15,000 of capital gain.

    d. Robert will recognize neither a gain or a loss in from these transactions in 2010.

23. The sale of a trade or business normally includes assets of various types. The transferee must determine the basis in the assets received in the transfer relative to the consideration paid for the business. The transferor must determine the amount received for the assets transferred relative to the consideration received for the business. Which of the following statements best describes how this is to be accomplished?

    a. The transferor must first apply IRC Section 1231 requirements to the transaction.

    b. The transferee must first apply IRC Section 1245 requirements to the transaction.

    c. Transferor and transferee must agree to the application of IRC Sec. 1060.

    d. Transferor and transferee should agree to the application of IRC Sec. 1231.

24. Which of the following forms is required by the IRS to be attached to the returns of both the transferor and the transferee in the year of the sale to report the sale and purchase of a business that does not include any like-kind exchanges?

    a. IRS Form 4797.

    b. IRS Form 8594.

    c. IRS Form 8824.

    d. IRS Form 468.

25. Carl and Roy want to exchange their businesses in a like-kind exchange. They will exchange assets, including cash, accounts receivable, real property and personal property. Which of the following statements best describes how the like-kind exchange rules will be applied?

    a. The allocation rules of IRC Sec. 1060 must be applied to divide assets into special categories and to allocate the purchase price to each class. Gains will be deferred and losses will be recognized on exchanges that qualify under IRC Sec. 1231.

    b. The exchange of a business for another business can be treated as a like-kind exchange of one property for another property. The total gain will be treated as long term capital gain and any loss will be ordinary loss.

    c. Carl must allocate the purchase price to the various assets he transferred to Roy and defer the gain realized to the various assets he received from Roy. Carl should use IRC Sec. 1060 as a guide for allocating the purchase price to the various assets he transferred to Roy.

    d. Do not select this answer.

26. Grady sells 3 garbage trucks for $100,000. His tax basis in the trucks is $50,000 and includes accumulated depreciation of $20,000. He acquired the trucks 3 years ago and has used them in his waste disposal business. Grady has no nonrecaptured Section 1231 losses from prior year. How will Grady recognize the gain on the transaction?

    a. Grady will recognize a $50,000 long-term capital gain on the transaction.

    b. Grady will recognize a $20,000 ordinary gain and $30,000 long-term capital gain.

    c. Grady will recognize a $50,000 ordinary gain on the transaction.

    d. Grady will recognize a $30,000 ordinary gain and $20,000 long-term capital gain.

27. Amos sold some equipment he had used in his business for 5 years. Andrew offered him $50,000 for the equipment. Amos's tax basis in the equipment is $20,000 including $15,000 of accumulated depreciation. Amos has $4,000 of nonrecaptured Section 1231 losses from the two prior years. How will Amos recognize the gain on the transaction in 2010?

    a. Amos will recognize $30,000 as long term capital gain.

    b. Amos will recognize $15,000 as long term capital gain and $15,000 as ordinary income.

    c. Amos will recognize $19,000 as ordinary income $11,000 as long term capital gain.

    d. Amos will recognize $19,000 as ordinary income and $15,000 as long term capital gain.

28. If a unrecaptured Section 1250 gain is held more than 12 months, what tax rate will be applied?

    a. No tax rate will be applied.

    b. 15%.

    c. 25%.

    d. 35%.

Lesson 3: Personal Residence Transactions

INTRODUCTION

Two of the most common large-scale transactions encountered by practitioners are the purchase and sale of a taxpayer's personal residence. A homebuyer generally incurs various settlement and closing costs, such as title and attorney fees, in connection with a residence purchase. These costs may be deductible, capitalizable (added to basis), or in some cases, neither. A taxpayer can exclude up to $250,000 ($500,000 if married filing jointly) of gain realized on the sale or exchange of a personal residence. The residence is often a married couple's most significant asset. Consequently, the tax considerations of a residence transfer between spouses are very important. This lesson discusses the tax issue of excluding gain in spousal transfers, both in divorce situations and as a result of the death of a spouse.

IRS Pub. 523, "Selling Your Home," contains information on what constitutes an improvement versus repair, information on closing statements that should be included in basis, and other information useful for this topic. Worksheets 1 and 2 of Pub. 523 can be used to compute the taxable gain and should be retained with the taxpayer's records.

Learning Objectives

Completion of this lesson will enable you to:

- Recognize the requirements for a principal residences and how to exclude the gain on the sale of a residence and on spousal transfers of a residence.

Costs Incurred to Purchase a Home

Settlement or closing costs paid by the buyer may be deductible, capitalizable (added to basis), or in some cases, neither. In the year a property is sold, property taxes must be apportioned between the buyer and seller based on the number of days each held the property during the real property tax year. Real estate taxes apportioned at closing are deductible for the portion of the tax year the home is owned, regardless of the tax accrual dates under local law and whether the buyer or seller actually paid the tax. However, the amount of property tax the seller paid on behalf of the buyer (without reimbursement) reduces the buyer's basis; conversely, the amount the buyer pays on behalf of the seller (without reimbursement) increases the buyer's basis. The proration of taxes is normally shown on the closing statement for the sale.

Points (a form of prepaid interest) generally must be amortized and deducted over the life of the loan. However, points paid for the purchase, construction, or improvement of a principal residence are deductible when paid in certain circumstances. The IRS has advised that payment of a loan origination fee can be viewed as a payment for the use of money and therefore treated as points.

In addition to points (including loan origination fees), mortgage lenders usually charge the borrower a variety of fees for obtaining the loan. These fees are not deductible because they are treated as a payment for services rather than as a payment for the use of money. The borrower may also incur attorney, appraisal, and title fees in connection with the purchase of a home. These types of expenditures are added to the property's basis. Other incidental expenses associated with a home purchase, such as recording fees and transfer taxes, are added to the basis of the home.

Example 3A-1 Analyzing a closing statement.

James purchased a home from John. The contract provided for a sales price of $140,000, proration of property taxes, one loan discount point to be paid by John, and any remaining points paid by James. In addition, the lender required James to pay a loan origination fee of 1% of the loan balance.

Excluding Gain on the Sale of a Residence

A taxpayer can exclude up to $250,000 ($500,000 if married filing jointly) of realized gain from the sale of a principal residence. Gain (or loss) is computed based on the selling price less expenses of the sale and the taxpayer's

adjusted basis in the residence. Adjusted basis is original cost or, if the taxpayer postponed gain under former IRC Sec. 1034 when the residence was acquired, cost adjusted for deferred gain. The cost of improvements (but not repairs or fixing-up expenses) made to the residence increases the taxpayer's basis and any depreciation claimed on the property decreases basis.

Definition of Principal Residence

Whether a property qualifies as a taxpayer's principal residence depends upon all the facts and circumstances. For example, a houseboat, a house trailer, or a house or apartment a taxpayer is entitled to occupy as a tenant-shareholder in a cooperative housing corporation may qualify as a principal residence.

Multiple Residences. If a taxpayer uses more than one property as a residence, the one that qualifies as the principal residence depends upon all the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property the taxpayer uses the majority of time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, other relevant factors for determining a taxpayer's principal residence include (but are not limited to): (1) taxpayer's place of employment; (2) the principal place of abode of the taxpayer's family members; (3) the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card; (4) the taxpayer's mailing address for bills and correspondence; (5) the location of the taxpayer's banks; and (6) the location of religious organizations and recreational clubs with which the taxpayer is affiliated.

A district court has ruled that taxpayers must determine whether they spend the majority of time at a particular residence on an annual basis (*Guinan*). Although the taxpayers spent more days at the home in question than at either of the other two homes they owned during the five years before that home was sold, the court determined which was their principal residence for each of those years. Based on the days spent at their homes each year, the taxpayers spent the majority of the days at the home in question during only one of the five years.

Surrounding Land. Excludable gain from the sale or exchange of a principal residence can include gain attributable to vacant land provided (1) the vacant land is adjacent to the land containing the dwelling unit of the taxpayer's principal residence, (2) the taxpayer owned and used the vacant land as part of his principal residence, (3) the taxpayer sells or exchanges the dwelling unit within two years before or two years after the date the vacant land is sold or exchanged, and (4) the Section 121 requirements are met with respect to the vacant land. Only one maximum exclusion of $250,000 ($500,000 for joint filers) applies to the combined gains from the separate sales of the dwelling and the surrounding vacant land.

Example 3B-1 Sale of vacant land qualifies for gain exclusion.

In 2006, Michael, a single taxpayer, buys a house on one acre of land that he uses as his principal residence. In 2007, he buys 29 acres of land adjacent to his house and uses the adjacent land as part of his principal residence. In 2010, Michael sells the house and one acre for a $25,000 loss and the 29 acres for a $270,000 gain, in two separate transactions. On his 2010 return, Michael may combine the two sales and exclude the net $245,000 gain.

Variation: If Michael sold the 29 acres in November 2010 but does not sell the residence and one acre until October 2012, he must report the $270,000 gain from the sale of the 29 acres on his 2010 return. Because the sale of the residence dwelling occurs within two years from the sale of the 29 acres, Michael can later file an amended return for 2010 excluding the entire gain previously reported. (Note: Had the sale of the dwelling unit occurred in 2011 before the due date, including extensions, of Michael's 2010 return, he could have avoided reporting the gain on his 2010 return, as originally filed.)

Gain Exclusion Requirements

The taxpayer must meet all three of the following tests for the full gain exclusion to apply:

1. *Ownership.* The taxpayer must have owned the residence for periods aggregating at least two years during the five years ending on the date of the sale or exchange.

2. *Use.* The taxpayer must have occupied the residence as a principal residence for periods adding up to at least two years within the five-year period ending on the date of the sale or exchange. Short, temporary absences are generally counted as periods of use. However, a one-year sabbatical leave is not considered a short, temporary absence. However, certain periods of nonqualified use may preclude excluding some of the gain.

3. *One Sale in Two Years.* The taxpayer must not have used the $250,000 (or $500,000) exclusion for any residence sold or exchanged during the two-year period ending on the date of the current sale or exchange. The date of sale is generally the earlier of the date the deed passes (is conveyed) or the time possession and the burdens and benefits of ownership are (from a practical standpoint) transferred to the buyer. This will usually be the date of the closing statement.

Example 3B-2 Ownership and use during nonconcurrent periods.

Tom and Nancy lived in a condo they rented from September 1, 2005, through 2007. On January 1, 2008, they purchased the condo. On July 1, 2008, they moved in with Tom's ailing father to help take care of him. On September 1, 2010, while still living with Tom's father, they sold the condo.

The sale of the condo will qualify for the gain exclusion because Tom and Nancy owned the condo for at least two years out of the five years preceding the sale (from January 1, 2008, until September 1, 2010), and they used the condo as their principal residence for at least two years during the five-year period ending on the date of sale (from September 1, 2005, until July 1, 2008).

Ownership Requirement. Usually, the passage of clear title is the single most important factor for determining whether and when the taxpayer owns a residence. However, taxpayers who have assumed enough of the benefits and burdens of ownership in a residence may be considered to own the home. Some of the factors considered are the right to use and possess the property, duty to maintain the property, extent of freedom to improve the property without seller's permission, risk of loss, obligation to pay the property taxes, and the responsibility to insure the property against loss.

An individual treated as owning the corpus of a grantor trust (under IRC Secs. 671–679, which includes revocable living trusts) is treated as the owner of a residence owned by the trust for the two-year ownership requirement. Any sale or exchange of the property while the grantor is alive is treated as if made by the grantor. Similarly, a residence owned by a single-owner disregarded entity is treated as owned by the owner of such entity and any sale or exchange of the property is treated as if made by the owner.

Use Requirement. In *Gummer*, the Court of Federal Claims rejected the IRS' argument that the principal residence use test under former IRC Sec. 121 must be based on strict physical occupancy. The taxpayer owned and lived in her home for 22 years before moving to an apartment. Due to declining home values, she did not sell the property until four years later. Agreeing with the taxpayer that a facts and circumstances rather than a "physical presence" test was more appropriate, the court found that an individual who does not physically occupy the residence for the requisite period may have extenuating circumstances which prevent physical presence but do not deny the characterization of use of the property as a principal residence for the requisite time. Likewise, a taxpayer's home did not lose its status as a principal residence while the taxpayer was transitioning to retirement in another state, based on all the facts and circumstances.

Special Rules for Uniformed Services, Foreign Services, and Intelligence Community. Military, foreign service personnel, or members of the intelligence community serving on official extended duty can elect to suspend the five-year test period (for up to ten years). To meet the qualified extended duty, the taxpayer (or his or her spouse) must be serving extended duty at a duty station at least 50 miles from the residence or living in government quarters at the government's order. *Extended duty* is a period of active duty greater than 90 days (or an indefinite period of duty). The election is made by filing a return (original or amended) for the sale year and claiming the gain exclusion. [The Heroes Earnings Assistance and Relief Tax Act of 2008 (2008 Heroes Act) removed an expiration date of this provision applicable only to members of the intelligence community. It also removed the requirement that the assignment for the intelligence community be outside of the United States.]

Example 3B-3 Extension of residency test for military member.

Bill bought a house on January 1, 2007, and used it as his principal residence for three years. On January 1, 2010, Bill began a qualified period of extended military duty. He returns on January 1, 2018, and uses his house as his primary residence until he sells it on December 31, 2018. For the two-out-of-five-year use test, Bill can elect not to count the 8-year period that he was on extended military duty. Therefore, the time considered for the test is the period from January 1 through December 31, 2018, and the period from January 1, 2007—December 31, 2009. Since Bill used the home as his primary residence for more than 24 months during that time, he meets the use test for excluding gain under IRC Sec. 121.

Debtors in Bankruptcy. A bankruptcy trustee is entitled to use the Section 121 gain exclusion rules to the same extent that the individual debtor would have been able to had he sold the residence. Pursuant to Reg. 1.1398-3, a bankruptcy estate succeeds to and takes into account the Section 121 exclusion with respect to property transferred into the estate.

Use Test during Periods of Out-of-residence Care. Periods of residence in a licensed care facility (e.g., nursing home) count as if the individual were living at home if the taxpayer becomes physically or mentally incapable of self-care. However, for this rule to apply, the individual must occupy his personal residence for an aggregate period of at least one year during the five-year period before the property is sold.

Decedent's Residence. When a decedent's residence transfers to a surviving spouse, the decedent's periods of ownership and use carry over to the surviving spouse, provided the surviving spouse has not remarried when the residence is sold or exchanged.

For other taxpayers inheriting a decedent's residence, including the decedent's estate, gain must be recognized to the extent the sales proceeds exceed the property's fair market value at the date of the decedent's death (or alternate valuation date, if applicable). Under IRC Sec. 1014(a), the basis in property acquired from a decedent is the property's FMV at the date of death (or alternate valuation date, if applicable). Further, the holding period is automatically deemed to be greater than one year so any gain would receive long-term capital gain treatment. However, if the heir uses the property as his own personal residence, the Section 121 gain exclusion rules will apply based on the heir's personal use and ownership of the property.

Involuntary Conversions. If the basis of property acquired in an involuntary conversion is determined (in whole or in part) under IRC Sec. 1033(b), then for purposes of satisfying the Section 121 requirements, the taxpayer is treated as owning and using the acquired property as his principal residence during any period of time that he owned and used the converted property as his principal residence.

When a taxpayer's principal residence is completely destroyed, any gain from the insurance proceeds can be treated as the sale of the residence that, if the property qualifies, can be excluded under IRC Sec. 121. In this advisory, which deals with a house destroyed in a natural disaster, the IRS came to the following conclusions about whether a home's partial or complete destruction qualifies as a Section 121 exchange:

1. Because the Code does not specifically apply to a partial destruction, IRC Sec. 121 applies only to a complete destruction.

2. Factors indicating that a complete destruction has occurred include:

    a. whether the damage to the home is so extensive that it is not advantageous to use any remaining structure (or portion thereof) to restore the property, and

    b. the cost of repairs substantially exceeds the home's FMV before the damage.

Partial Gain Exclusion

A taxpayer who fails to meet the Section 121 ownership and use requirements or the one-sale-in-two-years requirement is eligible for a partial gain exclusion if the principal residence was sold or exchanged by reason of (1) a change in place of employment; (2) health; or (3) unforeseen circumstances.

For each of the three situations where a partial exclusion may be available (change in employment, health reasons, or unforeseen circumstances), safe harbors are available. (See discussion of each of the three qualifying circumstances later in this lesson.) If the taxpayer meets the safe harbor, the sale is deemed to be by reason of that event. However, taxpayers who do not meet a safe harbor can still qualify for a partial exclusion if they demonstrate that one of the three qualifying situations was the *primary reason* for the sale or exchange. The following may indicate that an event or circumstance was the primary reason for a premature home sale:

1. a short time between the sale and the circumstances giving rise to it,
2. the property's suitability as the taxpayer's principal residence materially changes,
3. the taxpayer's financial ability to maintain the property is materially impaired,
4. the taxpayer used the property as a residence while he or she owned it,
5. the circumstances giving rise to the sale were not reasonably foreseeable when the taxpayer began using the property as the principal residence, and
6. the circumstances giving rise to the sale occurred while the taxpayer owned and used the home as a principal residence.

The partial exclusion is based on a fraction, which is multiplied by the maximum allowable exclusion. The numerator of the fraction is the *shorter* of: (1) the lesser of the aggregate amount of time during the five-year period ending on the date of the sale or exchange that the taxpayer either (a) owned the residence or (b) used it as his or her principal residence, or (2) the amount of elapsed time since the taxpayer last used the $250,000 (or $500,000) exclusion. The numerator of the fraction can be expressed in days or months. The denominator of the fraction is 730 days or 24 months (i.e., two years), depending on the measure of time used in the numerator.

Example 3B-4 Applying the partial exclusion rules.

Sandy sold her residence on September 1, 2009, and excluded $245,000 of gain. She bought a new house on the same date. On December 1, 2009, she moved out of the house to accept a promotion in a state 400 miles away. She sold the house on October 1, 2010, and realized a $25,000 gain. Although she did not own and occupy the house for two years *and* it has been less than two years since she used the exclusion, Sandy is allowed a partial exclusion since she moved because of a change in place of employment.

She owned and occupied the residence for 91 days, and at the time of sale it had been 395 days (i.e., 13 months) since she last used the exclusion. The shortest of these two periods is 91 days, so she is entitled to an exclusion of up to $31,164 [(91 ÷ 730) × $250,000 maximum allowable exclusion]. Any gain in excess of $31,164 would be taxed as a long-term capital gain.

Change in Place of Employment. The change in place of employment test is met if the primary reason for the sale or exchange is a change in the location of the employment of a qualified individual. For this purpose, a qualified individual is the taxpayer, the taxpayer's spouse, a co-owner of the property, or a person whose principal place of abode is in the same household as the taxpayer.

The regulations provide a distance safe harbor under which the sale or exchange is deemed to be by reason of a change in place of employment if (1) the change in place of employment occurs while the taxpayer owns and is using the property as a principal residence and (2) the individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment, or, if there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged is at least 50 miles. Employment includes commencing employment with a new employer, continuing with the same employer, and commencing or continuing self-employment.

Example 3B-5 Sale qualifies by reason of change of employment.

In February, Ann buys a condo that is five miles from her place of employment and uses it as her principal residence. In December of that same year, Ann, who works as an emergency medicine physician, obtains a

job that is located 51 miles from her condo. Because she may be called in to work unscheduled hours and, when called, must be able to arrive quickly, Ann sells her condo and buys a new one that is four miles from her new job. Because her new job is only 46 miles farther from the old condo than her former job, the sale is not within the safe harbor rule. However, Ann is still entitled to the partial gain exclusion from the sale since, under those facts and circumstances but not under the safe harbor, the primary reason for the sale is the change in her place of employment.

Health Reasons. The health reason test is met if the primary reason for the sale or exchange is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of a disease, illness, or injury to a qualified individual. A qualified individual is the same as for the change-of-employment test but also includes any relatives of a qualified individual and descendants of the taxpayer's grandparents. A sale or exchange that is merely beneficial to the general health or well-being of the individual does not qualify. Under a safe harbor rule, a change in residence recommended by a physician qualifies as a health reason.

Unforeseen Circumstances. An unforeseen circumstance is the occurrence of an event that the taxpayer cannot reasonably anticipate before purchasing and occupying the residence. Under a safe harbor, the sale or exchange is deemed to be by reason of unforeseen circumstances if any of the following events occur while the taxpayer owns and uses the property as a principal residence:

1. the involuntary conversion of the property;

2. natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under IRC Sec. 165(h));

3. any of the following in the case of a qualified individual (as defined earlier for the change-of-employment test): (a) death; (b) cessation of employment as a result of which the individual is eligible for unemployment compensation; (c) a change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary for the production of income, but not for the maintenance of an affluent or luxurious standard of living); (d) divorce or legal separation under a decree of divorce or separate maintenance; or (e) multiple births resulting from the same pregnancy;

4. an event the IRS determines to be an unforeseen circumstance and publishes in guidance of general applicability or in a ruling directed to a specific taxpayer.

Example 3B-6 Sale of residence due to unforeseen circumstances.

Sandra works as a teacher and Al works as a pilot. In 2010, they buy a house they use as their principal residence. Six months later, Al is furloughed from his job. Sandra and Al are unable to pay their mortgage during the furlough period so they sell their house. The sale is deemed to be by reason of an unforeseen circumstance since a change in employment makes them unable to pay their housing costs.

Example 3B-7 Known condition does not qualify as an unforeseen circumstance.

Nancy buys a house that she uses as her principal residence. The property is located on a heavily trafficked road. Nancy sells the house nine months later because the traffic is more disturbing than she expected. Nancy is not entitled to a partial gain exclusion since none of the safe harbors apply and the traffic is not an unforeseen circumstance because Nancy could have reasonably anticipated the traffic when she bought the house.

Variation: Nancy purchased the house on a bystreet that was not well-traveled. However, two months after she purchased the home, road construction on a major nearby street detoured traffic through her neighborhood, causing excessive noise. Nancy was not informed about the upcoming road construction when she purchased the house. The excessive traffic is an unforeseen circumstance because Nancy had no reason to expect traffic conditions to change so quickly.

Effect of Rental or Business Use on Exclusion of Gain

The fact that a residence is rented or used partly for business (i.e., a home office) at the time of the sale does not automatically preclude gain attributable to such business use from being excluded. Instead, the gain exclusion depends generally on whether the taxpayer meets the ownership and use requirements and the one-sale-in-two-years test at the time of the sale. However, there are two exceptions to this general rule of meeting the requirements at the time of sale: (1) gain exclusion cannot be claimed to the extent of depreciation adjustments attributable to periods after May 6, 1997; and (2) after 2008, certain nonqualified uses of the residence may preclude full exclusion of gain from the sale.

Post-May 6, 1997, Depreciation. Gain exclusion cannot be claimed to the extent of depreciation adjustments attributable to periods after May 6, 1997. Even if depreciation is not claimed, the adjusted tax basis of the property must still be reduced by the allowable depreciation. In addition, forgoing depreciation deductions does not prevent the recognition of gain for allowable depreciation attributable to periods after May 6, 1997. The rule for recognizing gain to the extent of depreciation claimed after May 6, 1997, applies even if the property is no longer used for rental or business purposes at the time of sale.

Nonqualified Use. The gain exclusion from the sale of a principal residence ($500,000 for joint filers and $250,000 for single filers) is not available to taxpayers for periods of nonqualified use. *Nonqualified use* is any period *after 2008* that the property is not used by the taxpayer, or the taxpayer's spouse or former spouse as a principal residence (i.e., rental, business use, etc.). However, nonqualified use does not include any period of such use that occurs (1) any time during the five-year period ending on the date of sale that occurs after the last day of use as a principal residence, or (2) any time (up to two years) that the taxpayer is temporarily absent due to change in place of employment, health, or unforeseen circumstances. Gain is allocated to nonqualified use by multiplying it by a fraction, with the aggregate periods of nonqualified use as the numerator and the total period the taxpayer owned the property as the denominator. Gain taxable because of post-May 6, 1997, depreciation (see previous discussion) is not taken into account in determining the gain allocated to nonqualified use.

Example 3B-8 Conversion to rental does not prevent gain exclusion.

In 1998, Sally purchased a home that she used as her personal residence until December 31, 2007. At that time, she acquired a new residence and converted her former residence to a rental property. She still resides in the new residence. On November 1, 2010, she sold the rent house, recognizing a $50,000 gain. At the time of sale, Sally had claimed depreciation deductions totaling $5,000.

Although the property was converted to rental use, it still qualifies as Sally's residence at the time of sale because (1) she owned the property for at least two of the five years before the sale (she owned it since 1998), (2) she occupied the property as her principal residence for at least two years during the five-year period ending on the date of sale (during the five-year period ending November 1, 2010, Sally lived in the house from November 1, 2005, through December 31, 2007, a period of two years, two months), and (3) she has not used the gain exclusion for any residence during the two-year period ending on the date of sale. Thus, she can exclude $45,000 ($50,000 − $5,000) of the gain because it is less than her $250,000 gain exclusion limitation. However, $5,000 of the gain is taxable because gain to the extent of the post-May 6, 1997 depreciation cannot be excluded. This amount is taxed at a maximum rate of 25% under the unrecaptured Section 1250 gain rules.

The $50,000 gain is reported in Part III of Form 4797. On line 2, Part I of Form 4797, the phrase "Section 121 exclusion" must be written and the gain exclusion amount ($45,000) entered as a loss in column (g).

Example 3B-9 Gain exclusion subject to nonqualified use.

Floyd bought a vacation home in an exclusive area on January 1, 2005. On January 1, 2011, he converts the property into his principal residence, and he and his wife live there for all of 2011 and 2012. On January 1, 2013, he sells the home for a $450,000 gain. Floyd's total ownership period is eight years (2005–2012). The two years of post-2008 use as a vacation home (2009–2010) count against him and result in a nonexcludable (taxable) gain of $112,500 (2/8 × $450,000). The remaining $337,500 of gain is excludable.

Property Used in Part as Principal Residence. The gain exclusion rules do not apply to any portion of a property that is separate from the dwelling unit for which the taxpayer does not satisfy the use requirement. Thus, if a portion of

the property was used as a principal residence and a portion separate from the dwelling unit was used for non-residential purposes, only the gain allocable to the residential portion is excludable under IRC Sec. 121. However, no allocation is required if both the residential and nonresidential portions of the property are within the same dwelling unit. But, gain to the extent of any depreciation claimed after May 6, 1997, is still not eligible for exclusion. For this purpose, a dwelling unit includes a house, apartment, condominium, mobile home, boat, or similar property [i.e., the definition found in IRC Sec. 280A(f)(1), excluding appurtenant structures or other property]. Also, a single structure can consist of more than one dwelling unit if each unit has its own entrance, cooking and bathroom facilities. In that case, only the dwelling unit used as a principal residence qualifies for exclusion.

When an allocation is required, a taxpayer must allocate basis and amount realized between the residential and nonresidential portions of the property using the same allocation method used to determine depreciation adjustments.

Example 3B-10 Effect of home office use on gain exclusion.

Robert, an attorney, buys a house in 2007. The house is a single dwelling but Robert uses one room regularly and exclusively as a law office from the date of purchase until the property is sold in 2010. For 2007–2010, Robert claims $2,000 of depreciation with respect to the portion of the property used as his home office. On the sale, he realizes a gain of $30,000.

Although the room used for Robert's home office does not meet the use test when he sold the property, no allocation of gain is required since it is part of the residential dwelling unit. However, Robert must recognize $2,000 of the gain as unrecaptured Section 1250 gain since this is the amount of post-May 6, 1997, depreciation he claimed for the business portion of the dwelling. The remaining $28,000 of gain is excludable.

Variation: If Robert's home office were located in a detached garage, an allocation of gain would be required. Thus, if the detached garage constituted 20% of the property, 20% of the gain ($6,000) must be recognized ($2,000 as unrecaptured Section 1250 gain and $4,000 as Section 1231 gain).

Excluding Gain from Mixed-use Property When a Like-kind Exchange Occurs. Taxpayers often hold property for use as a business and personal residence. When this single dwelling is exchanged for a like-kind property, gain can be excluded under the rules for personal residences under IRC Sec. 121 and deferred under IRC Sec. 1031, gain deferral on like-kind exchanges. Any gain in excess of the $250,000 ($500,000 for married taxpayers filing jointly) personal residence exclusion may be deferred if the property was exchanged for a like-kind property used in a trade or business or as an investment. This deferral is subject to recapture of any depreciation claimed on the portion of the asset used in the taxpayer's business or held for investment. Additionally, any non-like-kind (boot) property received as part of the exchange is taken into account to the extent it exceeds the gain excluded under the personal residence rules.

Essentially, a taxpayer that engages in a transaction that qualifies for both (1) the exclusion of gain from disposition of a principal residence under IRC Sec. 121 (see "Gain Exclusion Requirements" earlier in this lesson) and (2) the deferral of gain from exchanging like-kind properties under IRC Sec. 1031 is eligible to apply both statutory provisions in accordance with the following guidelines established in Rev. Proc. 2005-14:

1. Gain is first excluded to the extent of the $250,000 ($500,000 for married filing jointly) personal residence exemption under IRC Sec. 121.

2. The personal residence exclusion does not apply to the extent there is gain attributable to depreciation adjustments for periods after May 6, 1997. However, the deferral of gain as part of a like-kind exchange applies to these portions.

3. Boot (cash or other non-like-kind property) is taken into account only to the extent it exceeds the gain excluded under IRC Sec. 121.

4. The basis in the replacement property (the property received in the like-kind exchange) is increased by the amount of gain excluded under the Section 121 rules.

Example 3B-11 Exchanging residence previously converted to rental.

Chris buys a house in his hometown for $210,000 and uses it as his principal residence for five years. However, he is then asked to transfer to another city and decides to rent out the house for the next two years. For each of those two years he collects rent, pays expenses, and deducts $20,000 in depreciation. He then considers acquiring a townhouse in exchange for the house he currently owns but is renting. Chris exchanges his old house, receiving $10,000 and a townhouse with a $460,000 fair market value (FMV) that he intends to rent out.

Chris realizes a $280,000 gain on the exchange [$470,000 realized less the adjusted basis of $190,000 ($210,000 − $20,000 depreciation)]. Since he has owned and occupied the house as his principal residence for two of the last five years prior to the exchange, he can exclude $250,000 of gain before applying the deferral available under the like-kind exchange rules (the house is investment property at the time of the exchange because it is being rented). The remaining $30,000 of gain (including the $20,000 attributable to depreciation) is deferred under the nonrecognition rules of like-kind exchanges. Chris does not have to recognize the $10,000 (boot) received since it is not in excess of the amount of excluded gain ($250,000). The basis in the townhouse replacement property is equal to: (1) the basis of the relinquished residence ($190,000), plus (2) gain excluded under IRC Sec. 121 ($250,000), less (3) boot received ($10,000); i.e., $430,000.

Example 3B-12 Exchanging residence with a home office in the same dwelling unit.

Barb, a single taxpayer, buys a home for $210,000. From 2005–2009 (five years), she uses 2/3 of the house (by square footage) as her principal residence and 1/3 of the house as a qualifying home office for her business. Barb claimed $30,000 of depreciation for the business portion during this time.

In 2010, Barb exchanges the entire property for a residence and a separate property that she intends to use as a qualifying home office. The combined FMV of the two replacement properties is $360,000 ($240,000 for the replacement residence and $120,000 for the replacement business property). The $360,000 amount matches the relinquished property's FMV; therefore, no cash changes hands in the exchange.

Under IRC Sec. 121, Barb excludes the $100,000 of realized gain allocable to the residential portion of the relinquished property [proceeds (FMV) of $240,000 (2/3 of total proceeds of $360,000) minus basis of $140,000 (2/3 of relinquished property's original basis of $210,000)]. The remaining $80,000 of realized gain is allocable to the business portion of the relinquished property [proceeds (FMV) of $120,000 (1/3 of total proceeds of $360,000) minus basis of $40,000 (1/3 of relinquished property's original basis of $210,000 reduced by depreciation of $30,000)]. Under the rules of Rev. Proc. 2005-14, Barb applies the Section 121 exclusion rules before applying the Section 1031 deferral rules to the business portion of the property. Pursuant to Reg. 1.121-1(e), Barb can exclude $50,000 of the $80,000 gain allocable to the business portion because the office space was part of a single dwelling unit that was also her principal residence. Barb cannot exclude the remaining $30,000 of gain allocable to the business portion because it is attributable to depreciation deductions after May 6, 1997. However, that portion of the gain is deferred under IRC Sec. 1031.

Barb's tax results are illustrated as follows:

	Total	Residence	Business
FMV received	$ 360,000	$ 240,000	$ 120,000
Cost basis	$ 210,000	$ 140,000	$ 70,000
Less depreciation	(30,000)	—	(30,000)
Adjusted tax basis	$ 180,000	$ 140,000	$ 40,000

	Total	Residence	Business
Realized gain	$ 180,000	$ 100,000	$ 80,000
Less IRC Sec. 121 exclusion	(150,000)	(100,000)	(50,000)
Less IRC Sec. 1031 deferral	(30,000)	—	(30,000)
Taxable gain	$ -0-	$ -0-	$ -0-

Barb's basis in the residential portion of the replacement property is its FMV of $240,000. Barb's basis in the business portion of the replacement property is $90,000 (adjusted tax basis in the relinquished business portion of $40,000 plus the Section 121 exclusion of $50,000).

Election to Not Apply Gain Exclusion

A taxpayer can elect to have the gain exclusion rules not apply. If the election is made, the taxpayer recognizes any gain realized on the transaction.

Example 3B-13 Electing out of gain exclusion rules.

Tara owns two houses (House 1 and House 2). She lived in House 1 for two years, then moved into House 2 and has lived there two years. Tara is now selling House 1 (which she has been trying to sell for two years) and will realize a $40,000 gain. She plans to sell House 2 within a year and anticipates a $60,000 gain on the sale. Both sales would qualify for the $250,000 exclusion, but she cannot use it on House 1 and again on House 2 because of the one-sale-in-two-years rule. Tara can elect out of the exclusion when she sells House 1 and recognize the $40,000 gain. Then, she can exclude the $60,000 gain on House 2.

Effect of Filing Status on the Exclusion

Qualifying for the Exclusion. Married taxpayers filing a joint return for the year of sale may exclude up to $500,000 of gain if:

1. either spouse owned the home for periods aggregating two years or more during the five-year period ending on the sale date,

2. both spouses used the home as a principal residence for periods aggregating two years or more during the five-year period ending on the sale date, and

3. neither spouse is ineligible for the exclusion because he or she had sold another home within the two-year period ending on the sale date to which the exclusion applied.

Entering the Marriage with One Spouse Owning a Home. When only one individual entering a marriage owns a principal residence, close attention to the calendar and to use by the non-owning spouse can make the difference between a completely tax-free gain and partially taxed gain.

Example 3B-14 One spouse owns a residence before marriage.

Karl owns a house that he has owned and used as his principal residence for 12 years. He marries Missy, who has resided in an apartment she has rented and used as a principal residence for 10 years. After their marriage, the first for both of them, Missy moved into Karl's house. Later, Karl and Missy decide to move and Karl sells the house for a $450,000 gain.

Whether the gain is totally excluded depends on how long Missy used Karl's home as a principal residence before the sale. If Missy used the home as a principal residence for at least two years during the five-year period ending on the sale date, the full $450,000 gain is excluded because all three of the requirements for excluding up to $500,000 of gain will have been met. This is true even though the house is owned solely by Karl. If Missy uses the home as a principal residence for less than two years during the five-year period ending on the sale date, only $250,000 of the gain will be excluded since only Karl met the use test.

Both Spouses Entering the Marriage Owning Homes. If both parties entering a marriage intend to move into a new principal residence after marriage, each can sell his or her former residence and claim an exclusion up to $250,000 if they each meet the three qualifications. The provision limiting the exclusion to only one sale every two years by the taxpayer does not prevent a husband and wife filing a joint return from each excluding up to $250,000 of gain from the sale or exchange of each spouse's principal residence owned at the time of their marriage, provided each spouse would be permitted to exclude up to $250,000 of gain if they filed separate returns.

Example 3B-15 Excluding gain after marriage on each spouse's pre-marital residence.

Don and Maureen lived in separate residences that they each owned for more than two years before they were married on February 1, 2010. They purchased a new house together and sold their old ones in March 2010. Don realized $185,000 gain on the sale of his house and Maureen realized a gain of $175,000. Being married does not affect *each* spouse's ability to exclude up to $250,000 of gain on the sale of a residence. They do not qualify for the $500,000 exclusion on either of the residences because the use test is not met. To meet that test, both spouses would have had to occupy one of the residences for at least two out of the previous five years. Because the gain from each sale is entirely excluded from income, neither sale is reported on Don and Maureen's 2010 Form 1040.

Variation 1: Assume instead that Don realized $300,000 gain on the sale of his old residence. Here, Don can exclude $250,000 on the sale of his residence; Maureen can exclude the entire $175,000 of her gain. Don must include $50,000 ($300,000 – $250,000) of gain on their joint return.

Variation 2: Assume the same facts as in Variation 1 except Maureen and Don lived in Don's old house for 2½ years before their marriage, and Maureen lived in her home the 2½ years before that. They apparently have two choices:

1. They can exclude the $300,000 gain on Don's house. They qualify for the $500,000 exclusion on a joint return on his house because both spouses occupied it for more than two of the previous five years. The gain on Maureen's house would not be excludable because the $500,000 exclusion applies to *one* residence.

2. They can treat the transactions as in the original example (i.e., exclude $250,000 of gain on Don's house and $175,000 on Maureen's). Maureen meets the use test for her residence because she lived in it for more than two of the previous five years. Don meets the use test for his old residence, so each is entitled to a $250,000 exclusion.

In this example, they would be better off excluding the $250,000 on Don's and the $175,000 on Maureen's, for a total exclusion of $425,000. Then, Maureen would evidently be electing out of excluding the gain on Don's house and would therefore be eligible for her own $250,000 exclusion. (See "Election to Not Apply the Gain Exclusion" earlier in this lesson.)

Spousal Transfers Gain Exclusion

Dividing the Residence between Spouses in Divorce Situations

In a divorce, one of the spouses often moves out of the residence and divorce proceedings, which may take several months to several years to complete, are commenced. In dividing up the marital estate, the marital residence is usually disposed of in one of the following ways:

1. *Residence Is Sold Immediately.* The residence is sold immediately as part of the divorce proceedings. When this occurs, the proceeds of the sale are usually divided between the two spouses.

2. *Ownership Is Transferred to One Spouse.* One of the spouses receives sole ownership of the residence while the other spouse receives other assets or cash to equalize the property settlement.

3. *Sale of Residence Is Delayed.* One spouse continues to occupy the residence for some period following the divorce. The house then may be sold at some future date (such as when the children finish school) and the proceeds divided between the former spouses in the manner specified by the divorce agreement.

Residence Sold as Part of Divorce Proceedings. The divorce agreement may specify that the residence must be sold as part of the divorce process so that the proceeds can be split between the spouses. If the property is owned jointly or is community property, each spouse is considered to have sold half the property. If each spouse independently meets the two-out-of-five-years ownership and use tests and the one-sale-every-two-year rule, then each spouse's share of the gain can be sheltered by the $250,000 exclusion. The fact that the spouses file separate returns for the year of sale or are divorced and file as single persons does not make a difference.

Example 3C-1 Immediate sale of residence after divorce.

Tim and Jan Smith were divorced during the year. They sell the home they owned jointly and used as a principal residence for 10 years. The home is sold for $600,000, resulting in a gain of $400,000. Each of them can exclude their $200,000 share of the gain from tax.

Ownership Transferred Incident to Divorce. Transferring ownership of the principal residence from one spouse to the other during marriage or in a divorce is governed by IRC Sec. 1041. Neither spouse recognizes gain or loss on the transfer, and the receiving spouse's basis in the residence is the combined basis of both spouses before the transfer. Even where the transferring spouse receives other assets or cash to even out the property settlement, there is no gain or loss or change in the basis of the residence.

If a taxpayer transfers a residence to a spouse or former spouse incident to a divorce, the transferee's period of ownership includes the transferor's ownership period.

Example 3C-2 Exclusion of gain after transfer to spouse incident to divorce.

For 25 years, Tom and Jane Jones used a home owned by Tom as their principal residence. They divorce, and pursuant to their divorce decree, Tom transfers ownership of the home to Jane. Six months later Jane sells the home at a $200,000 gain. The gain is excluded under IRC Sec. 121. Jane meets the two-out-of-five years use test, and also meets the two-out-of-five years ownership test because she can include Tom's ownership period as her own.

Delayed Sale of Residence under Divorce Agreement. For divorcing couples with children, it is common for one spouse to move out and the other to reside in and maintain the home for the children. After the children complete school or otherwise move away from home, the home is often sold and the proceeds divided between the now divorced spouses.

For purposes of the use test, a spouse who continues to own all or part of the marital residence but no longer resides there (i.e., the nonresident spouse) is considered to be using the residence as a principal residence while such taxpayer's spouse or former spouse is granted use of the property under a divorce or separation agreement.

Example 3C-3 Meeting the use test for delayed sale pursuant to divorce.

Randy and Ann have jointly owned their residence for seven years. They divorce and Ann moves into an apartment. The decree states that Randy can live in their jointly-owned house until it is sold, and he does so. Four years later, the house is sold at a gain of $300,000. Each former spouse can exclude their $150,000 share of the gain. In meeting the use test, Ann is considered to be using the house as her principal residence during the time Randy resides there. (Randy meets the use test because he actually lives in it.)

There may be situations where couples divorce and the spouse who continues to use the residence as a principal residence remarries. Given the appropriate facts, it is the authors' opinion that up to $750,000 of gain can be excluded on the sale of a residence in this situation. Consider the following example.

Example 3C-4 Exclusion of gain after remarriage of resident former spouse.

Tim and Nancy Jones own a home they have used as their principal residence for the last 20 years. The tax basis in the home is $100,000, and it is now worth $1 million. The Joneses get divorced, and the divorce decree specifies that Tim and Nancy remain co-owners of the residence and that Nancy is to retain use of the residence at least until their youngest child reaches age 18 in three years. At that time, the house is to be sold and the proceeds split equally between Tim and Nancy.

Shortly after Tim moves out, Bob moves in. Nancy and Bob get married and three years later the house is sold for $1.1 million, resulting in a $1 million gain.

At the time of the sale, Tim, Nancy, and Bob have all used the house as a principal residence for at least two of the last five years. For purposes of the use test, Tim is allowed to count not only his actual use but also Nancy's use because such use is pursuant to their divorce decree. Tim and Nancy also satisfy the two-year ownership test. As a result, Tim and Nancy are each allowed to exclude $250,000 of the $500,000 gain allocated to them. In addition, if Bob and Nancy file a joint return for the year of sale, presumably an additional $250,000 of gain could be excluded on that return because only one spouse has to meet the ownership test. Thus, it appears a total of $750,000 of gain can be excluded, 100% of the $500,000 of gain reportable by Nancy and Bob and $250,000 of the $500,000 gain reportable by Tim.

Transfer of Residence Due to Death of Spouse

If a taxpayer dies and the surviving spouse has not remarried when a residence is sold or exchanged, the surviving spouse's period of ownership and use includes the period the deceased taxpayer owned and used the property.

Example 3C-5 Residence transferred to spouse upon taxpayer's death.

Ed has lived in his residence for ten years. During the year, he marries Tracy. Three months later, Ed dies. Tracy is considered to have owned and occupied the residence for 10 years.

Example 3C-6 Post-death sale by surviving spouse.

Al and Dee have lived in their home for many years and would recognize a $600,000 gain if they sold it. The property is held in joint tenancy when Al dies on August 1, 2010. Assuming they reside in a non-community property state, and after basis adjustments the remaining gain upon sale would be $300,000. If Dee sells the residence in 2011, the full $500,000 joint return gain exclusion will be available, and none of the gain will be taxable.

Reporting Requirements When a Principal Residence Is Sold

Sales of real property are usually reported on Form 1099-S (Proceeds From Real Estate Transactions). Principal residence sales can be excluded from the Form 1099-S reporting requirements if the sales price is $250,000 or less ($500,000 or less in the case of a married individual) and the seller provides certain written assurances to the person responsible for reporting the sale. The seller's assurances certify that he (the seller) meets the rules for excluding gain and the entire gain is excludable (i.e., there is no business or rental use after May 7, 1997). Sales with proceeds exceeding $250,000 ($500,000 for married individuals) must be reported on Form 1099-S even when the gain is fully excludable by the seller.

For purposes of this certification, the term "seller" includes each owner of the residence that is sold. Therefore, a separate certification must be received from each owner (including a spouse) or the real estate reporting person must timely file a Form 1099-S and furnish a copy to any owner that does not make the certification.

If gain from the sale of a principal residence is entirely excluded or the sale results in a loss, the sale should not be reported on the return (even if a Form 1099-S was received). When all or a portion of a gain is taxable, the entire gain is reported on Schedule D (Capital Gains and Losses) and the excluded amount, if any, is reported as a loss with the description "Section 121 exclusion." See Example 3B-8 for how to report the gain when a portion of the home was used for rental purposes. Worksheets 1 and 2 in IRS Pub. 523, "Selling Your Home," can be used to compute the adjusted basis of the home sold, realized gain or loss, the exclusion amount, and any taxable gain.

An Employer or Relocation Service Company's Purchase of a Taxpayer's Home

Sometimes, when an employee is transferred to a new location, the employer will purchase his home. The amount paid can be fair market value (FMV) as established by appraisals, a guaranteed percentage of the employee's basis

in the home if the appraisal is less than basis, or any other amount agreed to. A relocation service company (RSC) may be retained by the employer to manage the sale of the employee's home for a fee that is usually 2%–3% of the home's FMV. The carrying costs incurred between the time the employee receives his check and the time the house is sold as well as closing costs at the time of sale are borne by the employer. The employer benefits from (or pays the price for) any fluctuations in FMV during that period.

If an employer hires a third-party RSC to buy an employee's home for FMV unreduced by closing costs that are incurred in a normal sale, the tax consequences to the employee are usually more favorable. If the price paid for the home does not exceed FMV, no taxable income accrues to the employee, although the arrangement, in effect, pays him for otherwise unavoidable closing costs. The employee's gain on the sale of the former residence is higher, but the gain likely is excluded.

Some companies take their moving expense reimbursement plan a step further and reimburse employees for any amount by which FMV (generally determined by appraisal) exceeds the sales price of their old house. As with reimbursed closing costs, this reimbursement is taxable compensation to the employee (*Keener*). If the company buys the house from the employee at its appraised FMV instead, the employee has no taxable compensation income from the sale. However, if the employer purchases the home directly or indirectly for a price in excess of FMV, the excess is taxable compensation income to the employee. Furthermore, if the employer (or RSC) resells the home to a third party who had previously made a similar offer to the employee, the payment of brokerage fees by the employer (or RSC) results in taxable income to the employee.

Example 3E-1 Sale of residence by employee to employer-provided relocation service.

Dante was transferred from California to Texas. His employer hired a relocation firm that purchased Dante's California home for its FMV of $275,000. The amount paid to Dante was not reduced for the closing costs that he would have paid in a normal sales transaction (approximately $22,000). Dante's basis in the California home was $120,000. He purchased a new home in Texas for $300,000.

Assuming Dante can exclude the entire $155,000 ($275,000 – $120,000) gain from income, he need not report the sale of the residence on his return. The fact that the price paid by the relocation service was not reduced by normal selling expenses has no tax consequences to Dante.

Variation: Had Dante sold the California house himself for $275,000 and incurred $22,000 of selling expenses, he would have netted $253,000. If Dante's employer then reimbursed him for the $22,000, that amount would have been reported as income. The $22,000 of selling expenses reduced Dante's gain on the sale, but this is of no tax consequence to him if he is able to exclude the entire gain. Thus, the employer reimbursement results in Dante's recognizing $22,000 of taxable income that he cannot exclude under the gain from the sale of a residence rules or claim as the reimbursement of a deductible moving expense.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. Which of the following items from a closing statement are usually amortized over the life of the loan?

    a. Attorney fees relating to the purchase of the residence.

    b. Appraisal fees paid in relation to the purchase of the residence.

    c. Recording fees related to the purchase of the residence.

    d. Points paid as prepaid interest to obtain a loan to purchase the residence.

30. Ralph and Wanda, a married couple who file jointly, sold their principal residence in 2010 for $1,000,000 cash. The sale qualified for the gain exclusion available under IRC Sec. 121. They realized a gain of $550,000. How much gain must they recognize in 2010?

    a. $0.

    b. $50,000.

    c. $250,000.

    d. $550,000.

31. The gain realized in the sale of a personal residence is calculated as the selling price, as adjusted, less the adjusted basis of the residence. There are adjustments allowed in determining the tax basis and to calculate the realized gain on the sale of a personal residence. Which of the following would **not** be used in determining the tax basis of personal residence when reporting its sale?

    a. Any gain deferred from the prior sale of a residence under IRS Sec. 1034.

    b. The cost of improvements made to the residence.

    c. The cost of repairs made to the structure.

    d. The expenses related to the sale of the residence.

32. Taxpayers who own multiple residences must determine which one is their principal residence. Which of the following statements best describes what determines the principal residence for the purpose of excluding the gain from the sale of a residence?

    a. The principal residence is determined by the taxpayer's place of employment and voter registration.

    b. The principal residence is determined by the address listed on a taxpayer's federal tax return.

    c. The principal residence is usually determined by the where the majority of time is spent but numerous facts and circumstances can go into the decision.

33. Mike and Madge purchased a house with 2 acres of land for their personal residence on May 5, 1970. In 1971, they purchased the 35 acres of land adjacent to their residence. They used the land as part of the residence and enjoyed the beautiful view. Mike and Madge lived in the house until it was sold. It was never rented or unoccupied. In January of 2010, they sold the adjacent 35 acres, realizing a gain of $350,000. In November 2010, they sold the house and the 2 acres originally purchased in 1970 to an party unrelated to the other sales transaction. On the house sale, they realized a gain of $50,000. How much gain can Mike and Madge exclude in 2010 on their joint tax return?

    a. $50,000.

    b. $350,000.

    c. $400,000.

    d. $500,000.

34. Taxpayers may exclude gain from the sale of a principal residence. In which of the following situations would the taxpayers qualify for the full exclusion of the gain related to the sale in 2010?

    a. Ralph and Mary purchased their first home on June 1, 1950. It has been their principal residence from the purchase date until they moved on July 15, 2010 except for the 4 years they lived in England while Ralph was stationed there (1951 to 1955). Their realized gain is $50,000.

    b. Jane and John purchase a home on June 1, 1950 and lived there until December 31, 2007. At that time they purchased a new home. They rented the house until it was sold on November 1, 2010. Upon the sale of the home, they realized a gain of $50,000. During the time the house was rented they had $3,000 of depreciation.

    c. Roy and Rhonda purchased their first home on June 1, 1950 for $60,000 and lived there until they sold the house in 2010. For a period of 9 months in 2009, they rented the house while they traveled. Their gain on the sale is $200,000, due in part to the improvements they made to the house and property and the excellent maintenance of property.

35. Ronald, a single man, sold his residence on September 1, 2009 and excluded a $200,000 gain. He purchased a new home on the same date. Three months later on December 1, 2009 he moved 600 miles away to accept a promotion. He sold his house on October 1, 2010 and realized a $45,000 gain. How much gain must Ronald recognize in 2010?

    a. $0.

    b. $13,750.

    c. $31,250.

    d. $45,000.

36. Jerald and Jerry purchase a home in 2007. Jerry uses one room in the house regularly and exclusively as a piano studio for teaching piano students. She taught from the day of purchase until the property was sold in 2010. Jerald and Jerry claimed $3,000 of depreciation with respect to the piano studio portion of the property. On the sale they realized $50,000. How will they report their gain?

    a. All of the gain is fully excluded.

    b. $3,000 as ordinary income.

    c. $3,000 as unrecaptured Section 1250 gain.

    d. $50,000 as Section 1245 gain.

37. Randy purchased a residence for $155,000 and used it as his principal residence for five years. He decides to transfer to an office 1,000 miles away and makes the decision to rent his former residence. Two years later, he finds a condo in his new city valued at $450,000. The owners of the condo transfer the ownership to Randy for $10,000 cash and Randy's former residence. The previous residence was rented for the entire two years since Randy moved. During that time, Randy collected rent, paid expenses, and deducted a total of $15,000 of depreciation. It is Randy's intent to rent the newly acquired condo. Which of the following statements best describes how Randy will record the transaction?

    a. Randy will first calculate the gain deferral available under IRC Sec. 1031. The deferred gain will be $270,000. He can exclude $260,000 of the gain pursuant to IRC Sec. 1031. The remaining $10,000 gain is boot and reported as ordinary gain. His basis in the condo is equal to $200,000.

    b. Randy will calculate the gain exclusion available under IRC Sec. 121. The realized gain will be $320,000. He can exclude $250,000 pursuant to IRC Sec. 121. The remaining $70,000 gain is then deferred under the like-kind exchange rules. His basis in the condo is equal to $380,000.

    c. Randy will calculate the gain exclusion under IRC Sec. 121. The realized gain is $320,000. He can exclude $250,000 pursuant to IRC Sec. 121. The remaining $70,000 gain including $15,000 of depreciation and $10,000 of boot is ordinary income. His basis in the condo is $450,000.

    d. Randy will first calculate the gain deferral under IRC Sec. 1031. The deferred gain is $320,000. He can exclude $260,000 of the gain pursuant to IRC Sec. 1031. The remaining $10,000 gain is boot and reported as ordinary gain. His basis in the condo is equal to $200,000.

38. Carl purchased a home in 1999. It has been his principal residence for the full time he has owned it. He marries Faye in 1999 and she moves into Carl's house. They file a joint tax return after their marriage. In 2010, Carl and Faye decide to purchase a larger home and sell Carl's house. The realized gain on the sale of the house is $300,000. Faye never owned a home before her marriage to Carl. She lived with her mother until she married him. How much, if any, gain can they exclude on their 2010 joint tax return as a result of the house transaction?

    a. $0.

    b. $50,000.

    c. $250,000.

    d. $300,000.

39. If the ownership of a principal residence is transferred from one spouse to the other due to a divorce, how is gain recognized in the transfer?

    a. Neither spouse recognizes a gain or loss on the transfer of the property.

    b. Each spouse is eligible for a gain exclusion based on the FMV of the property.

    c. The spouse that receives the property in the divorce will have to recognize a gain on the property, based on the FMV of the residence.

40. If an employer purchases the home of an employee because the employee has been transferred to a new location due to employment, which of the following is true?

    a. If carrying costs are incurred between the time the employee is paid by the employer for the home and the actually sells, the employee foot the costs during the actual closing on the home.

    b. If the employee's house sells for a higher amount than the employer paid the employee for the house and this amount is reimbursed to the employee, it becomes taxable compensation to the employee.

    c. If a third-party relocation company purchases the employee's house for FMV without any closing costs, the employee must include the closing costs a taxable compensation for the year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. Which of the following items from a closing statement are usually amortized over the life of the loan? **(Page 179)**

    a. Attorney fees relating to the purchase of the residence. [This answer is incorrect. Attorney's fees can be added to the basis of residence. They can be added to the property's basis per Reg. 1.263(a)-2.]

    b. Appraisal fees paid in relation to the purchase of the residence. [This answer is incorrect. Appraisal fees can be added to the basis as indicated by Reg. 1.263(a)-2.]

    c. Recording fees related to the purchase of the residence. [This answer is incorrect. IRS Reg. 1.263 (a)-2 allows recording fees to be added to the basis of the residence.]

    d. Points paid as prepaid interest to obtain a loan to purchase the residence. [This answer is correct. Points in the form of prepaid interest generally must be amortized and deducted over the life of the loan. They do not increase the tax basis of the residence.]

30. Ralph and Wanda, a married couple who file jointly, sold their principal residence in 2010 for $1,000,000 cash. The sale qualified for the gain exclusion available under IRC Sec. 121. They realized a gain of $550,000. How much gain must they recognize in 2010? **(Page 179)**

    a. $0. [This answer is incorrect. Ralph and Wanda's gain exceeds the amount that they can exclude under IRC Sec. 121, therefore they must recognize part of the gain.]

    b. $50,000. [This answer is correct. Ralph and Wanda's gain exceeds the amount they can exclude under IRC Sec. 121 by $50,000, since the maximum exclusion for taxpayers filing jointly is $500,000. They must recognize $50,000 for gain realized.]

    c. $250,000. [This answer is incorrect. Ralph and Wanda's gain exceeds the amount they can exclude under IRC Sec. 121, but $250,000 is the maximum exclusion for taxpayers that are not filing jointly.]

    d. $550,000. [This answer is incorrect. Ralph and Wanda are allowed an exclusion under IRC Sec. 121. They will not have to recognize the full amount as a gain in 2010.]

31. The gain realized in the sale of a personal residence is calculated as the selling price, as adjusted, less the adjusted basis of the residence. There are adjustments allowed in determining the tax basis and to calculate the realized gain on the sale of a personal residence. Which of the following would **not** be used in determining the tax basis of personal residence when reporting its sale? **(Page 179)**

    a. Any gain deferred from the prior sale of a residence under IRS Sec. 1034. [This answer is incorrect. Any gain deferred in the prior sale of a residence must be used in calculating the gain on future sales. IRC Sec 121.]

    b. The cost of improvements made to the residence. [This answer is incorrect. The cost of improvements made to the residence increases the taxpayer's basis in the residence and would be used in determining the basis.]

    c. The cost of repairs made to the structure. [This answer is correct. Repairs or fixing-up expenses made to the residence do not increase the basis of the property.]

    d. The expenses related to the sale of the residence. [This answer is incorrect. Expenses related to the sale of a residence are an adjustment to the selling price for determining the realized gain. Gain (or loss) is computed based on the selling price less expenses of the sale and the taxpayer's adjusted basis in the residence.]

32. Taxpayers who own multiple residences must determine which one is their principal residence. Which of the following statements best describes what determines the principal residence for the purpose of excluding the gain from the sale of a residence? **(Page 179)**

    a. The principal residence is determined by the taxpayer's place of employment and voter registration. [This answer is incorrect. The place of employment and location of voter registration are factors to be considered but do not by themselves determine the principal residence.]

    b. The principal residence is determined by the address listed on a taxpayer's federal tax return. [This answer is incorrect. The address on the tax return may help substantiate the principal residence but it alone does not determine the matter.]

    c. The principal residence is usually determined by the where the majority of time is spent but numerous facts and circumstances can go into the decision. [This answer is correct. Reg. 1.121-1(b)(2) provides guidance in this area. If a taxpayer used more than one property as a residence, the amount of time each is used, will normally be considered the principal residence. However, there are several other factors and circumstances to be considered before making a determination, such as taxpayer's place of employment, the principal place of abode of the taxpayer's family members, the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card, the taxpayer's mailing address for bills, the location of the taxpayer's banks and the location of religious organizations and recreational clubs with which the taxpayer is affiliated.]

33. Mike and Madge purchased a house with 2 acres of land for their personal residence on May 5, 1970. In 1971, they purchased the 35 acres of land adjacent to their residence. They used the land as part of the residence and enjoyed the beautiful view. Mike and Madge lived in the house until it was sold. It was never rented or unoccupied. In January of 2010, they sold the adjacent 35 acres, realizing a gain of $350,000. In November 2010, they sold the house and the 2 acres originally purchased in 1970 to an party unrelated to the other sales transaction. On the house sale, they realized a gain of $50,000. How much gain can Mike and Madge exclude in 2010 on their joint tax return? **(Page 179)**

    a. $50,000. [This answer is incorrect. Based on Reg. 1.121-1(b)(3)(l), Mike and Madge should be able to maximize the gain they can exclude by including the surrounding land.]

    b. $350,000. [This answer is incorrect. Mike and Madge should be able to take advantage of a higher gain exclusion by following the guidance in Reg. 1.121-1(b)(3)(l) concerning the sale or exchange of a principal residence including gain attributable to adjacent vacant land.]

    c. $400,000. [This answer is correct. They can exclude the gain from the sale of land given that it was used as part of their residence, it was adjacent to the land containing the dwelling unit, they owned and used the vacant land as part of their residence, the land was sold within two years before or two years after the sale of the residence and it meets the requirements of IRC Sec. 121.]

    d. $500,000. [This answer is incorrect. $500,000 is the maximum gain that can be excluded. However, they cannot exclude more gain than they realize.]

34. Taxpayers may exclude gain from the sale of a principal residence. In which of the following situations would the taxpayers qualify for the full exclusion of the gain related to the sale in 2010? **(Page 179)**

    a. Ralph and Mary purchased their first home on June 1, 1950. It has been their principal residence from the purchase date until they moved on July 15, 2010 except for the 4 years they lived in England while Ralph was stationed there (1951 to 1955). Their realized gain is $50,000. [This answer is correct. Ralph and Mary qualify for the full exclusion of the gain. They satisfy the ownership and use requirements. They also satisfy the one sale in two years rule. They meet the three tests for the $500,000 gain exclusion to apply under IRC Sec 121.]

    b. Jane and John purchase a home on June 1, 1950 and lived there until December 31, 2007. At that time they purchased a new home. They rented the house until it was sold on November 1, 2010. Upon the sale

of the home, they realized a gain of $50,000. During the time the house was rented they had $3,000 of depreciation. [This answer is incorrect. Jane and John qualify to exclude some of the gain but not all of the gain. Gain exclusion cannot be claimed for allowable depreciation for periods after May 6, 1997 according to IRC Sec. 121(d)(6) and 1250(b)(3).]

c. Roy and Rhonda purchased their first home on June 1, 1950 for $60,000 and lived there until they sold the house in 2010. For a period of 9 months in 2009, they rented the house while they traveled. Their gain on the sale is $200,000, due in part to the improvements they made to the house and property and the excellent maintenance of property. [This answer is incorrect. Roy and Rhonda qualify to exclude some but not all of the gain. Gain exclusion cannot be claimed for certain nonqualified uses of the residence after 2008 or for allowable depreciation. Their situation would require that part of their gain be allocated to the nonqualified use and some to the allowable depreciation. Neither amount would qualify for the gain exclusion pursuant to IRC Sec. 121.]

35. Ronald, a single man, sold his residence on September 1, 2009 and excluded a $200,000 gain. He purchased a new home on the same date. Three months later on December 1, 2009 he moved 600 miles away to accept a promotion. He sold his house on October 1, 2010 and realized a $45,000 gain. How much gain must Ronald recognize in 2010? **(Page 179)**

a. $0. [This answer is incorrect. Ronald will qualify to exclude a portion of the gain due to the partial gain exclusion included in IRC Sec. 121 (c).]

b. $13,750. [This answer is correct. Ronald moved because of a change in his place of employment. Although he does not qualify to exclude up to $250,000, he does qualify for a partial gain exclusion. Ronald owned and occupied the residence for 3 months. At the date of the sale it had been 13 months since Ronald had last used the exclusion. According to the IRS regulations, the partial gain Ronald can exclude is determined by multiplying the maximum exclusion ($250,000) by a fraction with a denominator of 24 months and a numerator of the lesser of the time he owned and used the residence or the period since Ronald had last used the exclusion. Three months is the shorter of these periods so Ronald can exclude up to $31,250 [$250,000 x (3 months ÷ 24 months)]. The gain he realized in 2010 was $45,000 so he is allowed to recognize $13,750 ($45,000-$31,250).]

c. $31,250. [This answer is incorrect. This is the calculated amount of gain Ronald can exclude. The gain to be reported would the total gain less this amount.]

d. $45,000. [This answer is incorrect. Ronald does not meet the requirements of IRC Sec. 121 rules for excluding the maximum gain on the sale of a residence. He did not own and use the home for two years as a residence and he had excluded a gain in the two previous years.]

36. Jerald and Jerry purchase a home in 2007. Jerry uses one room in the house regularly and exclusively as a piano studio for teaching piano students. She taught from the day of purchase until the property was sold in 2010. Jerald and Jerry claimed $3,000 of depreciation with respect to the piano studio portion of the property. On the sale they realized $50,000. How will they report their gain? **(Page 179)**

a. All of the gain is fully excluded. [This answer is incorrect. Gain to the extent of allowable depreciation can not be excluded under IRC Sec. 121.]

b. $3,000 as ordinary income. [This answer is incorrect. There are no ordinary income items involved in this transaction based on IRC Sec. 121.]

c. $3,000 as unrecaptured Section 1250 gain. [This answer is correct. Gain is recognized to the extent of allowable depreciation is unrecaptured Section 1250 gain and cannot be excluded under IRC Sec 121. The remaining $47,000 gain is excludable.]

d. $50,000 as Section 1245 gain. [This answer is incorrect. The gain from the sale of a principal residence is subject to Section 121. In this case, most of the gain is excluded.]

37. Randy purchased a residence for $155,000 and used it as his principal residence for five years. He decides to transfer to an office 1,000 miles away and makes the decision to rent his former residence. Two years later, he finds a condo in his new city valued at $450,000. The owners of the condo transfer the ownership to Randy for $10,000 cash and Randy's former residence. The previous residence was rented for the entire two years since Randy moved. During that time, Randy collected rent, paid expenses, and deducted a total of $15,000 of depreciation. It is Randy's intent to rent the newly acquired condo. Which of the following statements best describes how Randy will record the transaction? **(Page 179)**

    a. Randy will first calculate the gain deferral available under IRC Sec. 1031. The deferred gain will be $270,000. He can exclude $260,000 of the gain pursuant to IRC Sec. 1031. The remaining $10,000 gain is boot and reported as ordinary gain. His basis in the condo is equal to $200,000. [This answer is incorrect. Based on Rev. Proc. 2005-14, Randy must first consider the IRC Sec. 121 rules associated with a personal residence.]

    b. Randy will calculate the gain exclusion available under IRC Sec. 121. The realized gain will be $320,000. He can exclude $250,000 pursuant to IRC Sec. 121. The remaining $70,000 gain is then deferred under the like-kind exchange rules. His basis in the condo is equal to $380,000. [This answer is correct. The gain exclusion available under IRC Sec. 121 is to be calculated before applying the like-kind exchange rules pursuant to Rev. Proc 2005-14.]

    c. Randy will calculate the gain exclusion under IRC Sec. 121. The realized gain is $320,000. He can exclude $250,000 pursuant to IRC Sec. 121. The remaining $70,000 gain including $15,000 of depreciation and $10,000 of boot is ordinary income. His basis in the condo is $450,000. [This answer is incorrect. Based on the guidelines established in Rev. Proc 2005-14, boot is taken into account only to the extent it exceeds the gain excluded under IRC Sec 121.]

    d. Randy will first calculate the gain deferral under IRC Sec. 1031. The deferred gain is $320,000. He can exclude $260,000 of the gain pursuant to IRC Sec. 1031. The remaining $10,000 gain is boot and reported as ordinary gain. His basis in the condo is equal to $200,000. [This answer is incorrect. The IRS guidance provided in Rev. Proc. 2005-14 requires the gain deferrals rules for the sale of a residence be applied first.]

38. Carl purchased a home in 1999. It has been his principal residence for the full time he has owned it. He marries Faye in 1999 and she moves into Carl's house. They file a joint tax return after their marriage. In 2010, Carl and Faye decide to purchase a larger home and sell Carl's house. The realized gain on the sale of the house is $300,000. Faye never owned a home before her marriage to Carl. She lived with her mother until she married him. How much, if any, gain can they exclude on their 2010 joint tax return as a result of the house transaction? **(Page 179)**

    a. $0. [This answer is incorrect. Carl and Faye will be allowed a gain exclusion based on the requirements listed in IRC Sec. 121.]

    b. $50,000. [This answer is incorrect. Although Carl meets the two year ownership and usage requirement so he can exclude up to $250,000 of the gain realized in accordance with IRC Sec. 121, he is also eligible for an exclusion due to his marriage to Faye.]

    c. $250,000. [This answer is incorrect. This would be the maximum gain exclusion on the principal residence for Carl if he had not married Faye. His marriage allows a different exclusion based on the rules in IRC Sec. 121.]

    d. $300,000. [This answer is correct. Since Carl owned the home for two or more of the five previous years before the sale, since both spouses used the home as a principal residence for two or more years before the sale and since neither spouse is ineligible for the IRC Sec. 121 exclusion because they had sold another home within the two-year period before the sale, married taxpayers filing a joint return for the year of the sale may exclude up to $500,000 of gain. Since both Carl and Faye meet the requirements and even though the house is owned soley by Carl, the entire exclusion applies.]

39. If the ownership of a principal residence is transferred from one spouse to the other due to a divorce, how is gain recognized in the transfer? **(Page 189)**

    a. Neither spouse recognizes a gain or loss on the transfer of the property. [This answer is correct. Transferring ownership of the principal residence from one spouse to the other during marriage or in a divorce is governed by IRC Sec. 1041. Neither spouse recognizes gain or loss on the transfer, and the receiving spouse's basis in the residence is the combined basis of both spouses before the transfer.]

    b. Each spouse is eligible for a gain exclusion based on the FMV of the property. [This answer is incorrect. The gain exclusion only comes into play if the residence is sold as part of the divorce proceedings. In that case, if the property is owned jointly or is community property, each spouse is considered to have sold half the property. Each spouse's share of the gain can be sheltered by the $250,000 exclusion on the sale.]

    c. The spouse that receives the property in the divorce will have to recognize a gain on the property, based on the FMV of the residence. [This answer is incorrect. Based on the rules including in IRC Sec. 1041, the spouse receiving the property does not have to recognize a gain. Gain is recognized if the principal residence is sold as part of the divorce proceedings.]

40. If an employer purchases the home of an employee because the employee has been transferred to a new location due to employment, which of the following is true? **(Page 191)**

    a. If carrying costs are incurred between the time the employee is paid by the employer for the home and the actually sells, the employee foot the costs during the actual closing on the home. [This answer is incorrect. The carrying costs incurred between the time the employee receives his check from his employer for the house and the time the house is sold as well as the closing costs at the time of the sale are borne by the employer, not the employee.]

    b. If the employee's house sells for a higher amount than the employer paid the employee for the house and this amount is reimbursed to the employee, it becomes taxable compensation to the employee. [This answer is correct. Based on IRS regulations, if the employee is reimbursed for any amount by which the sell price of the house exceeds the price given to the employee, the reimbursement is taxable compensation to the employee.]

    c. If a third-party relocation company purchases the employee's house for FMV without any closing costs, the employee must include the closing costs a taxable compensation for the year. [This answer is incorrect. If an employer hires a third-party relocation company to buy an employee's home for FMV unreduced by closing costs that are incurred in a normal sale, the tax consequences to the employee are usually more favorable. If the price paid for the homes does not exceed FMV, no taxable income accrues to the employee as stated in Rev. Ruls. 72-339 and 2005-74.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TDBTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

29. Which of the following would probably *not* qualify as a principal residence for the taxpayer?

    a. A house boat where Jim spends most of his time both day and night. Jim maintains no other residence.

    b. A mansion where William entertains guests on most weekends, but is only there when entertaining.

    c. William's apartment in the city where he works, spend most of his time and receives his mail. William owns the apartment as part of a coop.

    d. A house in the country where Andrew spends the majority of his time with his family since they enjoy riding horses so much.

30. Vance and Wilma purchased a house on an acre of land that they used as primary residence from the date of purchase in 1950 until the sale of the house in 2010. In 1952, they purchased an adjoining 30 acres of unimproved land they considered the land as part of their residence and enjoyed hiking and camping on the land. In February 2010, they received an offer on the 30 acres of land and decided to sell the land for a $400,000 gain. Not wishing to recognize such a large gain what can they do to exclude the gain under the IRC Section 121?

    a. Report the sale as an installment sale up to five years after the sale of the 30 acres.

    b. Sell the house and the one acre of land five years after the sale of the 30 acres.

    c. Sell the house on the one acre lot within the two years of the sale of the 30 acres.

    d. Report the sale as a nontaxable transaction within three years of the sale of the 30 acres.

31. Stu and Ellie lived at 509 S. Oak from June 1, 1999 until May 30, 2008 when they moved in with Ellie's mother, to help take care of her. They purchased the house on Oak Street in June of 2007. In September 2010, they were still living with and taking care of Ellie's mother, so they decided to sell the house on Oak Street. They had been renting the Oak Street house to Tom and Betty since going to live with Ellie's mother. Which of the following statements is correct?

    a. Stu and Ellie cannot exclude the gain because they don't meet the use test and haven't owned the house for the last 5 years.

    b. Stu and Ellie cannot exclude the total gain since they had nonqualified use of the house for two years after they moved out.

    c. Stu and Ellie can exclude up to $500,000 of gain since they meet the ownership and use rules and have had no other sale in the last two years.

    d. Stu and Ellie can exclude the gain only if they sell the house to Tom and Betty and report the transaction as an installment sale.

32. Agnes bought a house on S. Pecan St. in January, 2005 that she used as her primary residence until July, 2007. In June, 2007, Agnes joined the marines and deployed to Iraq the next month. The deployment began an extended period of qualified military service. Agnes rented her house to her sister Trixie until she returned from service in December, 2009. In February, 2010 Agnes decides to sell her house and is successful the next month. Which of following statements best describes Agnes's situation?

    a. Agnes satisfies the ownership test under Section 121. However she rented the house for 6 years and did not satisfy the 2 year use test under Section 121. She only used the residence for 12 months after she returned. She cannot exclude any gain on her sale.

    b. Agnes has satisfied the ownership test under Section 121. However during her 6 years away she had several other residences. Under Section 121 the taxpayer must have used the residence as their principal residence for two of the prior five years. Agnes cannot exclude any gain on her sale.

    c. Agnes can elect to exclude the years of military service. She has owned and used the house as her residence for more than 2 years and she had not sold a residence in the last two years. She can exclude her gain.

    d. Do not select this answer choice.

33. Clara, a widow, became physically incapable of taking care of herself. In February, 2006, her family moved her from the home she had lived in for the last 50 years to a licensed nursing home, where she received care. In January, 2010, Clara decides that it is highly unlikely that she can ever live alone again and decides to sell her house. Clara realizes a gain of $100,000 on the sale when it is complete. Which of the following statements best describes Clara's tax situation regarding the sale of her residence?

    a. Clara cannot exclude the gain from the sale of her residence Clara must have owned and used the property as her primary residence for two of the prior five years. Clara lived in the house for 12 months in 2005 and 1 month in 2006. She does not satisfy the two year rule for the use of the residence.

    b. Clara can exclude the gain from the sale of her residence because she occupied her home for 13 months and was receiving "Out-of-Residence care" for the rest of the time. She can count her periods of residence in the nursing home as if she were living at home.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

34. Which of the following is not a valid reason for a taxpayer to met the partial gain exclusion under IRC Sec. 121?

    a. Circumstances that were unforeseen by the taxpayer to necessitated the sale of the primary residence.

    b. The taxpayer's health suddenly declines and must relocate for health treatment.

    c. The school zones are rezoned and the taxpayer's children would have to attend a new school. The taxpayer decides to sell the primary residence.

    d. The taxpayer is transferred to a new location by his job eight months after purchasing a new residence.

35. Dr. Moore sold his home in Albuquerque in November, 2009. In January, 2010 he purchased a home in Arlington within a mile of the hospital. He is a single ER doctor and must be able to report to the ER within 20 minutes. In March, 2010 he was transferred to Cook's Children hospital in Fort Worth, which is less than 45 miles away. He sells his home three months later and purchases one in Fort Worth near the hospital. Dr Moore realizes a gain on the sale of the house in Arlington of $50,000. He owned and used the house as a principal residence for 5 months. Which of the following statements best describes Dr. Moore's tax situation regarding the sale of the residence in Arlington?

    a. Dr. Moore did not own and use the Arlington home long enough to satisfy the two year rules for the exclusion of gain under Section 121. Therefore, he can not exclude any of the $50,000 gain.

    b. Dr. Moore did not meet the safe harbor for a change in employment location. Dr. Moore's new place of employment is less than 50 miles away. Therefore, he can not exclude any of the $50,000 gain.

    c. Dr. Moore has failed all three of the two year tests for use, ownership, and gain exclusion. He has also failed to meet the safe harbor for an exception to the rules. He cannot exclude any of $50,000 gain.

    d. Dr. Moore has failed all three of the two year tests. The primary reason for the sale is the change in employment. Dr. Moore can exclude part of the gain under the facts and circumstances rules.

36. Virginia purchased a residence in January, 2009 for herself and her mother. In May, her Mother became ill with an illness that the local doctors were not trained to treat. Her doctor referred them to a doctor in Atlanta. The doctor in Atlanta strongly recommended that they move to be close to the treating clinic. Virginia sold her home in January, 2010 and moved to Atlanta to be near the clinic so that her mother could receive proper treatment. Virginia realized a gain of $20,000. Which of the following statements best describes Virginia's tax situation regarding the sale of the residence?

    a. Virginia does not satisfy the two year use and ownership rules required for gain exclusion on the sale of a residence. Virginia cannot exclude any of the gain realized.

    b. Virginia is the sole owner of the home. Since it is Virginia's mother who is ill, the sale does not qualify to exclude any of the gain for health reasons.

    c. Virginia's mother is a relative and therefore qualifies Virginia's to use the "health reasons" to exclude all of the gain.

    d. Do not select this answer choice.

37. If a taxpayer has a residence that was rented for the previous year before the sale, it will not be eligible for any sort of gain exclusion since the taxpayer has not been using the house as their primary residence.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

38. Jeannene purchases a home for $300,000. She uses 1/3 of the home as a home office for her business. The other 2/3 of the square footage of the house she uses as her principal residence. From the time of purchase in 2005 until the property is sold in 2010, she claims $3,600 of depreciation on the home office part of her residence. In 2010, she sells the home for a realized gain of $40,000. Which of the following best describes Jeannene's tax situation regarding the sale of her home?

    a. Jeannene satisfies the two year rules for ownership, use, and prior exclusion of gain. Jeannene qualifies for the exclusion of gain on the sale of a principal residence. She can exclude all of her gain up to $250,000.

    b. Jeannene satisfies all the rules for the exclusion of gain on the sale of a principal residence, however, she has non-qualified use for part of the house. She used 2/3 of the residence as her home. Jeannene can exclude 2/3 of the gain on her residence in 2010.

    c. Jeannene satisfies all the rules for the exclusion of gain on the sale of a principal residence. She cannot exclude any gain attributable to depreciation. $3,600 of the gain is unrecaptured 1250 gain. Jeannene can exclude all the gain less the $3,600.

    d. Jeannene satisfies all the rules for the exclusion of gain on the sale of a principal residence, but she used only 2/3 of the residence as her home. She also has $3,600 of unrecaptured Section 1250 gain. Jeannene can exclude 2/3 of the gain on her residence in 2010 less the $3,600 of depreciation.

39. Joseph has owned and lived alone in his residence for 20 years. On May 1, 2009 he marries Mary who has never owned a home. On January 2, 2010 Joseph dies. In June, 2010 Mary sells the residence and realizes a gain of $70,000. Mary is the surviving spouse in a non-community property state and has not remarried. Which of the following statements best describes Mary's tax situation?

    a. Due to Joseph's death, there is a step up in basis on half the property which reduces the gain to $35,000. Mary's period of ownership and use becomes the same as Joseph's. Mary can file a joint return with Joseph and exclude up to $500,000 of gain on the sale.

    b. Due to Joseph's death, half of the property receives a step up in basis. This reduces the gain to $350,000. Mary does not satisfy the 2 year ownership and the 2 year use rule to qualify for the exclusion of gain. Mary cannot exclude any of the $350,000 from the sale of the residence.

    c. Mary is a surviving spouse who has not remarried by the date of the sale of the residence. As such her ownership period becomes the same as Joseph's. Her period of use as a residence also becomes the same as Joseph's. Mary can therefore exclude up to $250,000 of the gain on the sale of the residence.

    d. Do not select this answer.

40. Which of the following is correct regarding the reporting requirements when a taxpayer sells a principal residence?

    a. If the taxpayer is married and files jointly and sells the primary residence for $300,000, this must be reported on Form 1099-S.

    b. All gains and losses for the sale of a principal residence must be reported on the taxpayer's tax return each year.

    c. If the gain on a principal residence is taxable, it should be reports on Schedule D of the taxpayer's final return.

    d. The seller should provide the buyer with the written assurance that the sale meets the rules for excluding gain and the entire gain is excludable.

GLOSSARY

Applicable Federal Rate (AFR): The IRS determines federal short-term, midterm, and long-term rates on a monthly basis using average market yields of specified maturities. For a sale or an exchange, the AFR is the lowest rate in effect for any month in the 3-calendar-month period ending with the first calendar month in which there is a binding debt instrument. The term of the debt determines which AFR is applicable as follows:

Debt Instrument Term	AFR Used
Not over 3 years	Short-term rate
3 to 9 years	Midterm rate
Over 9 years	Long-term rate

The term of the debt instrument includes renewals and extension options.

Boot: A monetary consideration, usually cash, received or given (in a small amount) in a nonmonetary exchange. Boot often causes a gain that must be recognized.

Casualty loss: The complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected, or unusual nature.

Deferred exchange: One in which property received in the exchange (replacement property) is not received immediately upon the transfer of property given up (relinquished property).

Depreciable asset: Is tangible personal property or real property used in business or held for the production of income with a determinable useful life of more than a year. Some intangible property, such as copyrights and patents, may also be depreciable.

Depreciable property: any property that can be depreciated by the purchaser.

Depreciation recapture: Upon the disposition of depreciable property used in a trade or business, gain or loss is measured by the difference between the amount realized and the adjusted basis of the property. Such gain would normally be considered Section 1231 gain or loss and qualify for long-term capital gain treatment if it is a gain, or ordinary loss treatment if it is a loss. The recapture provisions of the code, Sections 291, 1245, and 1250, may operate to convert some or all of the previous Section 1231 gain into ordinary income. The justification for depreciation recapture is that it prevents a taxpayer from converting a dollar of ordinary deduction into tax-favored income treatment under Section 1231. The current maximum tax rate on recaptured depreciation in a sale is 25%.

Gain realized: The excess of the fair market value (FMV) of property received over the tax basis of the property given up.

Gain recognized: The gain reported as taxable income because of the transaction.

Installment method: A method of accounting enabling an individual or business to spread the recognition of gain on the sale of property over the payment period. Under this procedure, the seller computes the gross profit percentage from the sale (i.e., the gain divided by the contract price) and applies it to each payment received to arrive at the gain to be recognized.

Installment sale: Any disposition of property where at least one payment is received after the close of the tax year in which the sale occurs.

Involuntary conversion: The change of nonmonetary (operational assets) to monetary assets (insurance proceeds) as a result of circumstances beyond the control of the enterprise (e.g., partial or total destruction due to fire, theft, seizure, condemnation, or expropriation). It is a monetary transaction for which gain or loss must be recognized even though the enterprise reinvests the monetary assets received in replacement of nonmonetary assets.

Like-kind exchange: Sometimes referred to as "Section 1031 exchanges," like-kind exchanges involve a trade of one piece of property for another of similar or "like" kind. Under IRC §1031, trade or business gains and losses from

like-kind exchanges must be deferred. No gain or loss will be recognized on the exchange of property held in a trade or business or for investment if the property is exchanged solely for property of like kind, which is to be held in a trade or business or for investment. If there is no gain or loss recognized and no boot given or received in the transaction, then the adjusted basis of the new property will be equal to the adjusted basis of the old property given up in the exchange, thus deferring any gain to be recognized at a future time when the new property is sold. The definition of "like kind" property refers to the nature and character of the property and not to its grade or quality under Regulation §1.1031(a)-1(b).

Original issue discount (OID): The amount of the original issue price of a bond or other debt instrument discounted below par or face value. This can apply also to a collateralized mortgage obligation.

Principal residence: The place where a person lives most of the time. It is a question of facts and circumstances. The term *principal residence* is very important in many situations involving federal income taxes.

Points: Loan-origination fees (one-time charge paid for the use of money) that a buyer generally may deduct as interest—fully in the year paid if for the purchase or improvement of a principal residence or, if not, then ratably over the term of the loan.

Realized gain or loss: The difference between the amount received upon the sale or other disposition of property and the adjusted basis of such property.

Recognized gain or loss: The portion of realized gain or loss that is subject to income taxation.

Related parties: SFAS 57 defines related parties as, among others, management, owners, family members of owners or management, affiliates, or any party that "can significantly influence the management or operating policies" such that the entity might be "prevented from fully pursuing its separate interests" (SFAS 57, ¶2).

Repairs: Current expenditures to restore business-use property to an original condition or maintain the property through minor alterations rather than to extend its useful life. The cost of repairs normally is deductible annually. Substantial repairs that increase the value or extend the life of the property are treated as capital improvements and must have their cost recovered over a number of years.

Section 1231: IRC Section 1231 assets are depreciable assets and real estate used in a trade or business and held for more than one year. Under certain circumstances, the classification also includes timber, coal, domestic iron ore, livestock (held for draft, breeding, dairy, or sporting purposes), and unharvested crops.

Wraparound mortgage: An agreement in which the buyer initially does not assume and purportedly does not take subject to part of all of the mortgage encumbering the property (wrapped indebtedness) and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness.

INDEX

COMPANION TO PPC'S 1040 DESKBOOK

COURSE 3

Securities Transactions and Debt Transactions (TDBTG103)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to commonly encountered securities and debt transactions. The first lesson covers topics that pertain to reporting gain or loss on the sale of stock. The second lesson covers the rules for deducting bad debt losses and explains the tax treatment of debt discharge income and foreclosures.

PUBLICATION/REVISION DATE: December 2010

RECOMMENDED FOR: Users of *PPC's 1040 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation

CPE CREDIT: 7 QAS Hours, 7 Registry Hours

7 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **December 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Securities Transactions

Completion of this lesson will enable you to:

- Determine stock holding periods and capital gain tax rates.
- Determine the tax reporting requirements for mutual fund income and sales.
- Identify the tax rules for option writers, option holders, and Section 1256 contracts.
- Identify important aspects of short sales, wash sales, constructive sales, Section 1244 stock, qualified small business stock (QSBS), worthless securities, and employee stock options and make relevant calculations.
- Recognize the difference between a stock trader and an investor.

Lesson 2—Bad Debt Losses, Debt Discharge Income, and Foreclosures

Completion of this lesson will enable you to:

- Differentiate between business and nonbusiness bad debts.
- Identify the rules of debt discharge income for a solvent taxpayer and an insolvent taxpayer and make relevant calculations.
- Identify the tax rules for foreclosures involving recourse, nonrecourse, and seller-financed debt.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Securities Transactions

INTRODUCTION

This lesson covers commonly encountered security transactions. Unless held by a dealer, securities are generally capital assets subject to the capital gain provisions. However, the gains and losses of a securities trader who makes the mark-to-market election under Section 475(f) are ordinary rather than capital.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine stock holding periods and capital gain tax rates.
- Determine the tax reporting requirements for mutual fund income and sales.
- Identify the tax rules for option writers, option holders, and Section 1256 contracts.
- Identify important aspects of short sales, wash sales, constructive sales, Section 1244 stock, qualified small business stock (QSBS) worthless securities, and employee stock options and make relevant calculations.
- Recognize the differences between a stock trader and an investor.

Capital Gain Rates and Stock Holding Periods

Stock Holding Periods

A nondealer's sale of stock results in long- or short-term capital gain or loss depending on the stock's holding period. Stock sales receive long-term treatment whenever the holding period exceeds one year.

A stock's holding period generally begins on the day following the day of acquisition and ends on (and includes) the day of disposition. For securities traded on an established securities market, the holding period begins on the day after the *trade date* and ends on the date of disposition (i.e., the trade date). The *settlement date* is ignored. Thus, the taxpayer's overall method of accounting does not affect when the transaction is reported, and gain or loss must be reported in the tax year the disposition (i.e., trade date) falls.

Stock can be acquired other than by purchase, which can impact how the holding period is determined. These include the following:

1. *Stock Dividends.* If the stock dividend is nontaxable, the taxpayer's holding period for the new stock is the same as for the old shares upon which the dividend was based. If the stock dividend is taxable, the holding period of the new shares begins on the date of distribution.

2. *Dividend Reinvestment Plans.* Where a shareholder buys stock under a dividend reinvestment plan, either with the company or through a company-arranged open market transaction, the participating shareholder's holding period begins on the date following the day on which the shares are credited to the participant's account.

3. *Stock Splits.* The holding period for stock received in a stock split is the same as for the old shares upon which the stock split was based.

4. *Stock Received as a Gift.* When a taxpayer receives a gift of stock and his or her basis is determined with reference to the donor's, his or her holding period includes that of the donor. However, if the donee's basis in the gifted stock is fair market value (FMV) at the date of gift (i.e., when gifted property is sold at a loss and the donor's basis in the stock exceeded its FMV at the time of the gift), the donee's holding period begins on the day after the date of the gift.

5. *Inherited Stock:*

    a. For 2010, repeal of the Section 1014 estate tax value basis rules eliminates the automatic long-term holding period that would otherwise be available to stock received from a decedent's estate. A tacked

holding period may be available, however, which allows the estate or other recipient to include the period held by the decedent, as well as the period that the estate (or other recipient) holds the stock. For the decedent's holding period to tack onto the recipient's holding period, the estate's or recipient's basis in stock (for gain or loss) must be the same (in whole or in part) as the stock would have in the decedent's hands.

b. For years after 2010, stock inherited from a decedent is automatically deemed to be held more than one year. Therefore, the sale or exchange of inherited stock will result in long-term treatment regardless of how long the heir actually holds it. In reporting a sale, the word "INHERITED" should be written in column (b) on Schedule D instead of the date the property was received.

6. *Stock Acquired by Exercising a Stock Option.* The holding period of stock acquired by the exercise of a stock option begins on the date after the option is exercised.

7. *Tax-free Stock Exchange.* If stock is received in a tax-free exchange, the holding period of the old stock tacks on to that of the new stock.

8. *Employer Stock Received from an Employer's Retirement Plan.* If a taxpayer receives employer stock in a distribution from its retirement plan, his or her holding period in the stock usually begins on the day after the day the plan trustee delivers the stock to the transfer agent with instructions to reissue it in the taxpayer's name. To the extent the distributed stock includes net unrealized appreciation (NUA), gain from a subsequent sale may automatically receive long-term treatment to the extent of such NUA.

Identifying Shares Sold. Taxpayers often acquire stock in a company at different dates and at different prices. When less than the entire holding of stock is sold, identifying which shares were sold not only affects the amount of gain or loss but also whether the sale is long- or short-term. The two methods for identifying shares of stock sold when taxpayers sell less than their entire holdings in a particular stock are (1) the first-in, first-out (FIFO) method and (2) the specific identification method.

FIFO is used when a taxpayer does not or cannot specifically identify which shares of stock are sold. This method assumes the shares acquired first are sold first. See Example 1B-2 for a FIFO basis computation.

If the taxpayer specifically identifies the shares sold, the basis and holding period of those shares are used in computing the character and amount of gain or loss. Adequate identification is made when the taxpayer delivers the specific shares to be sold to the broker selling the stock. If the stock is held by the taxpayer's broker in street name (1) the taxpayer must, at the time of sale, specify to the broker which shares are to be sold; and (2) the broker must, within a reasonable time after the sale, confirm this specification to the taxpayer in a written document. The identified stock is then deemed to be sold even if the broker actually delivers to the buyer shares from another lot of stock.

Capital Gain Tax Rates

A *capital asset* is any property except:

1. inventory;

2. depreciable or real property used in the taxpayer's trade or business, but IRC Sec. 1231 allows capital gain treatment on such items;

3. specified literary or artistic property;

4. business accounts or notes receivable; or

5. certain U.S. publications.

Thus, securities generally are capital assets unless held by a dealer. Gains and losses from the sale of securities by a dealer produce ordinary income and losses rather than capital gains. (Reg. 1.471-5 defines a dealer as a

merchant of securities with an established place of business who is regularly engaged in the purchase of securities and their resale to customers. As a practical matter, few individuals meet this definition.)

Securities sold by a trader receive capital gain or loss treatment [unless the trader has made the mark-to-market election under Section 475(f)], and the trader's expenses, including subscriptions to financial periodicals, telecommunication and clerical expenses, and depreciation on data processing equipment and related software, etc., are deducted in arriving at adjusted gross income rather than as itemized deductions.

The applicable capital gain tax rate depends not only on how long property is held but also the type of property sold. A 15% long-term rate in 2010 generally applies if the property is held more than 12 months while a short-term rate (i.e., generally ordinary income rate) applies when the property is held one year or less. However, see discussion below for reduced capital gain rates when the gain, absent a preferential rate, would be taxed at the 10% or 15% ordinary income rates in 2010. Also, special rules and rates apply to the sale of collectibles, qualified small business stock, and unrecaptured Section 1250 gain.

The long-term capital gain rate for taxpayers in the 10% or 15% ordinary tax bracket is generally 0% (rather than 15% in 2010). However, to the extent long-term capital gain causes the taxpayer's taxable income to exceed the upper threshold of the 15% ordinary income tax bracket, the capital gain is taxed at 15%. Thus, taxpayers can have long-term capital gain taxed at two different rates.

Example 1A-1 Capital gain rate reduced for taxpayers in the lower tax brackets.

Nancy is single and has taxable income of $60,000 for 2010. Included in this amount is $42,000 of gain from the November 3, 2010, sale of stock she purchased in 2006.

The 2010 25% rate for a taxpayer using the single filing status begins at $34,000. Thus $16,000 ($34,000 − $18,000 of ordinary income) of Nancy's long-term capital gain would otherwise be taxed at 15%. As a result, this amount is taxed at 0%; the remaining $26,000 ($42,000 − $16,000) of capital gain is taxed at 15%. Nancy's 2010 tax is computed as follows:

Ordinary income	
$8,375 × 10%	$ 837
$9,625 × 15%	1,444
Long-term capital gain:	
$16,000 taxed at 0%	—
$26,000 taxed at 15%	3,900
Total tax	$ 6,181

Adjusted Net Capital Gain. The 15% and 0% capital gain tax rates apply to adjusted net capital gain in 2010. Qualifying dividends are taxed at the same rate as long-term capital gains in 2010. This is accomplished by adding qualified dividend income to the net capital gain to arrive at adjusted net capital gain. However, to prevent dividends from being offset by capital losses, adjusted net capital gain is computed by first reducing (but not below zero) net capital gain (i.e., net long-term gain) by (1) capital gain attributable to Section 1250 property and (2) 28% rate capital gains. Add qualified dividends amount to this to arrive at adjusted net capital gain.

Capital gain attributable to Section 1250 property is the gain on a sale of Section 1250 property to the extent depreciation adjustments on the property exceed those subject to ordinary income recapture. 28% rate capital gains are the sum of collectible gains (gains from assets such as art, rugs, antiques etc. that are capital assets in the taxpayer's hands and held for over a year) and Section 1202 gain from the sale of certain small business stock reduced (but not below zero) by losses from collectibles, net short-term capital losses, and long-term capital loss carryovers.

Gains and Losses from Pass-through Entities. Pass-through entities must determine and disclose to owners the proper category of capital gains and losses. Pass-through entities include regulated investment companies (i.e., mutual funds), real estate investment trusts (REITs), S corporations, partnerships, estates, trusts, common trust funds, and Section 1295 qualified electing funds.

Alternative Minimum Tax. The maximum capital gain rates also apply to AMT.

Capital Losses

Taxpayers offset capital gains with capital losses, and to the extent there are excess capital losses, up to $3,000 ($1,500 for married filing separate returns) can be deducted against ordinary income. Remaining capital losses can be carried forward indefinitely, retaining their character as either short- or long-term. However, losses not used in a decedent's final return expire unused.

A taxpayer's capital loss carryover is the amount that his or her total net capital loss for the year exceeds the lesser of (1) the allowable capital loss deduction for the year or (2) his or her adjusted taxable income for the year. "Adjusted taxable income" is taxable income increased by the allowable capital loss deduction for the year and the deduction for personal exemptions. For many taxpayers, this method of determining the carryover effectively allows them to convert all or part of a net capital loss deduction to a carryover when they receive no tax benefit from the deduction (e.g., they have negative taxable income for the year); however, this will not always be the case if the taxpayer would have positive taxable income without the deductions for personal exemptions and allowable capital losses.

Example 1A-2 Computing a capital loss carryover.

Al and Ann file a joint return for 2010. For 2010, they incur a $5,000 net capital loss. What is their capital loss carryover to 2011 based on the following three income scenarios?

	Scenario 1	Scenario 2	Scenario 3
Wages	$ 47,500	$ 47,500	$ 47,500
Business loss	—	(34,000)	(50,000)
Capital loss deduction	(3,000)	(3,000)	(3,000)
Standard deduction	(11,400)	(11,400)	(11,400)
Personal exemption deduction	(7,300)	(7,300)	(7,300)
Taxable income	$ 25,800	$ (8,200)	$ (24,200)
Adjusted taxable income	$ 36,100	$ 2,100	$ (13,900)
Capital loss used in 2010	3,000	2,100	—
Capital loss carryover to 2011	2,000	2,900	5,000

In Scenario 1, the capital loss carryover is computed using the $3,000 capital loss deduction allowed in 2010, since that amount is less than adjusted taxable income. In Scenarios 2 and 3, however, adjusted taxable income is less than the $3,000 allowable capital loss deduction for 2010 so the capital loss carryover is computed using the adjusted taxable income amount (but not less than zero).

When a taxpayer has capital gains and losses that are subject to different capital gain rates, the capital gains and losses are first divided into short- and long-term groups, with the long-term group further divided by capital gain tax rates [15% (or 0%), 25%, and 28% in 2010]. A net loss in a long-term group first offsets gains in the highest long-term rate group before being applied to gains in the next highest long-term rate group. For example, a net long-term loss in the 15% group offsets a net gain in the 28% group before offsetting net gain in the 25% group. If there is an overall net long-term loss, it offsets net short-term gain. If there is a net short-term capital loss, it first offsets net gain from the 28% long-term group before applying to net gains from the 25% and 15% groups.

A long-term capital loss carryover offsets long-term capital gains first, beginning with the highest (28%) long-term capital gain tax rate group. A short-term capital loss carryover offsets net short-term gain first; any remaining carryover offsets long-term gains, beginning with the highest long-term capital gain tax rate group.

Example 1A-3 Offsetting capital gains and losses.

For 2010, John has the following capital gains and losses (grouped by the applicable capital gains tax rate):

Category	Amount	Applicable Tax Rate Group
Unrecaptured Section 1250 gain	$ 4,000	25%
Net short-term loss	(3,000)	35%
Net collectibles gain	6,000	28%
Net long-term loss	(2,000)	15%

Using the ordering rules, the $2,000 long-term loss (15% group) first offsets the $6,000 collectibles gain (28% group, leaving a $4,000 collectibles gain, which is then offset by the $3,000 short-term capital loss. Thus, John has a $1,000 collectibles gain (subject to 28% tax) and a $4,000 unrecaptured Section 1250 gain (subject to 25% tax).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. The holding period for stock traded on an established securities market begins and ends on which of the following?

   a. Begins on the day after the trade date of the acquisition and ends on the trade date of the disposition.

   b. Begins on the day after the trade date of the acquisition and ends on the settlement date of the disposition.

   c. Begins on the day of the acquisition and ends on the day of disposition.

   d. Begins on the day the cash is paid for the acquisition and ends on the day the cash is received from the disposition.

2. Of the following, which two methods may be used to identify the basis and holding periods of shares of stock sold when the taxpayer does not sell all of a particular stock?

   a. The specific identification method and the low-basis method.

   b. The specific identification method and the high-basis method.

   c. The first-in, first-out (FIFO) method and the last-in first-out (LIFO) method.

   d. The first-in, first-out (FIFO) method and the specification identification method.

3. Sue purchased 100 shares of MG stock on January 2, 2010. The value of the MG stock rises dramatically during the year. Sue decides that she should sell all of the MG stock to take advantage of the increase in value. What is the earliest date that she can dispose of the MG stock and receive long-term capital gain treatment?

   a. January 2, 2011.

   b. January 3, 2011.

   c. July 3, 2010.

   d. December 31, 2010.

4. Tom and Betty have a $4,000 capital loss for 2010. On their 2010 joint tax return, they report the following information: wages of $50,900; business loss of $39,000; standard deduction of $11,400; and personal exemptions of $7,300. What is their capital loss carryover to 2011?

   a. $4,000.

   b. $3,500.

   c. $500.

   d. $0.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. The holding period for stock traded on an established securities market begins and ends on which of the following? **(Page 211)**

   a. Begins on the day after the trade date of the acquisition and ends on the trade date of the disposition. [This answer is correct. Under the IRS Revenue Rules, this accurately describes the holding period for the type of stock. In addition, the taxpayer's overall method of accounting does not affect when the transaction is reported.]

   b. Begins on the day after the trade date of the acquisition and ends on the settlement date of the disposition. [This answer is incorrect. The settlement date is ignored for this type of stock, according to the Revenue Rules.]

   c. Begins on the day of the acquisition and ends on the day of disposition. [This answer is incorrect. According to the Revenue Rules, the taxpayer excludes the day of acquisition when calculating the holding period.]

   d. Begins on the day the cash is paid for the acquisition and ends on the day the cash is received from the disposition. [This answer is incorrect. The taxpayer's overall method of accounting does not affect when the transaction is reported.]

2. Of the following, which two methods may be used to identify the basis and holding periods of shares of stock sold when the taxpayer does not sell all of a particular stock? **(Page 211)**

   a. The specific identification method and the low-basis method. [This answer is incorrect. The taxpayer may not arbitrarily select the shares with the lowest basis to manipulate the gain or loss.]

   b. The specific identification method and the high-basis method. [This answer is incorrect. The taxpayer may not arbitrarily select the shares with the highest basis to manipulate the gain or loss.]

   c. The first-in, first-out (FIFO) method and the last-in first-out (LIFO) method. [This answer is incorrect. The LIFO method is not one of the methods listed in the regulations.]

   d. The first-in, first-out (FIFO) method and the specification identification method. [This answer is correct. Under the IRS regulations, the taxpayer can specifically identify the shares sold, the basis and holding period of that stock is used in determining the character and amount of the gain or loss. The FIFO method is used when the taxpayer cannot specifically identify the shares sold.]

3. Sue purchased 100 shares of MG stock on January 2, 2010. The value of the MG stock rises dramatically during the year. Sue decides that she should sell all of the MG stock to take advantage of the increase in value. What is the earliest date that she can dispose of the MG stock and receive long-term capital gain treatment? **(Page 211)**

   a. January 2, 2011. [This answer is incorrect. The holding period of the MG stock as of January 2, 2011, would qualify the transaction for the short-term rate, as that rate is described in the Code.]

   b. January 3, 2011. [This answer is correct. Under the Internal Revenue Code, long-term capital gain tax rates generally apply if the stock is held for more than 12 months. Since the holding period begins the day after the acquisition, stock must be held one year and a day from the date of acquisition to receive long-term capital gain treatment.]

   c. July 3, 2010. [This answer is incorrect. According to the Code, if Sue sells the stock on July 3, 2010, the transaction will qualify for the short-term rate, which is generally ordinary income rate.]

d. December 31, 2010. [This answer is incorrect. Holding the stock until the end of the calendar year in which it was purchased does not necessarily qualify the transaction for the long-term rate under the Code. In this scenario, if Sue sells the stock on December 31, 2010, the transaction will qualify for the short-term rate.]

4. Tom and Betty have a $4,000 capital loss for 2010. On their 2010 joint tax return, they report the following information: wages of $50,900; business loss of $39,000; standard deduction of $11,400; and personal exemptions of $7,300. What is their capital loss carryover to 2011? **(Page 211)**

a. $4,000. [This answer is incorrect. This is the total amount of Tom and Betty's capital loss for 2010. They cannot carry forward the whole capital loss to 2011. Calculations must be performed to determine the correct carryover amount.]

b. $3,500. [This answer is correct. Under the Code, a taxpayer's capital loss carryover is the excess of the net capital loss over the lesser of the net capital loss deduction for the year or the adjusted taxable income. Adjusted taxable income is taxable income increased by the allowable capital loss deduction for the year and the deduction for personal exemptions. In this case, the tax loss is $9,800 ($50,900 − $39,000 − $3,000 − $11,400 − $7,300). The adjusted taxable income is $500 ($ − 9,800 + $3,000 + $7,300). The capital loss carryover is $3,500 ($4,000 − $500).]

c. $500. [This answer is incorrect. This is the amount of Tom and Betty's adjusted taxable income in 2010. Further calculations are needed, however, to determine how this amount affects their capital loss carryover for 2011.]

d. $0. [This answer is incorrect. If the calculations are performed correctly, Tom and Betty will have an amount of capital loss to carryover to 2011 that is greater than zero.]

Reporting Income and Sales from Mutual Funds

Reporting Shareholder Income

Capital gain or loss is recognized when an individual sells, exchanges, or redeems mutual fund shares. This includes an exchange of shares in one fund for shares in a different fund, even if the funds are in the same mutual fund family. The amount of gain or loss is the difference between the adjusted basis in the shares and the selling price (less any costs associated with the sale, exchange, or redemption) and is reported on Schedule D.

Distributed and Reinvested Income. Mutual fund income reported to shareholders on Form 1099-DIV is taxable to shareholders whether the income and gains are distributed, reinvested in additional fund shares, or retained by the fund itself. In addition, distributions declared and payable to mutual fund shareholders of record as of calendar year-end and paid by January 31 of the following year are taxable in the year declared. Thus, the Form 1099-DIV amount and actual distributions a shareholder receives during the year may differ.

Retained Capital Gains. In some cases, a mutual fund will retain (rather than distribute to shareholders) realized long-term gains. The fund must pay a fund-level income tax on retained gains and send a Form 2439 (Notice to Shareholder of Undistributed Long-Term Capital Gains) to each shareholder. Form 2439 reports each shareholder's portion of the retained gains and fund-level income tax paid on those gains. Each shareholder reports his or her share of the retained gain on Part II of Schedule D and claims a credit (on line 71 of Form 1040) for his or her share of income tax paid by the fund. In addition, box a of line 71 should be checked, and Copy B of Form 2439 must be attached to the shareholder's return. The shareholder's basis in fund shares is increased by the gain and reduced by the share of fund-level income tax reported on Form 2439.

Tax-exempt Income. Mutual fund income from tax-exempt interest is reported to shareholders in box 8 of Form 1099-INT. The shareholder should include these exempt interest amounts on the tax-exempt interest line on page 1 of Form 1040, along with other exempt interest income. Some or all of the tax-exempt interest may be an alternative minimum tax (AMT) preference item. The tax-exempt income is also used in computing the taxability of social security benefits and may result in some of the taxpayer's expenses associated with carrying the mutual fund shares being disallowed.

Return of Capital (Nontaxable) Distributions. A distribution that is not out of earnings and profits is a return of the shareholder's investment, or capital, in the mutual fund and is shown in box 3 of Form 1099-DIV. These return of capital distributions are generally not taxed; however, they do reduce the shareholder's basis in the shares. If a distribution exceeds the shareholder's basis in the funds, the excess is a taxable capital gain reportable on Schedule D (whether it is a short- or long-term gain depends on how long the shares were held).

Determining Basis in Mutual Fund Shares

Investors in mutual funds may reinvest dividends and capital gains so they have current income without actually receiving any distributions or, in some cases, a fund may retain realized capital gains. In these situations, special calculations are necessary to determine the tax basis of the mutual fund shares.

When mutual fund shares are sold, exchanged, or redeemed, their basis must be determined. The shares' original cost is the starting point. It is increased for the following items:

1. Reinvested dividends (included in income reported on Form 1099-DIV).
2. Reinvested capital gains (included in income reported on Form 1099-DIV).
3. Undistributed long-term capital gains (reported as income on Form 2439).
4. Reinvested tax-exempt dividends (reported on information statements issued by the fund).

The following reduce basis:

1. Distributions consisting of return of capital (reported as nontaxable distributions on Form 1099-DIV).

2. Fund-level income tax paid on retained long-term capital gains (reported on Form 2439).

A special rule applies to mutual fund load charges if (1) the load charges are incurred in a transaction in which the taxpayer acquires fund shares and a reinvestment right, (2) such shares are disposed of within 90 days, and (3) the taxpayer subsequently buys other mutual fund shares with a reduced load charge due to the reinvestment right. To the extent the load charge is reduced in the second transaction, the taxpayer cannot consider the original load charge in determining gain or loss in the disposition of the original mutual fund shares (it is considered in the second transaction instead). A reinvestment right is the right to acquire stock in a mutual fund without paying a load charge or with the payment of a reduced charge. This rule prevents taxpayers from taking a quick loss equal to the load charge on the original shares simply by switching to another fund in the same family.

Example 1B-1 Calculating basis when income is reinvested.

John purchased 100 shares of Blue Sky Growth Fund, a mutual fund, for $2,000 on February 1, 2008. He incurred a load charge of $100. His beginning cost basis in the mutual fund is $2,100, or $21 per share. In January 2009, he received a 2008 Form 1099-DIV reflecting a $150 dividend, which John reinvested in Blue Sky. In January 2010, John received a 2009 Form 1099-DIV reflecting a $300 long-term capital gain and a $100 dividend, both of which were reinvested in the fund. John sold all of his shares on August 3, 2010, for $3,100. John's basis in Blue Sky is determined as follows:

Original cost (including commissions)	$ 2,100
2008 dividend (reinvested in Blue Sky)	150
2009 capital gain (reinvested in Blue Sky)	300
2009 dividend (reinvested in Blue Sky)	100
Total tax basis	$ 2,650

Therefore, John reports a capital gain of $450 ($3,100 − $2,650) on his 2010 return. The gain associated with the shares acquired (from the reinvested income) on or after August 3, 2009, is short-term; the remainder of the gain is long-term.

If fund shares are bought at different times, the basis of shares sold must be determined by using an ordering procedure. The three methods for determining the basis of mutual fund shares are (1) first-in, first-out (FIFO); (2) the specific identification method; and (3) the average basis method.

FIFO Method. FIFO is used if the taxpayer does not elect an average basis method or does not use the specific identification method.

Example 1B-2 FIFO basis computation.

Bob purchased 100 shares of the INV Fund, a mutual fund, for $10 per share on February 1, 2009. On March 3, 2009, a $55 dividend was declared. Since Bob had designated that all dividends be reinvested, this $55 dividend purchased five additional shares. On February 2, 2010, he purchased an additional 100 shares for $12 per share. On July 2, 2010, Bob sold 125 shares for $15 per share. To compute Bob's basis in the shares sold, his transactions are summarized as follows:

Transactions	No. of Shares	Total Basis	Per Share Basis
2/1/09—original purchase	100	$ 1,000	$ 10
3/3/09—dividend reinvestment	5	55	11
2/2/10—second purchase	100	1,200	12
Total basis		$ 2,255	

Transactions	No. of Shares	Total Basis	Per Share Basis
FIFO basis of 125 shares sold:			
100 shares bought 2/1/09 (100 × $10)		$ 1,000	
5 shares bought 3/3/09 (5 × $11)		55	
20 shares bought 2/2/10 (20 × $12)		240	
Total FIFO basis of 125 shares sold		$ 1,295	

Bob has 80 shares remaining from his February 2, 2010 lot. These shares have basis of $12 each. On his 2010 return, Bob will have a long-term gain of $520 ($1,575 proceeds − $1,055 basis) on the 105 shares acquired in 2009 and a short-term gain of $60 ($300 proceeds − $240 basis) on the 20 shares acquired on February 2, 2010.

Specific Identification Method. Specific identification allows a taxpayer to sell shares he or she bought in a particular transaction. Since mutual fund shares are held by the fund or the fund's agent in book entry form, the question arises whether the specific identification requirements of Reg. 1.1012-1(c) apply. The Tax Court has stated they do. Thus, when a taxpayer places a sell order, he or she must identify the specific shares to be redeemed and must receive confirmation of the same.

Average Basis Method. Average basis can be used if the shares are in an account handled by a custodian or agent who acquires or redeems shares. Under Reg. 1.1012-1(e), average basis is figured using either the double-category or single-category methods, as explained later. A taxpayer electing to use an average basis method should attach an election statement to his or her return for the first year the election is effective, indicating which method (single-category or double-category) is being used. The taxpayer must disclose that the method is used each year a sale occurs. According to the Schedule D instructions, a taxpayer using an average basis should include "AVGB" in column (a) of Schedule D. Once a method is elected, it must be used for all shares held in the same mutual fund until revoked, which requires permission from the IRS.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. In calculating the tax basis of mutual fund shares, the original cost of the shares is increased by certain items. Which of the following does **not** increase the basis of the shares?

   a. Reinvested capital gains.

   b. Reinvested taxable and tax-exempt dividends.

   c. Undistributed long-term capital gains.

   d. Nontaxable distributions of return of capital.

6. There are three allowable methods for determining the basis of mutual fund shares sold when the shares are acquired at different times. Which of the following methods is **not** an allowable method?

   a. Specific identification method.

   b. First-in, first-out (FIFO) method.

   c. Last-in, first-out (LIFO) method.

   d. Average basis method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. In calculating the tax basis of mutual fund shares, the original cost of the shares is increased by certain items. Which of the following does **not** increase the basis of the shares? **(Page 220)**

   a. Reinvested capital gains. [This answer is incorrect. Capital gains reported on Form 1099-DIV are taxable to the shareholder even if the gains are reinvested instead of being distributed. These reinvested gains increase the basis of the mutual fund shares.]

   b. Reinvested taxable and tax-exempt dividends. [This answer is incorrect. Dividends reported on Form 1099-DIV are taxable to the shareholder even if the dividends are reinvested instead of being distributed. These taxable dividends increase the basis of the mutual fund shares. In addition, reinvested tax-exempt dividends from the mutual fund which are reported on Form 1099-INT also increase the basis of the mutual fund shares.]

   c. Undistributed long-term capital gains. [This answer is incorrect. Long-term gains retained by the mutual fund are taxable to the shareholder. These amounts are reported to the shareholder on Form 2439 and increase the basis of the mutual fund shares.]

   d. Nontaxable distributions of return of capital. [This answer is correct. Under the Internal Revenue Code, distributions that are not out of the fund's earnings and profits are a return of capital and generally are not taxable to the shareholder. However, the basis of the mutual fund shares is reduced by the amount of the distribution.]

6. There are three allowable methods for determining the basis of mutual fund shares sold when the shares are acquired at different times. Which of the following methods is **not** an allowable method? **(Page 220)**

   a. Specific identification method. [This answer is incorrect. The specific identification method is an allowable method for determining the basis of mutual fund shares sold. Under this method, the specific shares to be sold must be identified and confirmed.]

   b. First-in, first-out (FIFO) method. [This answer is incorrect. The FIFO method is an allowable method for determining the basis of mutual fund shares sold. This method assumes the shares acquired first are sold first.]

   c. Last-in, first-out (LIFO) method. [This answer is correct. LIFO is not an allowable method under the regulations for determining the basis of mutual fund shares sold.]

   d. Average basis method. [This answer is incorrect. Average basis method is an allowable method for determining the basis of mutual fund shares sold. Taxpayers electing this method must attach election statements to their tax returns indicating whether the single-category or the double-category methods are being used.]

Section 1244 Stock Losses

A taxpayer who incurs a loss on an original investment in Section 1244 stock can treat it as an ordinary loss (rather than a capital loss) up to certain dollar limits. The loss is triggered (1) by either a sale or exchange, or (2) at the time the stock becomes worthless. Section 1244 stock is issued to an individual (or partnership) for money or other property by a domestic small business corporation.

Section 1244 Stock Requirements

Section 1244 stock generally can be either common or preferred stock. However, stock issued before July 19, 1984, must be common stock to qualify for Section 1244 treatment. Common stock does not include securities that are convertible into common stock or common stock that can be converted to other securities. The determination of whether stock qualifies as Section 1244 stock is made when the stock is issued.

A corporation (either C or S) is treated as a small business corporation if, when stock is issued, the aggregate amount of money and other property it received in exchange for stock or as a contribution to capital or paid-in-surplus does not exceed $1 million. Thus, stock associated with the first $1 million of capital (i.e., capital stock and paid-in-capital) can qualify as Section 1244 stock. When total capital exceeds $1 million, the corporation (not the shareholders) may designate the Section 1244 shares issued in that year instead of a proportional allocation. For the stock to receive Section 1244 treatment when it becomes worthless or is sold by the taxpayer, the corporation must have derived more than 50% of its aggregate gross receipts from sources other than investments (such as interest, dividends, royalties) during the five most recent tax years ending before the date the taxpayer's loss is sustained (or since inception if the corporation is in existence for less than five years).

Claiming a Section 1244 Loss

An ordinary loss on Section 1244 stock can be claimed only by an individual to whom the stock was originally issued (or an individual who was a partner in a partnership when it acquired the stock from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership). Shareholders who acquire their stock by gift or inheritance or by purchase from the original holder are not eligible for Section 1244 treatment.

The maximum amount that can be claimed as an ordinary loss in a tax year is $50,000 for a single taxpayer or $100,000 on a joint return. The $100,000 maximum applies whether the losses are sustained by one or both spouses. The $50,000 and $100,000 limitations are annual limitations on the amount treated as ordinary loss under IRC Sec. 1244. Any losses in excess of the $50,000 and $100,000 limitations are treated as capital losses subject to the usual capital loss limitation rules.

For losses sustained by a partnership, the $50,000 and $100,000 limits apply separately to each partner. The partner's share of the partnership's Section 1244 loss is limited to the lesser of his distributive share percentage when the stock is issued or the partner's distributive share percentage when the loss is sustained. (The partnership is considered the original owner.) If the partnership distributes the stock to the partners, they will not be entitled to Section 1244 loss treatment because they are not the original owners.

Losses on Worthless Securities

Taxpayers are allowed a capital loss for worthless securities held as capital assets. The loss can be taken only when the security becomes wholly worthless; losses for partial worthlessness cannot be claimed. This rule requires taxpayers to correctly identify the year that a security becomes wholly worthless.

Generally, a security is considered worthless at the time it first has no liquidation value and no reasonable hope or expectation exists that the security will become valuable at some future date. A taxpayer may be able to establish worthlessness by showing a fixed and identifiable event demonstrating the worthlessness of the security.

The question of when a security becomes worthless has been the subject of many court cases and IRS rulings. For example, bankruptcy is not sufficient to permit a loss claim when it is possible that the shareholders will obtain

stock in a reorganization. In *Thun*, a loss claimed three years before the corporation ceased business was not allowed, but in *Steadman*, a taxpayer's loss two years prior to the corporation filing bankruptcy was allowed. Stock is also worthless at the date a corporation elects to be treated as a disregarded entity if its liabilities exceed the value of its assets, including intangibles, at that date. Worthlessness depends on the particular facts. Practitioners faced with a possible worthless security issue should review relevant court decisions and other authorities. In any event, one court suggested that a loss be claimed in the earliest year possible.

To give taxpayers relief from the obvious difficulties of determining when a security becomes worthless, IRC Sec. 6511(d)(1) allows a seven-year statute of limitations (instead of the normal three-year period) to file an amended return for refund claims due to losses from worthless securities (or bad debts).

Example 1D-1 Timing of worthless stock loss.

Teddy bought 200 shares of HAU Corp. for $15 per share in 2000. HAU is a publicly traded company. As of the end of 2010, the stock price had declined to $1.50 per share, and the company was in Chapter 11 bankruptcy.

Teddy cannot take a worthless stock deduction in 2010 for his anticipated loss on HAU stock. The stock is not wholly worthless—as evidenced by its trading value. To establish a deductible capital loss, Teddy must sell his shares or wait for an event that renders his stock worthless. Even if his ownership interest is significantly diluted in the Chapter 11 reorganization, he will be unable to claim a loss as long as he holds securities that have some value—however nominal. If, however, HAU is liquidated in bankruptcy, Teddy should be able to claim a worthless security loss when it is established that his equity holder class will receive nothing in liquidation.

Abandoned Securities

A loss established by abandonment of a security, other than a security in a corporation affiliated with the taxpayer, that is a capital asset is treated as a loss from the sale or exchange of a capital asset on the last day of the year. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security.

Futures Contracts and Publicly Traded Options

A publicly traded option giving the holder the right to sell a specified stock at a set price (the strike price) on or before a specified date is called a put option. An option giving the holder the right to buy at a set price on or before a specified date is referred to as a call option.

A taxpayer who grants put or call options is called a *writer*. A taxpayer who owns a put or call option is called a *holder*. Writers of options receive a premium or fee for agreeing to take the risk to buy or sell securities under the terms of the option. Holders of options pay the premium to either the option writer or a previous holder to acquire the opportunity to buy or sell securities under the terms of the option.

The following discussions expand on and illustrate the taxation of publicly traded options.

Tax Rules for Option Writers

Option writers (sometimes called *grantors*) have tax consequences when an option (1) lapses without exercise (i.e., expires), (2) is exercised, or (3) is offset by a closing transaction. The receipt of the premium for writing an option has no tax consequences to the writer until one of these events occurs.

Option Lapses (Expires). When a put or call option lapses (expires), the premium payment received by the option writer is a short-term capital gain at that time.

Example 1E-1 Effect of lapse of option on writer.

On November 3, 2010, Ernie wrote a January 2011 put option at $20 per share for 100 shares of QwikBux, Ltd. He received a premium of $250 for writing the option. The stock soared to $28 per share the January 2011 expiration date, and the option was not exercised.

Ernie treats the $250 as short-term capital gain occurring in 2011. No gain or loss is reported in 2010 since the option is still open at December 31, 2010.

Option Exercised. If a put is exercised (i.e., the writer must purchase the stock), the writer reduces his or her tax basis in the shares acquired by the amount of premium received. If a call is exercised (i.e., the writer must sell the stock), the writer adds the premium to the proceeds from the sale of the securities to the option holder.

Example 1E-2 Effect of exercise of option on writer.

On October 3, 2010, Buford wrote a December 2010 put option for 100 shares of MightyFine, Inc., at a price of $10 per share. He also wrote a December 2010 call option for 100 shares of Shiftee Stores Corp. at a price of $8 per share. Buford received premiums of $300 for writing the MightyFine put option and $400 for writing the Shiftee Stores call option. Both options were exercised by their holders in December 2010. Buford paid $1,000 to acquire the MightyFine shares and received $800 for delivering 100 shares of Shiftee Stores.

Buford's tax basis in the 100 shares of MightyFine that he now holds is $700 ($1,000 paid to acquire the shares − $300 premium received for writing the put option).

Buford's sales proceeds from the 100 shares of Shiftee Stores delivered to the call option holder (i.e., $800) are increased by the $400 received for writing the call option on the shares. He then calculates capital gain or loss using his basis and his holding period in the shares delivered.

Closing Transaction. A closing transaction occurs when the writer's economic obligation under the option's terms is offset and, in effect, canceled by purchase of an equivalent option. If an option writer enters into a closing transaction, any gain or loss is short-term and is measured by the difference between the amount received from premiums for writing the option and the amount paid to acquire options in the closing transaction.

Example 1E-3 Effect of closing transaction on writer.

Assume the same facts as in Example 1E-2, except Buford decides he wants to avoid the consequences of having the options he wrote exercised. Therefore, he acquires offsetting positions on December 1, 2010, by purchasing a December 2010 put option for 100 shares of MightyFine (at $10 per share) for $400 and a December 2010 call option for 100 shares of Shiftee Stores (at $8 per share) for $600.

Buford has a $100 short-term capital loss from his MightyFine option writing ($300 premium received − $400 paid in closing transaction) and a $200 short-term capital loss from his Shiftee Stores option writing ($400 premium received − $600 paid in closing transaction). These losses are recognized on December 1, 2010, the date the closing transactions occurred.

Tax Rules for Option Holders

The tax consequences to option holders depend on whether the options expire, are exercised, or are sold before expiration. To summarize:

1. The loss on an expired option will be either short-term or long-term depending on how long the option was held, unless the option is part of a straddle (see discussion below).

2. If a put option is exercised (i.e., the holder sells the stock to the option writer), the cost of the option is deducted from the sales proceeds received from the sale of the securities under the terms of the put.

3. If a call option is exercised (i.e., the holder buys the stock from the option writer), the cost of the option is added to the cost of the securities acquired under the terms of the call.

4. If an option is sold prior to expiration, gain or loss will be either short- or long-term depending on how long the option was held (see holding period rules for options included in straddles below).

Example 1E-4 Effects of option transactions on holder.

On March 5, 2010, Selena made the following option transactions: (1) bought an April 2010 call option to purchase 100 shares of McD, Ltd., at $15 per share for $150, (2) bought a June 2010 put option to sell 100

shares of Fort, Inc., at $10 per share for $250, and (3) bought a December 2010 call option to purchase 100 shares of Luckee, Inc., at $7 per share for $100.

On March 5, 2010, Selena did not own any shares in McD, Ltd., Fort, Inc., or Luckee, Inc. On March 16, 2010, Selena sells her McD option for $600, recognizing a $450 short-term capital gain.

On June 18, 2010, Fort was selling for $14 per share; thus, Selena let the option expire. She has a short-term capital loss of $250 when it expires because she held it for one year or less.

On December 17, 2010, Luckee is selling for $15 per share, and Selena exercises her option. Her option cost of $100 is added to the $700 paid to exercise the call; so her basis in the shares is $800. Her stock's holding period starts on December 18, 2010, the day after she acquired the shares by exercising her option.

Put Options Treated as Straddles. Purchasing a put option on stock owned by the taxpayer can result in the application of the straddle rules under IRC Sec. 1092. Holding a position [including an option to buy (other than a qualified covered call as described in IRC Sec. 1092) or sell] that substantially diminishes a taxpayer's risk of loss of holding property is a straddle. Although stock is generally excluded from the definition of personal property when applying the straddle rules, it is included when it is part of a straddle in which at least one of the offsetting positions is an option to buy or sell the stock or substantially identical stock or securities. However, a straddle consisting entirely of regulated futures contracts, nonequity options (e.g., an option on the S&P 500 index), or dealer equity options is not subject to this rule. Instead, the mark to market rules apply.

If the straddle rules apply, losses on positions making up the straddle may be deferred until the year any gains are recognized on the remaining position(s). Loss is deferred to the extent of unrecognized gain in the offsetting positions, determined as of the close of the year. For a protective put (i.e., a put option acquired with respect to stock owned by the option holder), any loss incurred because the option expires unexercised is deferred to the extent the stock would generate a gain if sold on the last day of the tax year. If the straddle rules apply, the option's holding period is also subject to special rules. If the taxpayer held the stock subject to the option for more than 12 months before purchasing the put option, any loss on the option's expiration is long-term. If the taxpayer held the stock subject to the option for 12 months or less before acquiring the put, the option's holding period does not begin until the offsetting position (i.e., the stock) is sold. Thus, if the option expires before the stock is sold, the loss is short-term. Also, any interest and carrying charges associated with the straddle must be capitalized.

Example 1E-5 Applying the straddle rules to expired put options.

Assume the same facts as in Item 2 of Example 1E-4. Also assume that Selena owns 100 shares of Fort, Inc., that she purchased three years ago for $5 per share. Selena does not sell the Fort stock during 2010. At December 31, 2010, it is worth $14 a share. Thus, Selena has an unrecognized gain with respect to the Fort stock of $900 [($14 FMV less $5 basis) × 100 shares]. None of the loss on the expired put can be recognized during 2010 since the $900 unrecognized gain in the Fort stock exceeds the $250 loss on the expired put.

Variation: Assume instead that Selena's basis in the 100 shares of Fort is $20 per share. Thus, at December 31, 2010, she has an unrecognized loss of $600 [($14 FMV − $20 basis) × 100 shares]. Selena recognizes the $250 long-term loss when the put option expires (June 18, 2010). This is because the stock she owns would not generate a gain (if sold on December 31, 2010) that exceeds the loss she realized on the expiration of the option. In fact, in this situation, a sale of the stock would result in a loss.

Straddles and Qualified Covered Call Options. Under a special rule in IRC Sec. 1092(c)(4), a straddle consisting of a stock and a qualified covered call option on the stock do not constitute a straddle for purposes of the loss deferral rules unless such positions are part of a larger straddle. This exception to the straddle rules normally applies when an individual writes a publicly traded call option on stock he or she owns as an investment strategy to enhance the investment return on the stock.

A qualified covered call option is any option a taxpayer grants to purchase stock he holds (or stock he acquires in connection with granting the option), but only if all of the following are true: (1) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (2) the option is granted more than 30 days before its expiration date, (3) the option is not a deep-in-the-money option [i.e., an option with a strike price

lower than the lowest qualified benchmark (LQB); generally, the LQB is the highest available strike price that is less than the applicable stock price], (4) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing in options, and (5) gain or loss on the option is capital gain or loss.

In Rev. Rul. 2002-66, the IRS ruled that if a taxpayer owns stock on which he or she has written a qualified covered call option and acquires a put option on the same stock, the presence of the put option causes the stock and qualified covered call option to constitute a larger straddle and thus, no longer qualify for the exception to the straddle rules. The taxpayer is then subject to the loss deferral and other restrictions applicable to straddle positions, as discussed earlier.

Example 1E-6 Acquiring a put option disqualifies covered call option from straddle exception.

On October 4, 2010, Tom purchases 100 shares of ABC Corp. for $102 per share. On October 6, 2010, when the fair market value of ABC stock is $100, Tom writes a 12-month qualified covered call option on the 100 shares with a strike price of $110. On December 6, 2010, when the FMV of the stock remains at $100, Tom purchases a 12-month put option on 100 shares of ABC stock with a strike price of $95.

Before December 6, 2010, the combination of the qualified covered call option and the underlying ABC stock are not treated as a straddle for purposes of IRC Sec. 1092 and 263(g). However, beginning on December 6, 2010, all of the Tom's positions in ABC stock are part of a larger straddle and therefore, the exception for covered call options no longer applies to any of them beginning on that date. Thus, a loss realized on any part of the straddle (i.e., the ABC stock, the call option, or the put option) after December 6, 2010 could be recognized only to the extent it exceeded any unrecognized gain in the offsetting positions (determined at the close of the tax year). (See Example 1E-5.)

Section 1256 Contracts

IRC Sec. 1256 was enacted to curb abuse in the futures contract markets whereby taxpayers could accelerate the recognition of loss on a contract even though they held another contract with an offsetting but unrealized gain that would be recognized in the future. The abuse has been curtailed by requiring each Section 1256 contract held by the taxpayer at the end of the year to be treated as having been sold at FMV on the last day of the business year (i.e., marked to market). When the contract is subsequently closed in a future tax year, gain or loss realized is adjusted to account for gain or loss resulting from the prior year's marking to market. Any gain or loss from a Section 1256 contract is automatically treated as 60% long-term and 40% short-term capital gain or loss. Any loss on a Section 1256 contract recognized due to the mark to market rules is exempt from the wash sale rules described later in this lesson.

A *Section 1256 contract* is defined as any:

1. regulated futures contract (i.e., a contract that is traded on or subject to the rules of a qualified board or exchange, and for which the amount that must be deposited or withdrawn depends on a system of marking to market);

2. foreign currency contract (i.e., forward purchases or sales of foreign currency);

3. nonequity option (e.g., listed options on commodities, futures, foreign currencies, etc.);

4. dealer equity option (i.e., an equity option granted or purchased by an options dealer in the course of the dealer's business as a market maker in listed options); or

5. any dealer securities futures contract.

The term *Section 1256 contract* shall not include:

1. any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or

2. any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

The taxpayer can elect to carry a net Section 1256 loss back to the three previous tax years. A net Section 1256 loss for the year is the lesser of (1) the net loss on Section 1256 contracts for the year, or (2) the amount allowable as a capital loss carryover for the year. The amount that can be carried back cannot exceed the net Section 1256 gains for the year to which the loss is carried. A net Section 1256 gain for the year is the lesser of (1) the capital gains for the year considering only gains and losses from Section 1256 contracts, or (2) capital gain net income for the year. The election is made by checking box D on Form 6781.

Example 1E-7 Marked to market treatment of Section 1256 contracts.

John, a speculator, had an open position on a corn contract on December 31, 2009, with an unrealized profit of $3,500, which he recognized in 2009 per IRC Sec. 1256. When he closed the contract on June 2, 2010, he realized a profit on the contract of only $2,000 (reflecting a price decline since December 31, 2009).

John also entered into a futures contract in 2009 calling for delivery of 10,000 bushels of soybeans in May 2011 at $6 per bushel. On December 31, 2010, John still holds the contract, and the May soybean futures price has declined to $5.50 per bushel. How does John treat the decline in the price of the soybean futures on December 31, 2010?

In 2010, John recognizes a $1,500 loss on the corn contract and a $5,000 (10,000 × $.50) loss on the soybean futures contract. The aggregate loss of $6,500 is treated as $3,900 (60% × $6,500) long-term and $2,600 (40% × $6,500) short-term. John reports the transaction on Form 6781 (Gains and Losses From Section 1256 Contracts and Straddles), Part 1. Additionally, he can elect (on Form 6781) to carry a net Section 1256 loss back to the three previous tax years as discussed previously.

Example 1E-8 Section 1256 treatment when contract is closed.

Assume the same facts as in Example 1E-7. In March 2011, John closes out the soybean contract by offset when the May price is $6.75. How much gain does he recognize from this transaction in 2011?

The contract is again marked to market in 2011 for a total gain of $7,500 [($6.75 − $6.00) × 10,000)]. However, this gain is adjusted to reflect the $5,000 loss recognized in 2010. As a result, John recognizes a total gain of $12,500 in 2011. The gain is treated as a $7,500 (60% × $12,500) long-term and a $5,000 (40% × $12,500) short-term capital gain.

Short Sales

What Is a Short Sale?

A *short sale* occurs when a taxpayer sells borrowed securities. A short seller is betting that the price of the securities will decline. If it does, he can buy the securities (at the lower price) to replace those borrowed and sold short, and profit from the price difference. The short sale itself is not a taxable transaction. However, when the seller "covers" by delivering securities to the lender to replace those borrowed for the original short sale, a taxable sale is completed. While the short position is open, the taxpayer is charged interest to the extent the market value of the securities rises above the sales price plus commissions.

General Tax Consequences

Taxable gain or loss is computed based on the difference between the proceeds from the short sale and the tax basis of the securities delivered to cover. The holding period of the securities used to cover generally determines whether the gain or loss is short- or long-term. However, special holding period rules apply to prevent taxpayers from using short sales to convert short-term gains into long-term gains and long-term losses into short-term losses. These special rules under IRC Sec. 1233 are as follows:

1. If, on the date of the short sale, substantially identical property has been held by the taxpayer (or spouse) for a period less than one year (or if substantially identical property is acquired after the short sale, but

before the closing of the short sale by replacement of the borrowed securities), the holding period is deemed short-term regardless of how long the securities actually used to cover have been held. This rule applies only to gains.

2. If, on the date of the short sale, substantially identical property has been held by the taxpayer (or spouse) for more than one year, any loss from the short sale will be deemed to be long-term regardless of the holding period of the securities actually used to cover. This rule applies only to losses.

3. These deemed holding period rules apply only to the quantity of shares sold short.

The term *substantially identical property* is to be applied according to the facts and circumstances in each case.

Example 1F-1 Recognizing gain or loss on a short sale.

On March 17, 2010, Jenny borrows 100 shares of MXL stock from her broker and sells it short for $5,000 ($50 a share). She did not own any MXL stock at the time. On April 29, 2011, Jenny purchases 100 MXL shares for $6,000 and delivers them to her broker to close the short sale. Jenny does not report any gain or loss from the short sale until April 29, 2011, the date she closes it. She reports a $1,000 short-term capital loss in 2011 because the holding period for the delivered stock was less than one year.

Variation: Assume that when Jenny sold the stock short, she held 100 shares of MXL stock she had acquired on January 20, 2010, for $3,500. Here, Jenny's MXL stock is considered an appreciated financial position subject to the constructive sale rules. Thus, she must recognize a $1,500 short-term capital gain on March 15, 2010, the date she enters into a constructive sale of her MXL stock (the date of the short sale of other MXL stock).

Transferring borrowed stock to cover a short sale obligation does not close that sale. The sale remains open until it is finally discharged (generally, by delivering stock that the taxpayer owns or purchases to the second lender). However, if property sold short becomes substantially worthless before being delivered to close the transaction, the short sale is treated as closing and gain is recognized as of the date the property became substantially worthless. This prevents a taxpayer from deferring gain recognition.

Example 1F-2 Reconciling short sale proceeds.

Sally sold several stocks in her investment portfolio during 2010. The proceeds from these sales totaled $189,500. She also sold short 100 shares of Bubble.com stock for $62,200 and the short position was still open on December 31, 2010. However, Blue Sky Securities, Inc., Sally's brokerage firm, reported sales proceeds of $251,700 ($189,500 + $62,200) on the Form 1099-B issued to her.

The IRS will expect Sally's 2009 Schedule D to reflect securities sales of $251,700 (i.e., match the Form 1099—B amount). Sally should attach a reconciliation statement in support of Schedule D, as follows:

Gross proceeds per Form 1099—B	$ 251,700
Less: nontaxable short sale open at December 31, 2010	(62,200)
Reportable proceeds	$ 189,500

Applying the Constructive Sale Rules

The Section 1259 constructive sale rules that apply to taxpayers holding appreciated financial positions also apply to certain short sale transactions. The constructive sale rules are discussed later in this lesson. With regard to short sales, the constructive sale rules cause a taxpayer owning an appreciated security who enters into a short sale with respect to that security to recognize gain at the time of the short sale (rather than when the short sale is closed). This rule, which effectively eliminates short-against-the-box as a year-end gain deferral technique, applies unless an exception to the constructive sale rules applies.

Rev. Rul. 2002-44 clarifies how the constructive sale rules apply when a taxpayer acquires stock to close an appreciated short position. Under the ruling, if a taxpayer is holding a short position that has increased in value (because the underlying asset has decreased in value), merely acquiring the property to close the sale will trigger the gain (under the constructive sale rules), regardless of Reg. 1.1233-1(a)(1), which says gain or loss is recognized on the date the property is delivered to close the sale.

Example 1F-3 Recognizing loss on a short sale.

Courtney sells 100 shares of Acme Inc. (a publicly traded stock) short on October 29, 2010 when Acme is trading at $40 per share. Courtney does not own any Acme, Inc. stock. On December 30, 2010, Acme is trading at $43 per share, so Courtney's short position has declined in value. She instructs her broker to acquire 100 shares of Acme to close her short sale. The trade date of the purchase is December 30, 2010, but the shares are not delivered to the lender to close the short sale until January 4, 2011. Courtney does not realize her loss on the short sale until January 4, 2011.

Example 1F-4 Recognizing gain on a short sale.

Assume the same facts as Example 1F-3, except that on December 30, 2010, the Acme Inc. stock is worth $35 per share. Now, Courtney's short position is an appreciated financial position. So, when her broker purchases (on her behalf) the stock to close the transaction on December 30, 2010, the constructive sale rule applies. Courtney recognizes her gain on the short sale on December 30, 2010 (the trade date), even though the shares are not delivered to the lender to close the sale until January 4, 2011.

Applying the Wash Sale Rules

A discussion of wash sales continues later in this lesson. Under IRC Sec. 1091(e), wash sale principles also apply to short sale loss transactions when another short sale of substantially identical securities is entered into within 30 days before or after the closing of the short sale giving rise to a loss.

Example 1F-5 Short sale that is also a wash sale.

Will is convinced that DiveTech's stock value will decline, so on October 1, 2010, he sells 1,000 shares short at $30. The stock rises, and on December 3, 2010, DiveTech is selling for $35 a share. Will could use a 2010 short-term loss for tax purposes, so on December 3, 2010, he buys 1,000 shares at $35 and covers his short position. With his $5,000 short-term loss presumably recognized in 2010, Will sells another 1,000 shares of DiveTech short at $35 on December 6, 2010, because he is still convinced that DiveTech inevitably will decline.

In this case, Will entered into a short sale of identical stock three days after the December 3, 2010 closing of his original short position that gave rise to the $5,000 loss. Will's $5,000 loss will be deferred and added to the tax basis of the securities eventually delivered to close out his December 6, 2010, short position.

Employee Stock Options

Two basic kinds of stock options are received as compensation by employees—incentive stock options (ISOs, also referred to as qualified or statutory stock options) and nonqualified stock options (NQSOs).

Incentive Stock Options

An ISO can have both regular tax and alternative minimum tax (AMT) implications. (See "AMT Considerations" later in this key issue.) Generally, the recipient of an ISO recognizes no income for regular tax purposes upon the grant (when the option is received) or the exercise (when converting the option to stock) of the ISO. The price at which the option is exercised becomes the taxpayer's basis in the stock; the taxpayer then recognizes income on the difference between his basis and the sales price when the stock is sold. When stock received from the exercise of an ISO is sold, the transaction receives capital gain treatment if the participant has held the stock for at least one year, and the ISO was granted at least two years before.

If this holding period requirement is not met, the taxpayer will have a disqualifying disposition when the stock is sold. Generally, if the employee sells the stock within two years of the grant date or one year of the exercise date,

the difference between the option (exercise) price and the fair market value (FMV) on the date it is exercised (i.e., the bargain element) is ordinary income to the employee. If the amount realized upon the sale of the stock exceeds the FMV at the exercise date, the excess of sales price over the FMV at the exercise date is capital gain. However, if the amount realized is less than the FMV at the date of exercise and greater than the exercise price, only the excess of the amount realized (not the FMV) over the exercise price is taxed as ordinary income. This limitation on compensation income recognized only applies if the disposition is a sale or exchange on which a loss, if sustained, would be recognized. For example, if the stock is sold to a related party (under IRC Sec. 267) at a price less than the FMV at the date of exercise, the compensation amount is the excess of the exercise price over the option price. If the amount realized is less than the exercise price, the excess of the exercise price over the amount realized is capital loss.

Example 1G-1 Disqualifying disposition of ISO stock.

Brian is an executive with Gem Corp. In January 2008, he was granted ISOs to purchase 2,000 shares of Gem's stock at $50 per share (which was the market price of its stock on that date). Brian exercises the options in February 2010 when the stock is trading at $61 per share; no regular tax consequences occur. His regular tax basis in the 2,000 shares is $100,000 (the exercise price). (However, AMT tax consequences exist at the time of exercise. See the discussion following this example.)

Brian sells the 2,000 shares in December 2010 for $134,000 (2,000 shares × $67 per share), realizing a $34,000 ($134,000 − $100,000) gain for regular tax purposes. Brian's sale of the stock within one year of the date the option was exercised is a disqualifying disposition. Therefore, Brian must recognize $22,000 (of the total $34,000) as ordinary income for regular tax purposes in 2010, computed as follows:

	Value of stock on exercise date (2,000 shares × $61)	$ 122,000
	Exercise price paid (2,000 shares × $50)	(100,000)
(1)	Excess of value over exercise price	$ 22,000
	Amount realized from the stock disposition (2,000 shares × $67)	$ 134,000
	Exercise price paid (2,000 shares × $50)	(100,000)
(2)	Excess of amount realized over exercise price	$ 34,000
	Ordinary income [lesser of (1) or (2)]	$ 22,000

The $22,000 is compensation income and is reported to Brian on either Form W-2, box 1 (for employees), or Form 1099-MISC (for former employees). The remaining $12,000 of gain realized on the sale ($34,000 − $22,000) is short-term capital gain (reported on Schedule D) because Brian held the stock for one year or less.

An employee has three months after termination of employment to exercise an ISO. The option generally must be exercised within three months of the employee's last day of employment by the corporation, its parent, or its subsidiary. Thereafter, the option becomes nonqualifying, resulting in less favorable tax treatment (see discussion later in this key issue). When an employee terminates employment because of permanent and total disability, the three-month period is extended to one year.

When an ISO is exercised, the employer must furnish a statement to the participant. It should include such data as the FMV of the stock received the exercise price per share, and the tax consequences of the exercise of the option and the eventual sale of the stock. Practitioners should review this information during the return preparation process.

AMT Considerations. The difference between the option price and the FMV on the date the option is exercised (unless the stock is subject both to restrictions on transferability and a substantial risk of forfeiture) is a positive AMT adjustment, increasing alternative minimum taxable income (AMTI), which may trigger AMT in the year an ISO is exercised. The taxpayer's stock basis for AMT is FMV at the date of exercise (cost plus amount included in AMTI as an adjustment). A taxpayer disposing of the stock will have a negative AMT adjustment for the excess of the basis for AMT over the basis for regular tax. If the stock is disposed of in the same year as exercise, the two adjustments

will offset, and the tax effect will be the same for both regular tax and AMT. A taxpayer may avoid the application of AMT resulting from an ISO exercise by staggering it so that the adjustment does not trigger AMT.

Alternatively, a taxpayer with AMT as a result of an ISO exercise will have a minimum tax credit (MTC) available to offset regular tax in future years. If the MTC is not used in the next three years, it becomes part of the taxpayer's long-term unused MTC, which can generate a refund. This AMT refundable credit is equal to the greater of 50% of the long-term unused MTC for the tax year or the amount (if any) of the AMT refundable credit amount determined under IRC Sec. 53(e) for the taxpayer's preceding year. Thus, although an individual may have to pay AMT when exercising an ISO, he or she can use any resulting MTC twice (e.g., half in one year and half in the next year) to compute the AMT refundable credit amount for each of two consecutive tax years, beginning with 2008.

Nonvested Stock. The stock received upon exercising an ISO may be subject to forfeiture (i.e., nonvested). For regular tax, receiving nonvested stock is no different than receiving vested stock if the holding period requirements are met. However, if the nonvested stock is sold in a disqualifying distribution (i.e., after it vests but before the holding period requirements are met), the ISO rules no longer apply. Therefore, compensation income is recognized at the sale date, equal to the excess of the stock's FMV on the date it vests (or, if less, the sales price, assuming the sale is not subject to loss deferral) over the exercise price. The stock's holding period begins on the vesting date.

Example 1G-2 Nonvested stock received by exercising an ISO.

In June 2008, Courtney, an executive with Round Top Enterprises, is granted an ISO to purchase 100 shares of stock at $100 per share. When the option is exercised, the stock cannot be transferred for six months. Courtney exercises the option in February 2009, when the stock price is $120 a share. On August 8, 2009, the stock vests. It is trading for $130 a share on that day. In February 2010, Courtney sells the stock for $150 a share. This is a disqualifying disposition because the ISO was granted less than 2 years before the stock was sold. Courtney recognizes compensation income of $3,000 [($130 − 100) × 100]. She also recognizes capital gain of $2,000 [(150 − 130) × 100]. This is a short-term capital gain because Courtney's holding period began on August 8, 2009 (the day the stock vested).

A provision in the 2006 Tax Relief and Health care Act requires that corporations furnish a written statement to the IRS containing specific information on employees who exercise ISOs or who receive stock under an employee stock purchase plan (ESPP) after November 16**,** 2009.

Nonqualified Stock Options (NQSOs)

An NQSO is any option that is not a qualified stock option, as defined in IRC Sec. 422. Unlike ISO holders who meet the required holding period, the recipient of an NQSO is not allowed to defer income recognition on the bargain element until the stock is sold or to have all the income associated with the option treated as capital gain.

Generally, the excess of the stock's FMV when the option is exercised over the option price (i.e., the bargain element) is taxable as compensation in the year of exercise. However, if the FMV of the option is readily ascertainable when the option is granted, income will be recognized then rather than when the option is exercised. From an employee's perspective, this may be the most advantageous time for income recognition if the stock value increases significantly after the option is granted. Unfortunately, if the option is not traded, it can be difficult to determine whether the option has a readily ascertainable FMV. An option does not have a readily ascertainable FMV unless the following conditions are met:

1. The option may be transferred freely.

2. The option is exercisable immediately in full.

3. There are no restrictions on the option or stock that have a significant effect on the FMV of either.

4. The FMV of the option privilege can be determined by the value of the property subject to the option, the probability of an increase or decrease in value, and the length of the option period.

The burden is on the taxpayer to prove that an option has a readily ascertainable value. Most NQSOs do not have a readily ascertainable value, and are therefore not taxed at the grant date.

Example 1G-3 Taxation of NQSOs.

Tom is an executive with Smith Corp., a closely held company. On March 1, 2007, he was granted NQSOs to purchase 3,000 shares of Smith Corp. stock at $30 per share (which was the market price of the stock on that date). The options have some restriction on transferability and therefore do not have a readily ascertainable FMV. Tom exercises the options on March 3, 2010, when the stock is trading at $45 per share.

Since the options had no readily ascertainable FMV at the grant date, there was no taxable event on that date. However, Tom must recognize $45,000 ($15 per share bargain element × 3,000 shares) of ordinary compensation income in 2010 when the options are exercised. Tom's basis in the stock is $135,000, or $45 per share ($30 per share option price + $15 per share compensation income × 3,000 shares). If he holds the stock as a capital asset for more than one year before he sells it, he will receive long-term capital gain (or loss) treatment.

Variation: If the options themselves had a readily ascertainable FMV of $5 per option at the date of grant (March 1, 2007), the value of the options ($5 × 3,000 = $15,000), is taxable to Tom in 2007 as ordinary compensation income. There would be no tax consequences to Tom in 2010 when he exercised the options. Tom's basis in the stock would be $105,000, or $35 per share (option price of $30 per share + $5 per option of compensation income recognized). If Tom holds the stock as a capital asset for more than one year after exercise before he sells it, he will receive long-term capital gain (or loss) treatment.

Example 1G-4 Cashless exercise of NQSOs.

Assume the same facts as in Example 1G-3 except that Tom exercises the NQSOs in a cashless transaction. Tom works with a brokerage firm that pays Smith Corp. $90,000 ($30 × 3,000 shares) on March 3, 2010 to purchase the NQSO shares on Tom's behalf. The brokerage firm immediately sells 2,000 shares for $90,000 ($45 per share) and uses the funds to repay Tom's margin loan.

Tom must recognize $45,000 ($15 per share bargain element × 3,000 shares) of ordinary compensation income in 2010 when the options are exercised. His basis in the remaining 1,000 shares of stock is $45,000 or $45 per share ($30 per share option price + $15 per share compensation income × 1,000 shares). If Tom holds the remaining 1,000 shares of stock as a capital asset for more than one year before he sells it, he will receive long-term capital gain (or loss) treatment on those shares.

The option may pertain to stock that is nontransferable or subject to a substantial risk of forfeiture (i.e., restricted stock). Here, compensation income generally is not recognized until the restrictions lapse, and it is based on the difference between the FMV of the stock when the restrictions lapse less the exercise price. This can be detrimental to the employee if the stock appreciates after the option is exercised and before the restrictions are lifted. Accordingly, if the stock is expected to appreciate, the employee might want to elect under IRC Sec. 83(b) to recognize the income when the option is exercised rather than when the restrictions lapse based on the appreciated value.

In *Hilen*, taxpayer borrowed funds from a commercial bank, used the borrowed funds to exercise stock options, and pledged the stock as collateral for the bank loan. Taxpayer recognized income equal to the difference between the exercise price and the fair market value and paid taxes on that gain. The stock subsequently declined in value, the taxpayer defaulted on his bank loan, and he filed an amended return reversing the recognition of income on the option gain. Taxpayer claimed the option exercise was nonrecourse financing, that he should not have to bear the risk of market value decline, and the recognition of gain should be delayed until he made a substantial payment on the debt. The court ruled the debt was recourse financing and the taxpayer must recognize income from the exercise of his nonstatutory stock options as stated in the original tax return.

So long as the sale of property (e.g., stock) at a profit could subject a person to suit under Section 16(b) of the Securities Exchange Act of 1934, such person's rights to such property are subject to a substantial risk of forfeiture. For stock acquired as a result of exercising an NQSO granted prior to an IPO, the six month holding period for Section 16(b) generally begins when the NQSO was granted, not when it was exercised.

Qualified Small Business Stock

Qualified small business stock (QSBS) is stock originally issued after August 10, 1993, by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock. The taxpayer must have acquired the stock at its original issue, or in a tax-free transaction such as a gift, inheritance, or partnership distribution.

In addition, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded. Ineligible businesses include certain personal service activities, banking and other financial services, farming, mineral extraction businesses, and hotels and restaurants. Thus, businesses such as manufacturing, wholesale or retail trade, and transportation activities generally qualify. QSBS can be acquired either in exchange for money or other property (but not stock) or as compensation for services.

When QSBS is sold, the normal capital gain and loss rules apply unless the stock is sold for a gain and either (1) held for more than five years under the 50% gain exclusion rule, or (2) held for more than six months and the sales proceeds are rolled over into other QSBS within 60 days under the Section 1045 rollover rules.

50% Gain Exclusion

Noncorporate taxpayers can exclude 50% of any gain realized from the sale of QSBS held more than five years. When the 50% exclusion applies, the remaining 50% of the gain is taxed at a 28% capital gains rate. Thus, the entire gain is taxed at an effective rate of 14% (50% of gain taxed $\times$ 28% rate). But, 7% of the excluded gain is an AMT preference item. Thus, for taxpayers subject to the 28% AMT rate, the effective rate on gains from Section 1202 stock is 14.98% [28% $\times$ (50% plus 7% $\times$ 50%)].

The gain eligible for exclusion for each taxpayer is limited on a per issuer basis and cannot exceed the greater of (1) $10 million reduced by the taxpayer's aggregate prior-year gains from stock of the same issuer, or (2) 10 times the taxpayer's basis in his QSBS from such corporation disposed of during the year.

The 2009 Recovery Act increased the 50% gain exclusion from the sale or exchange of QSBS held more than five years to 75% for qualified stock acquired after February 17, 2009 and before September 28, 2010.

For QSBS acquired after September 27, 2010 and before January 1, 2011, and held more than five years, the 2010 Small Business Act increases the gain exclusion to 100%.

Rollover of QSBS Gain

Under IRC Sec. 1045, noncorporate taxpayers who realize a gain from the disposition of QSBS held more than six months can elect to roll over (defer) the gain to the extent they acquire QSBS during the 60-day period beginning on the date of the sale. Gain is recognized to the extent the sales proceeds exceed the cost of replacement stock(s) reduced by any part of the cost of the replacement QSBS that was previously taken into account to defer recognition of gain on the sale of other QSBS. Gain treated as ordinary income is not eligible for rollover. When determining whether the replacement QSBS meets the Section 1202(c)(2) active business requirement, only the first six months the taxpayer holds the stock is taken into account.

The basis in the QSBS acquired is reduced for any gain deferred. In addition, the holding period of the replacement stock generally will include the holding period of the stock sold, except the replacement stock must be held for more than six months to do another tax-free rollover.

Example 1H-1 Rollover of gain on small business stock.

Charlie invests $400,000 in Eagle Corp., a manufacturing concern, on August 22, 2009. Eagle stock qualifies as small business stock under IRC Sec. 1202(c). On October 1, 2010, Charlie sells the Eagle stock for $625,000, resulting in a $225,000 gain. On October 13, 2010, he purchases stock in newly formed Hawk Corp. for $600,000. Hawk also qualifies as a small business corporation under IRC Sec. 1202(c).

Charlie elects to roll over the gain from the sale of the Eagle stock. Accordingly, he recognizes only $25,000 of the gain because this is the amount the sales proceeds ($625,000) exceed his investment in Hawk ($600,000). His basis in his Hawk stock is $400,000 ($600,000 cost less deferred gain of $200,000). His holding period in Eagle stock is added to the holding period of the Hawk stock for all purposes except for determining whether Hawk meets the active business requirement for the six-month period following purchase.

A taxpayer (other than a C corporation) that sells QSBS and elects to defer gain can satisfy the replacement QSBS requirement with QSBS that is purchased within the statutory period by a partnership in which the taxpayer is a partner on the date the QSBS is purchased (purchasing partnership). In addition, an eligible partner of a partnership that sells QSBS (selling partnership) and elects to defer gain can satisfy the replacement QSBS requirement with QSBS purchased by a purchasing partnership during the statutory period.

Wash Sale Losses

A loss from the sale or disposition of stock or securities is not deductible if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Stock or securities include stock options, but do not include commodity futures contracts and foreign currencies. In addition, dealers in stocks or securities are not subject to these rules if the loss is from a transaction made in the ordinary course of business. The wash sale rules apply only for losses; gains resulting from wash sales are taxable in the year of sale.

When a wash sale deferred loss transaction occurs, the basis of the substantially identical securities is increased by the realized but unrecognized loss. The holding period of the acquired securities includes that of the original stock sold.

Some taxpayers have tried to circumvent the wash sale rules by having a related party purchase the replacement stock or securities. Although the Section 1091 wash sale rules do not specifically apply to related parties, the courts generally have not allowed the loss in these situations. In *McWilliams*, the court found that the sale by one taxpayer and the purchase by a related taxpayer should be collapsed into a single related party transaction, resulting in loss disallowance under IRC Sec. 267. The Section 267 related party loss disallowance rules are even more onerous than the wash sale rules since they cannot be avoided by timing the sale and repurchase to avoid the 61-day window. Also, the disallowed loss does not automatically increase the basis in the acquired securities. Instead, it can only be used to offset any subsequent gain on a sale by the related party. Taxpayers and their IRAs are related parties. Thus, the sale of a security at a loss would be disallowed if, as part of a plan, the taxpayer's IRA purchased an identical security.

For the wash sale rules to apply, the stocks or securities must be substantially identical. All facts and circumstances must be considered in each case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. Also, IRC Sec. 1091 is not intended to apply to bona fide sales made to reduce a taxpayer's holdings of a security. Thus, a taxpayer who simply buys 200 shares of a stock and within the next 30 days sells 100 shares at a loss will not have the loss disallowed under the wash sale rules. However, the rules will apply if additional shares are acquired within the 30 days following the sale at a loss.

When a Form 1099-B is received for a loss transaction that is a wash sale, the transaction must be reported on Schedule D to avoid IRS matching problems.

Example 1l-1 Accounting and reporting for a wash sale.

Robert purchased 100 shares of XYZ Corp. stock on July 5, 2010, for $700. On September 7, 2010, he sold the shares for $500. On September 13, 2010, he purchased another 100 shares of XYZ for $600. Robert received a 2010 Form 1099-B reflecting the $500 sale on September 7, 2010.

Because the sale and subsequent repurchase of the XYZ stock is a wash sale, the $200 loss from the September 7 sale is not deductible. Instead, Robert's basis in the 100 shares acquired on September 13, 2010, is adjusted to $800 [cost of the reacquired shares ($600) plus the disallowed wash sale loss ($200)]. In

addition, the holding period for the shares acquired on September 13 includes the July 6–September 7 holding period for the original 100 shares.

The wash sale is reported on Part I of Schedule D (since it is a short-term transaction). The full amount of the loss is shown in column (f). On the next line, "Wash Sale" is entered in column (a), and the amount of loss not allowed is shown in column (f) as a positive amount.

Constructive Sales of Appreciated Financial Positions

General Rules

The *constructive sale* rules require recognition of gain (but not loss) upon a constructive sale of any appreciated financial position in stock, a partnership interest, or debt other than certain straight debt. These rules are aimed at transactions that have the effect of eliminating substantially all of a taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position.

A *constructive sale* occurs when the taxpayer (or a related person) enters into one of the following transactions for the same or substantially identical property:

1. a short sale;
2. an offsetting notional principal contract;
3. a futures or forward contract;
4. an acquisition of the actual property (i.e., a long position) that is the subject of a transaction listed in Items 1–3; or
5. under forthcoming regulations, a transaction that has substantially the same effect as an item in 1–4.

The gain is calculated as if the property were sold, assigned, or otherwise terminated at its fair market value (FMV) on the date of the constructive sale. The property's basis is increased by gain recognized on the constructive sale.

Example 1J-1 Collar transaction may result in constructive sale of stock.

Amy owns 100 shares of Allied Corp. stock with a basis of $65 a share and currently trading at $100 a share. She enters into a collar transaction whereby she buys a put option on Allied stock with a strike price of $95 and sells a call option on Allied stock with a strike price of $110. Thus, Amy has retained the risk of loss and opportunity for gain as long as the stock trades between $95 and $110 a share. Outside of that range, she is protected from further loss or opportunity for gain because the option transactions she entered into collar her stock.

Without indicating whether this is a constructive sale, Congress used this fact pattern as an example of a collar transaction in the TRA '97 Committee Reports and went on to state that it expects the IRS to provide safe harbor rules so investors know when collars will be treated as constructive sales. Practitioners should monitor this issue for guidance.

Definitions

Appreciated Financial Position. An *appreciated financial position* is any position relating to a stock, debt instrument, or partnership interest where there would be gain if the position were sold, assigned, or otherwise terminated at its FMV. "Position" means an interest, including a futures or forward contract, short sale, or option.

Straight Debt. A *straight debt* is any position with respect to a debt if the position unconditionally entitles the holder to receive a specified principal amount; interest payments are payable based on a fixed or variable rate, and the position cannot be converted (directly or indirectly) into stock of the issuer or any related person.

Offsetting Notional Principal Contract. An *offsetting notional principal contract* is an agreement that includes:

1. a requirement to pay all or substantially all of the investment yield (including appreciation) related to the property for a specified period and

2. a right to be reimbursed for all or substantially all of any decline in the value of the property.

Forward Contract. A *forward contract* is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

Exceptions to the Constructive Sale Rules

Nonmarketable Securities If Sale Closed within One Year. A contract for the sale of any stock, debt instrument, or partnership interest is not a constructive sale if the contract is settled within one year after the date the contract is entered into. This exception does not apply if the property is a marketable security (i.e., a security for which there is a market on an established securities market or otherwise).

Certain Sales Closed within 30 Days after the Close of the Tax Year. A contract for the sale of any stock, debt instrument, or partnership interest is not a constructive sale if (1) the transaction is closed before the end of the 30th day after the close of the tax year, (2) the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date the transaction is closed, and (3) at no time during the 60-day period in Item 2 is the taxpayer's risk of loss relating to the appreciated financial position reduced by reason of positions held for substantially similar or related property.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Certain losses on an original investment in Section 1244 stock are treated as ordinary losses instead of capital losses. Section 1244 stock is stock issued by a small business corporation. What is the maximum amount of money and other property that a corporation may receive for its stock, contributions to capital, and paid-in surplus and meet the definition of a small business corporation?

    a. $1,000,000.

    b. $500,000.

    c. $100,000.

    d. $50,000.

8. In certain situations, a taxpayer may recognize a capital loss when a security held as a capital asset declines in value. Which of the following events would justify a capital loss deduction for a decline in value?

    a. A company declares bankruptcy during the year even though the company expects to continue operations.

    b. A security for the first time has no liquidation value and no reasonable hope or expectation of becoming valuable at some future date.

    c. The market price of a security held by a taxpayer as a capital asset declines 80% during the year.

    d. A company that has historically paid significant dividends announces that no dividends will be paid during the current year.

9. On July 1, John paid Jennifer $300 for a 90-day put option that gave John the right to sell 100 shares of Alliance, Inc. stock for $30,000. The stock price for Alliance declines, and John exercises the put option. What is Jennifer's tax basis in the 100 shares of Alliance?

    a. $30,300.

    b. $30,000.

    c. $29,700.

    d. $300.

10. On April 1, Andrew paid Amy $200 for a 180-day call option that gave Andrew the right to purchase 100 shares of Gold, Inc. stock for $20,000. The stock price for Gold increases, and Andrew exercises the call option. What is Andrew's tax basis in the 100 shares Gold?

    a. $200.

    b. $19,800.

    c. $20,000.

    d. $20,200.

11. A Section 1256 contract that is open at the end of the year is treated as having been sold for fair market value on the last business day of the tax year. The mark-to-market gains and losses are taken into account when the contract is subsequently disposed. Regardless of the holding period, the capital gains and losses on a Section 1256 contract are automatically treated as:

    a. 40% long-term and 60% short-term.

    b. 60% long-term and 40% short-term.

    c. Long-term if the holding period is more than one year and short-term if the holding period is one year or less.

    d. 50% long-term and 50% short-term.

12. Assuming that a taxpayer does not hold substantially identical property, when does the taxpayer report loss from a transaction involving a short sale of a security that has increased in price?

    a. When the taxpayer borrows the securities from a broker.

    b. When the borrowed securities are sold to a buyer.

    c. When the taxpayer purchases securities to replace the borrowed securities.

    d. When the securities purchased by the taxpayer are delivered to the broker to replace the borrowed securities.

13. Sherrie owns 100 shares of Flash, Inc. stock that she acquired on February 15 of Year 1 for $3,000. On January 15 of Year 2, Sherrie sells 100 shares of Flash stock short for $4,000. On May 1 of Year 2, Sherrie closes out the short sale by delivering the 100 shares of Flash stock that she had purchased on February 15 of the prior year. What is the amount and type of gain or loss that Sherrie recognizes on the short sale?

    a. $1,000 short-term capital gain.

    b. $1,000 short-term capital loss.

    c. $1,000 long-term capital gain.

    d. There is no short sale in this scenario because the property is not considered substantially identical.

14. Generally, a taxpayer is allowed capital gain treatment on the sale of stock received from the exercise of an incentive stock option unless the sale is a disqualifying disposition. When does a disqualifying disposition occur?

    a. When the taxpayer sells the stock within two years of the exercise date.

    b. When the taxpayer sells the stock within two years of the grant date or the exercise date.

    c. When the taxpayer sells the stock within two years of the grant date or one year of the exercise date.

15. Generally, a nonqualified stock option is not taxable to a taxpayer until exercised unless the fair market value of the option is readily ascertainable when the option is granted. All of the following are conditions that must be met for an option to have a readily ascertainable value if the option is not actively traded on an established market **except**—

    a. The option is transferable and exercisable immediately in full by the taxpayer.

    b. There are no restrictions on the option or the stock that have a significant effect on the fair market value of either.

    c. The fair market value of the option privilege can be determined by the value of the property subject to the option, probability of an increase or decrease in value, and length of the option period.

    d. The option must be nontransferable.

16. Special rules that provide for gain exclusion or deferral apply to taxpayers who sell qualified small business stock (QSBS). To qualify as QSBS, the stock must be originally issued after August 10, 1993. In addition, a limit is placed on the aggregate gross assets that a C corporation may own at any time from August 10, 1993, to immediately after the issuance of the stock. This limit is which of the following?

    a. $50 million.

    b. $10 million.

    c. $1 million.

17. On August 1, Calvin purchases 200 shares of TAB, Inc. stock for $1,000. Calvin sells these shares for $800 on October 1. Three weeks later on October 21, he purchases 100 shares of TAB stock for $500. What is Calvin's tax basis in the 100 shares acquired on October 21?

    a. $500.

    b. $700.

    c. $800.

    d. $1,000.

18. Any position relating to a debt instrument, stock, or partnership interest where there would be gain if the position were assigned, sold, or otherwise terminated at its fair market value is referred to as which of the following terms?

    a. Offsetting notional principal contract.

    b. Forward contract.

    c. Straight debt.

    d. Appreciated financial position.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Certain losses on an original investment in Section 1244 stock are treated as ordinary losses instead of capital losses. Section 1244 stock is stock issued by a small business corporation. What is the maximum amount of money and other property that a corporation may receive for its stock, contributions to capital, and paid-in surplus and meet the definition of a small business corporation? **(Page 225)**

   a. $1,000,000. [This answer is correct. Under the Code, stock associated with the first $1 million of capital can qualify as Section 1244 stock. When total capital exceeds $1 million, the corporation may designate the Section 1244 shares issued in that year instead of a proportional allocation.]

   b. $500,000. [This answer is incorrect. The maximum amount of the limitation is more than $500,000. The maximum amount that a single taxpayer can claim as an ordinary loss on Section 1244 stock in a tax year is $50,000.]

   c. $100,000. [This answer is incorrect. The maximum amount of the limitation is more than $100,000. The maximum amount that a taxpayer filing a joint return can claim as an ordinary loss on Section 1244 stock in a tax year is $100,000.]

   d. $50,000. [This answer is incorrect. The maximum amount of the limitation is more than $50,000.]

8. In certain situations, a taxpayer may recognize a capital loss when a security held as a capital asset declines in value. Which of the following events would justify a capital loss deduction for a decline in value? **(Page 225)**

   a. A company declares bankruptcy during the year even though the company expects to continue operations. [This answer is incorrect. The filing of bankruptcy alone is not sufficient evidence that a security is totally worthless.]

   b. A security for the first time has no liquidation value and no reasonable hope or expectation of becoming valuable at some future date. [This answer is correct. According to the IRS Code, taxpayers are allowed a capital loss for the year a security held as a capital asset becomes totally worthless.]

   c. The market price of a security held by a taxpayer as a capital asset declines 80% during the year. [This answer is incorrect. Capital losses for partial worthlessness cannot be claimed.]

   d. A company that has historically paid significant dividends announces that no dividends will be paid during the current year. [This answer is incorrect. A change in a company's dividend policy is not evidence that the security is worthless.]

9. On July 1, John paid Jennifer $300 for a 90-day put option that gave John the right to sell 100 shares of Alliance, Inc. stock for $30,000. The stock price for Alliance declines, and John exercises the put option. What is Jennifer's tax basis in the 100 shares of Alliance? **(Page 226)**

   a. $30,300. [This answer is incorrect. This is the amount of the premium paid for the option plus the price paid to purchase the stock.]

   b. $30,000. [This answer is incorrect. This amount represents the strike price of the stock that must be purchased.]

   c. $29,700. [This answer is correct. Under the IRS Code, the writer's basis in the stock received is the option price for the stock less the premium received by the writer for granting the option.]

   d. $300. [This answer is incorrect. This amount is the premium paid for the put option.]

10. On April 1, Andrew paid Amy $200 for a 180-day call option that gave Andrew the right to purchase 100 shares of Gold, Inc. stock for $20,000. The stock price for Gold increases, and Andrew exercises the call option. What is Andrew's tax basis in the 100 shares Gold? **(Page 226)**

    a. $200. [This answer is incorrect. This amount is the cost of the option.]

    b. $19,800. [This answer is incorrect. This is the cost of the call option reduced by the basis of the stock acquired.]

    c. $20,000. [This answer is incorrect. This is the amount paid to acquire the stock.]

    d. $20,200. [This answer is correct. Under the Code, the holder's basis in the stock is the sum of the cost of the option and the cost of the stock acquired.]

11. A Section 1256 contract that is open at the end of the year is treated as having been sold for fair market value on the last business day of the tax year. The mark-to-market gains and losses are taken into account when the contract is subsequently disposed. Regardless of the holding period, the capital gains and losses on a Section 1256 contract are automatically treated as: **(Page 226)**

    a. 40% long-term and 60% short-term. [This answer is incorrect. The percentages of long-term or short-term capital gain or loss for purposes of the mark-to-market requirement under Section 1256 contracts are not correctly stated.]

    b. 60% long-term and 40% short-term. [This answer is correct. IRC Sec. 1256 was enacted to curb abuse in the futures contract markets whereby taxpayers could accelerate the recognition of loss on a contract even though they held another contract with an offsetting but unrealized gain that would be recognizable in the future. Any gain or loss from a Section 1256 contract is automatically treated as 60% long-term and 40% short-term capital gain or loss.]

    c. Long-term if the holding period is more than one year and short-term if the holding period is one year or less. [This answer is incorrect. The holding period of the Section 1256 contract is not a factor in determining the character of the gain or loss.]

    d. 50% long-term and 50% short-term. [This answer is incorrect. The percentages of capital gain or loss are not correctly stated per IRC Sec. 1256.]

12. Assuming that a taxpayer does not hold substantially identical property, when does the taxpayer report loss from a transaction involving a short sale of a security that has increased in price? **(Page 230)**

    a. When the taxpayer borrows the securities from a broker. [This answer is incorrect. A taxable event has not occurred.]

    b. When the borrowed securities are sold to a buyer. [This answer is incorrect. The short sale itself is not a taxable transaction.]

    c. When the taxpayer purchases securities to replace the borrowed securities. [This answer is incorrect. The short position is still open.]

    d. When the securities purchased by the taxpayer are delivered to the broker to replace the borrowed securities. [This answer is correct. Under the IRS Code, a short sale becomes a taxable sale when the taxpayer closes the transaction.]

13. Sherrie owns 100 shares of Flash, Inc. stock that she acquired on February 15 of Year 1 for $3,000. On January 15 of Year 2, Sherrie sells 100 shares of Flash stock short for $4,000. On May 1 of Year 2, Sherrie closes out the short sale by delivering the 100 shares of Flash stock that she had purchased on February 15 of the prior year. What is the amount and type of gain or loss that Sherrie recognizes on the short sale? **(Page 230)**

    a. $1,000 short-term capital gain. [This answer is correct. Under IRS Regulations, if, on the date of a short sale, substantially identical property has been held by the taxpayer for a period of one year or less, a gain on the short sale is a short-term capital gain regardless of how long the stock used to close the short sale has been held. In this example, the period between the acquisition of the stock (February 15) and the short sale (January 15) is less than one year.]

    b. $1,000 short-term capital loss. [This answer is incorrect. According to the rules for short sales in IRC Sec. 1233, a loss would not be recognized on the transaction.]

    c. $1,000 long-term capital gain. [This answer is incorrect. The stock had been held for less than one year, so using the rules in IRC Sec. 1233, any gain or loss would not be considered long-term.]

    d. There is no short sale in this scenario because the property is not considered substantially identical. [This answer is incorrect. According to the Code, the property in this scenario would be considered substantially identical, and a short sale has taken place.]

14. Generally, a taxpayer is allowed capital gain treatment on the sale of stock received from the exercise of an incentive stock option unless the sale is a disqualifying disposition. When does a disqualifying disposition occur? **(Page 232)**

    a. When the taxpayer sells the stock within two years of the exercise date. [This answer is incorrect. This answer choice does not correctly describe the requirements that must be met before a disqualifying disposition occurs.]

    b. When the taxpayer sells the stock within two years of the grant date or the exercise date. [This answer is incorrect. This answer choice does not include the correct number of years the taxpayer must hold the stock before capital gain treatment is allowed.]

    c. When the taxpayer sells the stock within two years of the grant date or one year of the exercise date. [This answer is correct. Under the Internal Revenue Code, these are the characteristics of a disqualifying disposition. Instead of receiving capital gain treatment, the taxpayer must recognize ordinary income equal to the lesser of (1) the excess of the FMV of the stock on the exercise date over the exercise price paid, or (2) the excess of the amount realized from the disposition of the stock over the exercise price paid.]

15. Generally, a nonqualified stock option is not taxable to a taxpayer until exercised unless the fair market value of the option is readily ascertainable when the option is granted. All of the following are conditions that must be met for an option to have a readily ascertainable value if the option is not actively traded on an established market **except**— **(Page 232)**

    a. The option is transferable and exercisable immediately in full by the taxpayer. [This answer is incorrect. These are two of the four conditions that must be met for the option to have a readily ascertainable value when not actively traded on an established market.]

    b. There are no restrictions on the option or the stock that have a significant effect on the fair market value of either. [This answer is incorrect. For the option to have a readily ascertainable value when not actively traded on an established market this is one of the four conditions that must be met under the regulations.]

    c. The fair market value of the option privilege can be determined by the value of the property subject to the option, probability of an increase or decrease in value, and length of the option period. [This answer is incorrect. This is one of the four conditions that must be met for the option to have a readily ascertainable value when not actively traded on an established market.]

d. The option must be nontransferable. [This is answer is correct. Under the IRS regulations, one of the conditions that must be met for the fair market value to be readily ascertainable is that the option is transferable. Thus, this answer is not a condition that must be met.]

16. Special rules that provide for gain exclusion or deferral apply to taxpayers who sell qualified small business stock (QSBS). To qualify as QSBS, the stock must be originally issued after August 10, 1993. In addition, a limit is placed on the aggregate gross assets that a C corporation may own at any time from August 10, 1993, to immediately after the issuance of the stock. This limit is which of the following? **(Page 236)**

a. $50 million. [This answer is correct. This is the amount of gross assets allowed under the IRS Code. In addition to the gross asset requirement, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded.]

b. $10 million. [This answer is incorrect. This amount is a limit used in determining the gain exclusion on the sale of QSBS.]

c. $1 million. [This answer is incorrect. This amount is the maximum amount of money and other property that a corporation may receive for its stock, contributions to capital, and paid-in surplus and meet the definition of a *small business corporation*, which is unrelated to the term *qualified small business stock*.]

17. On August 1, Calvin purchases 200 shares of TAB, Inc. stock for $1,000. Calvin sells these shares for $800 on October 1. Three weeks later on October 21, he purchases 100 shares of TAB stock for $500. What is Calvin's tax basis in the 100 shares acquired on October 21? **(Page 237)**

a. $500. [This answer is incorrect. This amount represents the sales price of the 100 shares purchased on October 21.]

b. $700. [This answer is correct. The $200 loss ($1,000 − $800) on the sale of the 200 shares on October 1 is not deductible since Calvin purchased 100 shares of substantially identical stock within 30 days of the sale. Under the IRS Code, this is considered a wash sale. The disallowed loss increases the basis of the stock acquired on October 21. The tax basis of the 100 shares is $700 ($500 + $200).]

c. $800. [This answer is incorrect. This amount represents the sales price of the 200 shares on October 1.]

d. $1,000. [This answer is incorrect. This amount represents the basis of the 200 shares acquired on August 1 and sold on October 1.]

18. Any position relating to a debt instrument, stock, or partnership interest where there would be gain if the position were assigned, sold, or otherwise terminated at its fair market value is referred to as which of the following terms? **(Page 238)**

a. Offsetting notional principal contract. [This answer is incorrect. This term refers to an agreement that includes a requirement to pay all or substantially all of the investment yield related to the property for a specified period and a right to be reimbursed for all or substantially all of any decline in the value of the property.]

b. Forward contract. [This answer is incorrect. This term refers to a contract to deliver a substantially fixed amount of property for a substantially fixed price.]

c. Straight debt. [This answer is incorrect. This term refers to any position with respect to debt if the position unconditionally entitles the holder to receive a specified principal amount.]

d. Appreciated financial position. [This answer is correct. Under IRC Sec. 1259, this is the definition of the term *appreciated financial position*. The constructive sale rules require recognition of gain (but not loss) for certain transactions involving an appreciated financial position.]

Investor versus Stock Trader

Taxpayers buying and selling securities for their own account generally will qualify as either an investor or trader for tax purposes. The distinction between trader and investor is important because the tax rules are generally more favorable for traders. As a general rule, most taxpayers are categorized as investors. However, in today's setting of online trading and discount brokers, some taxpayers are spending considerable time trading stocks on a regular basis, which may qualify them for trader status.

Taxation of Investors

Investors treat their stock holdings as capital assets and, when shares are sold, report either long-term or short-term capital gains or losses, depending on whether the shares were held for more than one year. The expenses they incur in connection with their stock investing activity are treated as Section 212 expenses incurred for the production of income. These expenses are deductible only as miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation. In addition, these expenses are not deductible in computing the taxpayer's alternative minimum tax (AMT). Any commissions paid in purchasing the securities are capitalized as part of its cost basis while commissions paid at the time of sale reduce the sales proceeds. Any interest expense incurred in the activity is deductible only to the extent of the taxpayer's net investment income.

The Tax Court has held that an investor cannot deduct the cost of a seminar in securities day trading. Jones had taken a Section 212(l) deduction for the course expenses. However, IRC Sec. 274(h)(7) denies a Section 212 deduction for "expenses allocable to a convention, seminar, or similar meeting." The court in *Jones* concluded that the day trading course was a "seminar or similar meeting" within the meaning of IRC Sec. 274(h)(7). The court observed that had Jones been a trader rather than an investor, the course expenses would have been deductible under Section 162.

Taxation of Traders

Unlike investors, securities traders are deemed to be conducting a trade or business, so their trading expenses are deductible as ordinary and necessary business expenses under IRC Sec. 162. A trader's business expenses include interest paid on margin accounts used in connection with the trading activity. However, if the taxpayer does not materially participate in the trading activity (e.g., a limited partner in a trader partnership), interest incurred in the activity is subject to the investment interest expense limitation. In addition, a trader's business status makes him or her eligible for claiming a home office deduction, provided the requirements of IRC Sec. 280A(c) are met. Individuals report their trading expenses (including interest on margin tax accounts) on Schedule C.

When a trader disposes of a stock, the general rule is that the sale is treated as a short-term or long-term capital gain or loss, depending on how long the stock was held. This capital asset treatment occurs because traders do not have customers to whom they sell stock; therefore, their stock does not meet any of the exceptions to capital asset treatment under IRC Sec. 1221. Thus, traders generally report their stock gains and losses as capital gains and losses on Schedule D and, accordingly, are subject to the $3,000 annual limitation that applies to net capital losses under IRC Sec. 1211(b) and the wash sale rules. The Section 1091 wash sale rules can be particularly detrimental to traders because they defer the recognition of a stock loss when the taxpayer acquires the same stock within a period beginning 30 days before and ending 30 days after the date of sale.

Mark-to-market Election. As an alternative to capital asset treatment, IRC Sec. 475(f) allows traders to elect to mark their stock holdings to market at the end of the tax year. If the election is made, all security gains and losses are treated as ordinary income and all securities on hand at year-end are deemed to be sold at the year-end market value, thus recognizing unrealized gains and losses. For traders, the primary benefit of making the election is that the $3,000 limitation on net capital losses and the wash sale rules no longer apply. Conversely, the trader is no longer allowed to treat trading activity gains and losses as capital asset transactions, but this should have minimal negative impact since traders by definition should have few, if any, long-term capital gains (see "Distinguishing Traders from Investors" later in this lesson).

Traders who choose to make the Section 475(f) mark-to-market election must follow the exclusive procedures set forth in Rev. Proc. 99-17. Existing taxpayers must (1) attach an election statement to either their timely filed return

or extension request for the year preceding the year the election is first effective, and (2) attach a completed Form 3115 "Application for Change in Accounting Method" to their return for the year of change, following the automatic IRS consent procedures described in Rev. Proc. 2008-52, as clarified, amplified, and modified by Rev. Proc. 2009-39. An election is effective for the tax year for which it is made and all subsequent tax years, unless revoked with the consent of the IRS.

Because capital gains and losses are specifically excluded from the definition of net earnings from self-employment (SE), earnings from a trading activity are not subject to the SE tax. A Section 475 mark-to-market election converting the gains and losses to ordinary income does not change their status for SE tax purposes. However, since a trader's net earnings are not SE income, he or she cannot contribute to a retirement plan (e.g., SEP or IRA) based on such income.

Tax Reporting Issues for Stock Traders. Because of the unique tax rules that apply to securities traders, properly reporting trading information on Form 1040 can be a challenge. Practitioners should consider the following reporting issues and recommended solutions:

1. *Schedule C Loss.* Traders who do not make a Section 475 election report no income and only expenses on Schedule C, resulting in a loss on that form. This reporting may get the IRS's attention since Schedule C losses sometimes stem from disallowable hobby losses. To help avoid IRS questions regarding this reporting, a footnote or statement explaining the taxpayer's trader status and the filing implications should be attached to the return.

2. *Reconciling to Forms 1099-B.* Because traders report their security sales on Schedule D, the amounts reported to them on brokers' Forms 1099-B will normally agree with the reported gross proceeds. However, traders who make the Section 475 election treat their trading gains and losses as ordinary income reported on Form 4797 (Part II). The Form 4797 instructions state that these traders should enter the total gross proceeds from Forms 1099-B on line 1 of Form 4797. To further help avoid IRS matching notices with respect to the Forms 1099-B, consider attaching a statement to the return explaining that the gross proceeds reported on the Forms 1099-B are not reported on Schedule D because they are reported on Form 4797 pursuant to a Section 475 mark-to-market election.

3. *Detailing Trading Activity.* Schedule D requires that each separate stock or security trade be reported separately. For traders, however, this can be a burdensome requirement given their large number of trades. In many cases, the taxpayer will have detailed records reporting each trade that can be attached to the return to support the amounts shown on Schedule D. The Form 4797 instructions state that traders who make the Section 475 mark-to-market election should attach a statement to the return detailing each trading transaction and carry the totals to line 10 of Form 4797.

Summary of Taxation Rules for Traders and Investors

Following is a summary of the tax treatment of investors and traders, including traders who make the Section 475 mark-to-market election.

Summary of Tax Attributes—Investors and Traders

	Investor	Trader	Mark-to-Market Trader
Gains and losses	Capital (Sch. D)	Capital (Sch. D)	Ordinary (Form 4797, Part II)
Interest expense	Investment interest expense (Form 4952)	Trade or business expense[a]	Trade or business expense[a]
Trading expenses	Miscellaneous itemized deductions subject to 2% AGI limitation (Sch. A)	Trade or business expenses (Sch. C)	Trade or business expense (Sch. C)
SE tax	Not applicable	Not applicable	Not applicable

Note:

[a] Assuming individual materially participates in the trading activity; if not, interest expense is investment interest expense.

Distinguishing Traders from Investors

There are no IRS guidelines on the distinction between a securities investor and a stock trader for tax purposes. The general presumption is that individuals hold stocks and securities as investors unless their actions demonstrate that they are carrying on a business of securities trading. The courts, however, have been more helpful by pointing out several factors to consider when evaluating whether an individual is an investor or a trader.

The Federal Court of Appeals and the Tax Court have used the following factors to determine whether an individual is a trader: (1) the taxpayer's investment intent; (2) the nature of the income to be derived from the activity; and (3) the frequency, extent, and regularity of the taxpayer's securities transactions. A taxpayer is a securities trader only when both of the following are true: (1) the taxpayer's trading activity is substantial; and (2) the taxpayer seeks to profit from short-term swings in the daily market movement, rather than to profit from the long-term holding of investments. Thus, it is important to look at such factors as the number of trades, the average holding period, the sources of income, and the taxpayer's ongoing involvement in the activity and the percentage of available trading days on which trading activity occurred.

The Tax Court considers the number of executed trades in a year and the amount of money involved in those trades when evaluating whether a taxpayer's activities are substantial. However, *Jamie* implies that the amount involved may be more important than the number of trades. In this case, the IRS agreed that the taxpayer was a trader even though he averaged only 84 trades each year over a three-year period, presumably because each sale averaged $67,190.

Ideally, trading should be regular and continuous rather than sporadic. Factors unrelated to securities trading may also bear on a court's decision. For example, in Cameron the taxpayer was collecting unemployment compensation while trading stocks. The Court observed that this helped undermine his argument that he was engaged in a trade or business.

Given that a trader has a short-term perspective, it would be reasonable to expect few, if any, long-term gains (i.e., stocks held more than one year). For example, in *Levin*, the taxpayer spent most of his working days engaged in making stock transactions and in performing his own research on companies to identify potentially attractive trades. The Court of Claims ruled he was a trader rather than an investor.

In contrast, in *Steffler*, the Tax Court assigned investor status to a taxpayer who claimed to have spent 40–60 hours per week on commodity trading activities over a three-year period. He conducted his activities under a firm name, had business cards, used a separate bank account, and did his own research using a computerized investment analysis system. Nonetheless, he lost his case because he actually traded only 5 to 12 days during each of the three years in question, bought only 16 to 44 contracts per year, and dealt in only five different commodities. Likewise, in *Chen*, the taxpayer had a great number of trades and appeared to be attempting to profit from daily market movements. However, this trading activity lasted only a few months. Because his activity was not continuous, the court found that the taxpayer was not a trader entitled to ordinary loss treatment and mark-to-market accounting. And finally, in *Estate of Yaeger*, the Second Circuit Court of Appeals focused mainly on the holding period. Although the taxpayer's trading activity was admittedly vigorous (over 2,000 transactions in a two-year period), he often held securities over a year and the shortest holding period was three months. The taxpayer was found to be an investor, not a trader.

Following is a summary of the factors from these and other cases that have been used to determine whether an individual is a trader or investor.

Characteristics of Traders and Investors

	Trader	Investor
Criteria for buying and selling stocks	Expected short-term swings in the market and stock price; stock selection based on technical factors.	A more long-term perspective; considers stock's income (dividends) and potential for long-term capital appreciation; stock selection based on fundamental factors.
Involvement	Substantial personal involvement; frequent, regular, and continuous; devotes considerable time to activity; a primary source of individual's income for meeting personal living expenses.	Active primarily on weekends or after-work hours; may rely on a broker or agent; has other primary sources of income for meeting personal living expenses. Relatively short periods of high-volume trading may occur.
Stock holding periods	Generally 30 days or fewer; few, if any, stocks held more than a year.	A mixture of long-term and short-term holding periods.
Frequency of trades	Daily or almost daily trading; average one or more trades each day; few periods without any activity.	Sporadic trading; no particular pattern to activity; may go for long periods without any activity.
Source of income	Short-term gains.	Interest, dividends, long-term gains.

Can an Individual Be Both a Trader and an Investor? There is nothing to prevent an individual who qualifies as a trader to also hold stocks and securities for investment. However, it is important for the individual to clearly designate which securities are held for trading and which are held for investment. The authors believe this is best accomplished by using separate accounts for investment and trading activity. Alternatively, meeting the identification requirements for traders who elect to mark securities to market (see below) should suffice for traders who do not make the mark to market election. However, these requirements may be onerous, and non-electing traders are not explicitly required to meet them.

A trader who makes the Section 475 mark-to-market election must clearly identify a security as not held for trading before the close of the day on which it was acquired, originated, or entered into. When substantially similar securities are held for trading and investing, the trader must hold the investment securities in a separate, nontrading account maintained with a third party.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Taxpayers are allowed to deduct their expenses in connection with their stock investing activities. How do taxpayers who qualify as securities traders classify these deductions on their income tax returns?

    a. Ordinary and necessary business expenses.

    b. Miscellaneous itemized deductions subject to the 2% AGI limitation.

    c. Long-term capital losses.

    d. Short-term capital losses.

20. Traders can elect to mark their stock holdings to market at the end of each tax year. What is the primary benefit of making this election?

    a. The capital gain and loss rules apply.

    b. The wash sale rules apply.

    c. The $3,000 limitation on capital losses and the wash sale rules no longer apply.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Taxpayers are allowed to deduct their expenses in connection with their stock investing activities. How do taxpayers who qualify as securities traders classify these deductions on their income tax returns? **(Page 248)**

    a. Ordinary and necessary business expenses. [This answer is correct. According to several court cases, this definition is allowable under IRC Sec. 162. The trader status allows the taxpayer to avoid having the expense be subject to the 2% AGI limitation. The ordinary and necessary business expenses are reported on Schedule C.]

    b. Miscellaneous itemized deductions subject to the 2% AGI limitation. [This answer is incorrect. A taxpayer categorized as an investor must report their investment expenses as miscellaneous itemized deductions.]

    c. Long-term capital losses. [This answer is incorrect. The expenses incurred by a trader would have a different tax classification than that of long-term losses.]

    d. Short-term capital losses. [This answer is incorrect. Although a securities trader may incur short-term capital losses, the expenses incurred by a trader are different from any short-term capital losses incurred, and thus would be classified separately on the tax return.]

20. Traders can elect to mark their stock holdings to market at the end of each tax year. What is the primary benefit of making this election? **(Page 248)**

    a. The capital gain and loss rules apply. [This answer is incorrect. When the mark-to-market election is made, the trader is no longer allowed to treat the securities as capital assets.]

    b. The wash sale rules apply. [This answer is incorrect. When the mark-to-market election is made, the trader no longer has to apply the wash sale rules.]

    c. The $3,000 limitation on capital losses and the wash sale rules no longer apply. [This answer is correct. If the election is made under IRC Sec 475(F), all security gains and losses are treated as ordinary income and all securities on hand at year-end are deemed to be sold at the year-end market value.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TDBTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. What is the required holding period of stock that is a capital asset to receive long-term tax treatment?

   a. One year.

   b. More than one year.

   c. Less than one year.

   d. More than six months.

2. Of the following types of property, which one would generally be considered a capital asset?

   a. Securities unless held by a dealer.

   b. Business accounts or notes receivable.

   c. Depreciable or real property used in the taxpayer's trade or business.

   d. Inventory.

3. Individual taxpayers are allowed to deduct up to $3,000 capital losses against ordinary income. What happens to the remaining capital losses?

   a. Carried back three years.

   b. Carried back two years.

   c. No carryback or carryover is allowed.

   d. Carried forward indefinitely.

4. The capital loss carryover is the amount that a taxpayer's total net capital loss for the year exceeds the lesser of the taxpayer's allowable capital loss deduction for the year or adjusted taxable income for the year. "Adjusted taxable income" is taxable income increased for which of the following deductions?

   a. Capital loss deduction and standard deduction.

   b. Standard deduction and personal exemption deduction.

   c. Business loss deduction and capital loss deduction.

   d. Capital loss deduction and personal exemption deduction.

5. When an individual sells, exchanges, or redeems mutual fund shares, the amount of gain or loss is reported on which of the following Form 1040?

   a. Schedule A.

   b. Schedule B.

   c. Schedule D.

   d. Schedule E.

6. On March 1, 2008, Joe purchased 100 shares of a mutual fund, Momentum Growth Fund, for $5,000. The load charge for the purchase was $200. At the beginning of the following year, Joe receives a 2008 Form 1099-DIV from the mutual fund that reports $100 of dividends and $200 of long-term capital gains, both of which have been reinvested. In January 2010, Jo received a 2009 Form 1099-DIV reflecting a $100 dividend, which was reinvested in the fund. Joe sells his 100 mutual fund shares on August 1, 2010 for $6,000. What is the amount and character of the gain or loss that Joe recognizes on the transaction?

   a. $1,000 long-term capital gain.

   b. $1,400 long-term capital gain.

   c. $600 long-term capital gain.

   d. $400 long-term capital gain.

7. What is the maximum amount of ordinary loss on Section 1244 stock that may be claimed by a taxpayer filing a joint return in a tax year?

   a. $500,000.

   b. $100,000.

   c. $50,000.

   d. $10,000.

8. The statute of limitations for losses from worthless securities is which of the following?

   a. Two years.

   b. Three years.

   c. Four years.

   d. Seven years.

9. An option that is publicly traded and gives the option holder the right to sell to the option writer a stated number of shares of stock at a fixed price on or before a specified date is which of the following?

   a. Section 1256 contract.

   b. Call option.

   c. Put option.

   d. Incentive stock option.

10. An option that is publicly traded and gives the option holder the right to buy from the option writer a stated number of shares of stock at a fixed price on or before a specified date is which of the following?

    a. Call option.

    b. Put option.

    c. Nonqualified stock option.

    d. Equity option.

11. Within certain limits, how many years can a taxpayer elect to carryback a net Section 1256 loss?

    a. None.

    b. Two.

    c. Three.

    d. Five.

12. Generally, what is the economic purpose of a short sale?

    a. To profit from an increase in the price of a stock.

    b. To profit from a decline in the price of a stock.

    c. To create capital losses.

    d. To convert short-term gains into long-term gains.

13. Steve does not own any stock in ACE, Inc. but borrows 500 shares of ACE stock from his broker on June 1 and sells it short for $10,000 ($20 a share). On September 1 of the following year, Steve purchases 500 shares of ACE stock for $7,500 ($15 a share) and delivers them to his broker to close the short sale. What is the amount and type of gain or loss that Steve recognizes on his short sale?

    a. $2,500 long-term capital gain.

    b. $2,500 long-term capital loss.

    c. $2,500 short-term capital gain.

    d. $2,500 short-term capital loss.

14. After an employee's termination, how long does the employee generally have to exercise an incentive stock option before it expires?

    a. Thirty days.

    b. Twelve months.

    c. Two years.

    d. Three months.

15. Katherine received a NQSO from OceanView, Inc., her employer, on July 1, 2009, that entitled her to purchase 1,000 shares of OceanView at $10 per share. The option did not have a readily ascertainable value. OceanView used a reasonable method to determine that the exercise price was the fair market value on the grant date and, thus, was not subject to IRC Sec. 409A. Katherine exercised the option on September 30, 2010, when the stock was trading at $15 per share. What is the amount of compensation income that Katherine must recognize and in what year?

    a. $10,000 compensation income in 2009.

    b. $15,000 compensation income in 2010.

    c. $5,000 compensation income in 2010.

    d. $5,000 compensation income in 2009.

16. Noncorporate taxpayers are allowed to elect to rollover gain from the sale of small business stock (QSBS) held for more than six months if stock in another QSBS is acquired within a certain time period beginning on the date of the sale. What is this time period?

    a. 60 days.

    b. 90 days.

    c. 180 days.

    d. 12 months.

17. A taxpayer cannot deduct the loss realized on the sale of stock or securities if the taxpayer purchases substantially identical stock or securities within the period beginning 30 days before and ending 30 days after the sale. The term used to describe this type of transaction is which of the following?

    a. Straddle sales.

    b. Constructive sales.

    c. Wash sales.

    d. Short sales.

18. An exception to the constructive sale rules applies to sales of nonmarketable securities if the sales contract is settled within a certain period after the date the contract is entered into. This time period is which of the following?

    a. Within thirty days.

    b. Within sixty days.

    c. Within six months.

    d. Within one year.

19. Taxpayers who qualify as stock traders and elect to mark their stock holdings to market at the end of each year must recognize security gains and losses as which of the following?

    a. Ordinary income and losses.

    b. Capital gains and losses.

    c. Miscellaneous itemized deductions.

    d. Do not select this answer choice.

20. The Federal Circuit Court of Appeals and the Tax Court identified certain factors that determine if an individual is a trader. Which of the following was **not** one of these factors?

    a. The extent, frequency, and regularity of the taxpayer's securities transactions.

    b. The nature of any income that will be derived from the activity.

    c. The investment intent of the tax payer.

    d. More long-term transactions than short-term transactions.

Lesson 2: Bad Debt Losses, Debt Discharge Income, and Foreclosures

INTRODUCTION

Transactions involving bad debt losses, debt discharges, and foreclosures are relatively common for individual taxpayers. This lesson covers the rules for deducting bad debt losses and explains the tax treatments of debt discharge income and foreclosures.

Banks, other financial institutions, and certain government agencies generally must report debt discharges (partial or complete) on Form 1099-C (Cancellation of Debt) if the discharge is $600 or more. The discharged amount includes any amount owed to the lender that is forgiven, including loan principal, interest, penalties, administrative costs, and fines. To determine the year in which a debt is discharged, the lender must identify an event (e.g., bankruptcy of debtor, running of statute of limitations for debt collection, nonpayment for a 36-month period, cessation of collection activities, etc.) indicating the debtor will never have to pay the amount that is discharged (considering all the facts and circumstances). Sometimes the lender will issue Form 1099-C for the wrong year. For example, in *DeShon*, the taxpayer received a 1099-C for 2001. However, the Tax Court determined that the debt discharge event actually occurred in 1999, when the credit card lender ceased collection activities. Since 1999 was a closed year, the taxpayer did not have to recognize taxable debt discharge income with respect to that particular credit card debt.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:

- Differentiate between business and nonbusiness bad debts.
- Identify the rules of debt discharge income for a solvent taxpayer and an insolvent taxpayer and make relevant calculations.
- Identify the tax rules for foreclosures involving recourse, nonrecourse, and seller-financed debt.

Business and Nonbusiness Bad Debts

Individual taxpayers can deduct two types of bad debt losses: business and nonbusiness. Business bad debts result in ordinary losses; nonbusiness bad debts result in short-term capital losses. This distribution has been the subject of much litigation due to the $3,000 annual limit on deducting net capital losses ($1,500 for married taxpayers who file separately).

Business Bad Debts

A business bad debt arises from:

1. a debt created or acquired in the ordinary course of the taxpayer's business (e.g., an account receivable), or

2. a worthless debt, the loss from which is incurred in the taxpayer's trade or business.

Item 2 is the most frequently contested, and often occurs when a shareholder or employee loans funds to a corporation and claims a business bad debt deduction when the loan becomes either wholly or partially worthless. (See "Employee versus Shareholder Loans" later in this lesson.)

Trade or Business Requirement. In determining whether a bad debt loss was incurred in the taxpayer's trade or business, the focus is on the relation the loss bears to the taxpayer's business. If at the time of total or partial worthlessness, the relation is "proximate" in the conduct of the trade or business, the debt qualifies as a business bad debt. The Supreme Court, in *Generes*, stated that in determining whether the relation is proximate, the *dominant motivation* for making the loan must be business oriented. A significant motivation does not satisfy this requirement.

A business debt usually is made in the course of the lender's own trade or business, as opposed to a loan to another business. However, the taxpayer may establish that a loan to another business is a business loan if it was made (1) as part of the taxpayer's business of making loans or of promoting businesses, or (2) to protect the taxpayer's status as an employee, source of income, business relationship, or business reputation. For example, in *Newsman*, the Tax Court concluded the taxpayer's substantial and recurring activities of promoting, organizing, financing, and selling various businesses constituted a trade or business. Therefore, the taxpayer's losses from loans advanced to the businesses and from guarantees of the businesses' loans qualified as business bad debt losses.

In Field Service Advice (FSA) 199911003, the IRS examined the factors for determining whether a taxpayer's lending of money qualifies as a trade or business. The IRS concluded the taxpayer could deduct the uncollectible amount of a note he had purchased as a business bad debt. The IRS found that the taxpayer was in the trade or business of lending money since he had loaned money and purchased notes for many years, had a reputation in the community as a lender and purchaser of notes, had been approached by unrelated borrowers and sellers of notes, and had taken action to enforce his rights under the note. Thus, the taxpayer's actions were consistent with an individual engaged in the money lending business.

The taxpayer's overall accounting method may affect whether a bad debt is deductible, even if it arises in the course of a trade or business. Thus, if the bad debt arose from an unpaid item of taxable income (e.g., account receivable for services rendered), a bad debt deduction is not allowed unless the related income was included in taxable income in either the current or prior tax year. For cash-basis taxpayers, a bad debt deduction is generally not allowed for uncollectible accounts receivable since these items are normally not included in income until received.

Partial versus Total Worthless Debt. A deduction can be claimed when a business bad debt becomes either partially or totally worthless. If the taxpayer can collect some, but not all, of the debt, the debt is partially worthless. If the taxpayer cannot collect any of the outstanding debt (even if part was collected in the past), the debt is totally worthless.

Before a taxpayer can deduct a partially worthless business debt, he must show that (1) partial worthlessness has occurred and (2) the amount was charged off on the books of the business. For tax purposes, the taxpayer has the following options:

1. Claim a deduction for any portion of the debt, up to the amount actually written off the books during the year. (For example, if EasyCredit, an accrual-basis sole proprietorship, wrote off $10,000 of a $30,000 receivable due from Thrift Co. for book purposes, the taxpayer can claim a current-year bad debt deduction for any amount up to and including $10,000.) Recording a book charge-off requires that the portion charged off must no longer appear as an asset in the business's financial records or on its financial statements. However, it does not mean the business must cancel the debt or notify the debtor of the charge-off. Thus, the taxpayer may still continue its collection efforts while claiming a tax deduction for a partially worthless debt.

2. Forgo a current-year tax deduction in favor of waiting until the balance of the debt is either collected or deemed worthless to claim a bad debt deduction.

The taxpayer can treat each partially worthless debt differently. However, in no case can a deduction be claimed any later than the year a debt becomes completely worthless.

A totally worthless debt is deductible only in the tax year it becomes totally worthless. Naturally, the deduction for that year does not include any amount deducted in an earlier year when the debt was only partially worthless.

Employee versus Shareholder Loans. In *Litwin*, the 10th Circuit allowed an employee-shareholder's business bad debt deduction for amounts loaned to the corporation. The deduction was allowed because the taxpayer's predominant motives for making the loans were that he (1) wanted to remain employed, earn a salary, and remain useful to society; (2) spent a large portion of his time working for the corporation; (3) intended to draw a salary in the future; and (4) took a sizable risk when he guaranteed loans far in excess of the value of his investment (indicating there

was another motive besides investment). Although the taxpayer's loans were much larger than the salary anticipated in the near future, the Court ruled his business motives outweighed his investment motives.

In contrast, the 7th Circuit ruled that a taxpayer's advances to a controlled corporation did not result in business bad debts. The taxpayer received no compensation from the corporation and was not considered to be in the business of loaning money, nor was he in the business of selling corporations he owned. Thus, when a taxpayer's predominant motivation for making loans is to protect his investment as a shareholder, nonbusiness bad debt status generally applies. *Mills* and *Scallen* illustrate situations in which the courts have ruled shareholders should be denied business bad debt deductions.

Loans versus Capital Contributions. The first step in analyzing a shareholder loan (for bad debt deduction purposes) is determining whether the advance is a valid debt as opposed to a capital contribution. Factors used in deciding whether payments by a shareholder to a corporation are debt or equity include (1) the name given to the certificate evidencing the indebtedness, (2) whether a fixed maturity date exists, (3) whether the party providing the funds can enforce payment, (4) the source of the payments, (5) whether the party providing the funds is given an increased participation in management, (6) the intent of the parties, (7) whether the corporation is adequately capitalized, (8) whether interest is paid, (9) whether the corporation can obtain loans from outside lenders, (10) the extent to which the corporation uses the advance to acquire capital assets, (11) whether shareholders provide funds in proportion to their stock interests, (12) whether the business repaid the amount advanced when due, and (13) whether the business's obligation to repay the advance is subordinated to other creditors.

In *Nachman*, a 50% shareholder-employee was allowed a business bad debt deduction for funds advanced to the corporation. The advance was treated as a loan because it (1) provided for payment of interest and the shareholder reported interest income on his return, (2) did not increase the shareholder's participation in management, and (3) was treated as a loan on the corporate books and tax returns. In addition, the corporation was adequately capitalized and used the funds for working capital. The loan met the trade or business requirement because the motivation for making the loan was to protect the corporation's line of credit. The bank required the shareholder to provide working capital to the corporation in return for continued financing.

Conversely, in *Kadlec*, an 80% shareholder was denied a bad debt deduction for funds advanced to the corporation; the funds were deemed to be a capital contribution. Although the shareholder received a note from the corporation, the factors indicating that the advance was actually a capital contribution were (1) the corporation could not obtain other financing, (2) the loan repayments were to be made from corporate profits, (3) the corporation was thinly capitalized, and (4) no interest payments were made on the note.

In *Bell*, the 8th Circuit upheld the Tax Court's denial of a business bad debt deduction for purported loans, which the Court characterized as capital contributions. The taxpayer made the purported loans to two corporations that he purchased to rehabilitate and resell. Moreover, he provided no personal services to the corporation. The purported loans were made to provide capital and thus were related to the taxpayer's role as shareholder of the corporations.

In *Indmar Products*, the Sixth Circuit ruled that the shareholders' cash advances to their closely held C corporation were debt rather than equity based on the following 11 factors.

1. *Descriptions on Documents.* If shareholder advances are not described as loans payable on the corporation's books and as loans receivable in the shareholder's financial records, the case is weakened for treating shareholder advances as debt.

2. *Maturity Date and Repayment Schedule.* The presence of a fixed maturity date and defined schedule of payments indicates debt. Actual repayments of purported debt principal amounts are very persuasive in making the case that shareholder advances are legitimate debt. However, fixed maturity dates and repayment schedules are not required for demand loans (payable at any time upon the demand of the shareholder-lender).

3. *Interest Rate and Payments.* The presence of a fixed rate of interest and the presence of actual interest payments indicate debt. Actual timely payments of fixed-rate interest persuasively make the case that shareholder advances are legitimate debt.

4. *Source of Repayment Funds.* The Sixth Circuit opined that relying on company profits to generate cash to repay loans is more characteristic of equity. However, in the real world, operating profits are often expected to be the main (if not the only) source of funds to repay even unquestionably legitimate third-party loans.

5. *Debt-to-Equity Ratio.* An excessively high debt-to-equity ratio indicates that shareholder advances may be equity. However, this factor is basically moot when the corporation demonstrates a pattern of repaying purported debt amounts along with appropriate interest.

6. *Overlap Between Shareholders and Lenders.* Purported loans made by shareholders strictly in proportion to their stock ownership interests indicate equity, unless there is only one shareholder.

7. *Security.* A lack of adequate security indicates equity.

8. *Availability of Debt Financing from Outside Sources.* When a corporation is demonstrably able to obtain third-party debt financing if it wishes, purported shareholder loans are more likely to be legitimate debt.

9. *Subordination.* Subordination of purported shareholder loans to all debt owed to third-party creditors is indicative of equity.

10. *Use of Proceeds.* Using the proceeds from shareholder advances to acquire long-term capital assets indicates equity, while using the proceeds for working capital indicates debt. In the real world, however, corporations commonly take out unquestionably legitimate third-party loans to acquire capital assets.

11. *Sinking Fund.* The Sixth Circuit opined that the existence of a sinking fund indicates debt. However, the existence of a sinking fund is actually just another form of security, and the security factor was already taken into account in item 7 above. Also, in the real world, many closely held corporations will be unwilling to establish sinking funds even for unquestionably legitimate third-party debt.

Tax Return Presentation. A business bad debt gives rise to an ordinary loss deduction. Report a bad debt that arises in the ordinary course of an individual's unincorporated business (i.e., accounts receivable) on Schedule C or F, whichever is applicable. Report a bad debt that is the result of an employee-shareholder loan to a corporation as an unreimbursed employee business expense (subject to the 2% of AGI limit) on Schedule A of Form 1040 (IRS Pub. 529, "Miscellaneous Deductions"). It is important to remember that miscellaneous itemized deductions are added back to income when making the AMT calculation.

Example 2A-1 Business bad debt.

Ted runs his business as a sole proprietorship. He guaranteed payment of a $10,000 note of his best supplier in an effort to ensure the supplier continued in business. The supplier later filed bankruptcy and defaulted on the note. Ted was forced to make full payment under his guarantee. His efforts to recover from the supplier proved unsuccessful. What is the nature of Ted's $10,000 bad debt loss?

Ted's loss is a business bad debt loss since his guarantee was spurred by his business motive to retain his best supplier. The bad debt loss is claimed on Ted's Schedule C.

Variation: Assume that Ted is an employee of his solely owned C or S corporation. In this case, the business bad debt deduction should be reported as unreimbursed employee business expense on Schedule A.

Nonbusiness Bad Debts

Bad debts that are not business bad debts are nonbusiness bad debts (assuming they are not actually gifts). A nonbusiness bad debt is deductible as a short-term capital loss only in the year it becomes totally worthless. A deduction for partial worthlessness of a nonbusiness debt is not allowed.

Timing of Nonbusiness Bad Debt Loss. Because of the difficulties in pinpointing the year a loan becomes wholly worthless, the normal three-year statute of limitations for filing amended returns does not apply to nonbusiness bad debt losses. Instead, a seven-year statute of limitations generally applies for refunds due to such losses.

The lender is not required to wait until the debt is due to determine it is worthless. The debt becomes worthless in the year when it becomes clear there is no chance of repayment. Bankruptcy of the debtor is generally good

evidence that an unsecured or nonpreferred debt is worthless. However, in most cases, worthlessness exists only after the debt is due and collection efforts have begun. The lender must show that reasonable steps were taken to collect the debt.

Tax Return Presentation. A nonbusiness bad debt is deducted as a short-term capital loss on Schedule D (subject to the normal limitations on short-term capital losses). If there is more than one nonbusiness bad debt deduction in the tax year, list each bad debt separately on Schedule D. A statement should also be attached to the tax return to document each nonbusiness bad debt. The following information should be included (IRS Pub. 17, "Your Federal Income Tax"): (1) a description of the debt, including the amount and due date; (2) the debtor's name and relationship to the taxpayer; (3) the collection efforts made; and (4) why the debt is considered wholly worthless.

Example 2A-2 Nonbusiness bad debt.

In January 2010, John, an attorney, made a personal unsecured loan of $5,000, due October 1, 2010 to Peter, a client. On September 1, 2010, Peter declared bankruptcy; the debt became totally worthless. Although Peter was a valued client, his business was not critical to the success of John's practice.

John can deduct the loss on Peter's bad debt as a nonbusiness bad debt. Since John is not in the business of lending money and no overriding business reason existed for him to make the loan, the debt is nonbusiness. The loss is reported as a short-term capital loss on Schedule D.

Variation: If the loan only became partially worthless in 2010, no portion of the loss would be deductible that year because it is a nonbusiness bad debt.

Intrafamily Loans

Bad debts resulting from loans between family members are subject to close scrutiny, and are generally presumed to be gifts unless it can be established that a bona fide loan exists. If a bona fide loan exists, a bad debt deduction is possible if the borrower defaults. To qualify as a bona fide loan, an advance must be made with a reasonable intention of noncontingent repayment. While no one factor is controlling, the courts review the intent of the parties and the existence of the following as evidence of a bona fide loan: (1) a note or other evidence of indebtedness; (2) interest being charged; (3) a fixed repayment schedule; (4) security or collateral; (5) a demand for repayment; (6) the parties' records, if any, reflecting the transaction as a loan; (7) any repayments made; and (8) the solvency of the borrower. Advances made after a family member becomes insolvent are deemed to be gifts since a reasonable expectation of repayment cannot exist when the advance is made.

Although these loan formalities help establish a debtor-creditor relationship, a bona fide debt can exist without them. In *Bowman*, the Tax Court allowed a taxpayer's nonbusiness bad debt deduction for money transferred to his daughter even though the only documentation was the notation "loan" on several of the checks. The Court found the taxpayer had a history of making similar loans to other family members and friends (which were repaid) and that his and his daughter's actions showed the requisite intent to establish a debtor-creditor relationship. However, the better the documentation, the better the chance of establishing the existence of a bona fide debt (and thus a bad debt deduction).

Example 2A-3 Bad debt loss from loan to relative.

Bowen loaned his son, Rocky, $3,000 to buy a car. Rocky was to pay Bowen $50 a month until the $3,000 was repaid. Rocky paid back $500 but was unable to repay the remaining $2,500, which was then forgiven by Bowen. There was no documentation of Bowen's loan to Rocky. Can Bowen deduct $2,500 as a nonbusiness bad debt?

Because the transaction was between relatives; had no business, profit, or investment motivation; and lacked evidence of being a bona fide debt, the forgiveness of the debt is considered a gift and not a bad debt loss. No deduction is allowed.

Loan Guarantees

To claim a bad debt loss deduction, a taxpayer making a payment on a loan guarantee that becomes unrecoverable (i.e., worthless) must be able to show that the guarantee was made in the course of his trade or business or in a transaction entered into with a profit motive. In addition, the taxpayer must receive reasonable consideration for entering into the guarantee agreement. For the guarantee of a nonfamily member's debt, consideration can be either direct (i.e., cash or other property) or indirect. Indirect consideration is determined in accordance with normal business practice and may, for example, be in the form of improved business relationships. For the guarantee of a

family member's debt, however, the consideration must be direct (i.e., cash or other property). Here, the term *family member* is defined very broadly (e.g., the term includes in-laws and step-relationships) and includes all individuals listed in IRC Sec. 152(a) relating to the dependency exemption.

When payment is made under a loan guarantee, the taxpayer usually assumes the role of the original lender. Thus, payment under the guarantee generally gives the guarantor the right to, in turn, demand payment from the borrower. The guarantor, therefore, cannot claim a bad debt loss until reasonable collection efforts against the borrower have failed. This often means a bad debt loss will not be allowable in the same year payment under the guarantee occurs. Once collection efforts have failed, the guarantor has either a business or nonbusiness bad debt loss (or a gift) depending on the facts and circumstances of the original guarantee transaction.

Example 2A-4 Paying on guarantee of family member's loan.

Alfred retired from farming in 2006 and thereafter began leasing his farmland to his son, Michael, who continued working the farm. Alfred had dealt with First National Bank (FNB) for many years. When Michael secured a farm loan from FNB, Alfred agreed to guarantee it to assist Michael and to ensure a continued good relationship with FNB. In 2010, Michael quit farming because of ongoing losses and, therefore, was unable to repay the balance of the FNB loan. Under the terms of the guarantee, Alfred paid FNB $110,000. Based on Michael's financial situation, Alfred will not be able to recover any of the funds from Michael.

Alfred cannot claim a $110,000 nonbusiness bad debt. Since Michael is a family member, Alfred can claim a nonbusiness bad debt for paying on the loan guarantee only if he had received from Michael cash or other property as consideration for his guarantee. Alfred received neither, so the $110,000 payment is not deductible.

Note: Alfred may also be deemed to have made a $110,000 gift to Michael, which must be reported for gift tax purposes. However, Alfred may be able to argue there was no gift because there was no donative intent. Instead, since Michael is insolvent and unable to repay the loan, it is a bad debt to Alfred, but it is not deductible because the requirements are not met for deducting bad debts associated with loan guarantees for family members. If the payment is not deemed to be a gift, Michael will have discharge of indebtedness income (see the discussion later in this lesson on the handling of discharge of indebtedness income).

Recoveries of Bad Debts

A taxpayer who deducts a bad debt and subsequently recovers (collects) all or part of the debt must include the amount recovered in income. However, the amount includable in income is subject to the tax benefit rule. The recovery is included in income only to the extent the original deduction provided a tax benefit. If a deduction gave rise to a net operating loss carryover or capital loss carryover that has not expired before the beginning of the tax year in which the recovery occurs, the deduction will be treated as having provided a tax benefit.

Presumably, the character of the income recognized because of a recovery is the same as that of the originally claimed bad debt deduction. Thus, the recovery of a business bad debt normally generates ordinary income while a nonbusiness bad debt recovery is treated as short-term capital gain.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. A business bad debt would generally **not** arise from which of the following transactions?

    a. An account receivable for services created in the ordinary course of the taxpayer's consulting business.

    b. A loan to a corporation made by a shareholder-employee when it can be demonstrated that the advance is valid debt.

    c. A loan to a business owned by the taxpayer's friend when the taxpayer is not in the business of making loans.

    d. A note receivable for funds advanced to a customer by a mortgage company.

22. A taxpayer has determined that an account receivable from the sale of inventory will not be fully collected. Of the following, which is **not** a consideration in determining if the taxpayer is allowed a business bad debt deduction?

    a. The taxpayer's overall accounting method.

    b. Partial worthlessness has occurred.

    c. The business has taken a charge-off on its books for the bad debt.

    d. The debt must be totally worthless to claim a business bad debt deduction.

23. Which of the following group of factors would support a capital contribution instead of a business bad debt deduction for an advance to a corporation by a shareholder-employee?

    a. The debt is recorded on the corporation's financials; interest payments are made; and the shareholder's role in management does not increase.

    b. The documents describe the advance as debt; there is a fixed maturity date; the corporation is adequately capitalized; and the funds are used for working capital.

    c. A corporation cannot obtain other financing, is thinly capitalized, and does not make interest payments on the note.

24. In February 2009, Freda, a firefighter, made a personal unsecured loan of $5,000 to her friend, Frank. The loan, which is due February 2011, requires monthly payments to Freda. In August 2009, Frank begins paying less than the required monthly payment, and it appears that Freda will not be entirely repaid. In 2010, Frank declares bankruptcy, and the remaining balance on the debt is worthless. In what year is Freda allowed to recognize a bad debt deduction?

    a. 2009.

    b. 2010.

    c. 2011.

    d. Never.

25. Factors that the courts may review in determining if a bona fide loan (as opposed to a gift) exists between family members include all of the following **except** which factor?

    a. Fixed payment schedule that includes interest payments.

    b. The parties' records reflecting the transaction as a loan.

    c. The solvency of the borrower.

    d. How often the family members see each other.

26. Mr. Richard Generous agrees to be the loan guarantor to a business associate, Mr. Humble Loveable. Mr. Generous and Mr. Loveable are not related. Mr. Loveable is unable to make the fourteenth loan payment and calls Mr. Generous to make the payment under the loan guarantee. Mr. Loveable is subsequently unable to make any remaining payments under the terms of the loan agreement, and Mr. Generous makes all the remaining payments. When will Mr. Generous be able to write off his guarantee payments as a bad debt loss?

    a. After reasonable collection efforts against Mr. Loveable have failed.

    b. Monthly as each guarantee payment is made.

    c. The year the guarantee is written.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. A business bad debt would generally **not** arise from which of the following transactions? **(Page 259)**

    a. An account receivable for services created in the ordinary course of the taxpayer's consulting business. [This answer is incorrect. The dominant motivation for the existence of the account receivable is business oriented. Accounts receivable is generated by the company selling products or services to customers on credit. This allows the risk of a business bad debt.]

    b. A loan to a corporation made by a shareholder-employee when it can be demonstrated that the advance is valid debt. [This answer is incorrect. The IRS frequently contests this type of deduction. Certain factors must exist for the advance to be considered debt instead of a capital contribution but it is considered business bad debt if the loan becomes either wholly or partially worthless.]

    c. A loan to a business owned by the taxpayer's friend when the taxpayer is not in the business of making loans. [This answer is correct. Under the Internal Revenue Code, a business debt is usually made in the course of the lender's own trade or business, as opposed to a loan to another business. This would be considered a nonbusiness bad debt.]

    d. A note receivable for funds advanced to a customer by a mortgage company. [This answer is incorrect. In this situation, if at the time of total or partial worthlessness, the relation is "proximate" in he conduct of the trade of business, the debt qualifies as a business bad debt.]

22. A taxpayer has determined that an account receivable from the sale of inventory will not be fully collected. Of the following, which is **not** a consideration in determining if the taxpayer is allowed a business bad debt deduction? **(Page 259)**

    a. The taxpayer's overall accounting method. [This answer is incorrect. For cash-basis taxpayers, a bad debt deduction is generally not allowed for uncollectible accounts receivable since these items are normally not included in income until the cash is received.]

    b. Partial worthlessness has occurred. [This answer is incorrect. According to Reg. 1.166-3(a), the taxpayer must show that partial worthlessness has occurred to deduct a portion as a bad debt deduction.]

    c. The business has taken a charge-off on its books for the bad debt. [This answer is incorrect. To claim a business bad debt deduction, the asset must no longer be reflected in the business's financial records.]

    d. The debt must be totally worthless to claim a business bad debt deduction. [This answer is correct. Under the IRS Regulations, total worthlessness is a requirement to claim a nonbusiness bad debt deduction, whereas partial worthlessness is allowed for a business bad debt deduction.]

23. Which of the following group of factors would support a capital contribution instead of a business bad debt deduction for an advance to a corporation by a shareholder-employee? **(Page 259)**

    a. The debt is recorded on the corporation's financials; interest payments are made; and the shareholder's role in management does not increase. [This answer is incorrect. In *Nachman*, a 50% shareholder-employee was allowed a business bad debt deduction for funds advanced to the corporation when these factors were present.]

    b. The documents describe the advance as debt; there is a fixed maturity date; the corporation is adequately capitalized; and the funds are used for working capital. [This answer is incorrect. The presence of these factors would indicate that the funds are debt instead of equity.]

    c. A corporation cannot obtain other financing, is thinly capitalized, and does not make interest payments on the note. [This answer is correct. In *Kadlec*, an 80% shareholder was denied a bad debt

deduction for funds advanced to the corporation because the funds were deemed to be a capital contribution.]

24. In February 2009, Freda, a firefighter, made a personal unsecured loan of $5,000 to her friend, Frank. The loan, which is due February 2011, requires monthly payments to Freda. In August 2009, Frank begins paying less than the required monthly payment, and it appears that Freda will not be entirely repaid. In 2010, Frank declares bankruptcy, and the remaining balance on the debt is worthless. In what year is Freda allowed to recognize a bad debt deduction? **(Page 259)**

    a. 2009. [This answer is incorrect. Although Frank was not making his full payments in 2009, a deduction for partial worthlessness is not allowed for a nonbusiness bad debt.]

    b. 2010. [This answer is correct. According to the Code, a nonbusiness bad debt is deductible only in the year it becomes totally worthless.]

    c. 2011. [This answer is incorrect. The lender is not required to wait until the debt is due to determine total worthlessness.]

    d. Never. [This answer is incorrect. A nonbusiness bad debt is deductible as a short-term capital loss once the appropriate timing is achieved under the Code.]

25. Factors that the courts may review in determining if a bona fide loan (as opposed to a gift) exists between family members include all of the following **except** which factor? **(Page 259)**

    a. Fixed payment schedule that includes interest payments. [This answer is incorrect. These factors support the existence of a loan instead of a gift.]

    b. The parties' records reflecting the transaction as a loan. [This answer is incorrect. The courts would review these records to determine the intent of the parties at the time the loan was made.]

    c. The solvency of the borrower. [This answer is incorrect. Advances made after a family member becomes insolvent are deemed to be gifts since a reasonable expectation of repayment cannot exist when the advance is made.]

    d. How often the family members see each other. [This answer is correct. The physical contact that the parties have with each other is not a relevant factor in the courts' reviews of such loans. While no one factor is controlling, the courts review the intent of the parties and the existence of evidence.]

26. Mr. Richard Generous agrees to be the loan guarantor to a business associate, Mr. Humble Loveable. Mr. Generous and Mr. Loveable are not related. Mr. Loveable is unable to make the fourteenth loan payment and calls Mr. Generous to make the payment under the loan guarantee. Mr. Loveable is subsequently unable to make any remaining payments under the terms of the loan agreement, and Mr. Generous makes all the remaining payments. When will Mr. Generous be able to write off his guarantee payments as a bad debt loss? **(Page 259)**

    a. After reasonable collection efforts against Mr. Loveable have failed. [This answer is correct. In his role as guarantor, under the regulations, Mr. Generous assumes the role of lender and must pursue collection efforts against Mr. Loveable before writing off the debt as uncollectible.]

    b. Monthly as each guarantee payment is made. [This answer is incorrect. It is not determinable at the time each guarantee payment is made if the debt from Mr. Loveable is uncollectible.]

    c. The year the guarantee is written. [This answer is incorrect. Under this scenario, no guarantee payments were made until the guarantee agreement had been in effect for over a year.]

Debt Discharge Income—Solvent Taxpayer

Cancellation or forgiveness of a debt (other than as the result of a gift) results in gross income for the debtor unless an exception applies because he is in bankruptcy or insolvent, or the debt is qualified farm debt, qualified real property business debt, a certain type of student loan, or qualified principal residence indebtedness (see discussions for these exceptions later in this lesson). A special rule applies to a reduction of a seller-financed (i.e., purchase money) debt owed to the seller of the property.

The American Recovery and Reinvestment Act of 2009 (2009 Recovery Act) permits a taxpayer to elect to defer the recognition of income arising from the cancellation of indebtedness from the reacquisition of certain debt in calendar year 2009 or 2010. To be eligible for deferral, the debt must have been issued by the taxpayer "in connection with" a trade or business. Generally the deferred cancellation of indebtedness income must be recognized ratably over five years beginning in 2014. Such deferral is terminated under certain circumstances.

Debt discharge income resulting from debt allocated to passive activity expenditures (e.g., when a rental property's mortgage balance is reduced by a lender) is passive income and can be offset by passive losses. Debt discharge income resulting from the cancellation of investment-related debt is treated as investment income for purposes of the investment interest expense limitation.

Example 2B-1 Loan renegotiation.

Helen borrowed $250,000 for her sole proprietor dress shop in 2007, financing it with a balloon payment loan from Qwik Savings. Helen reports her business on a cash-basis. In 2010, she was forced to sell the business. Unfortunately, its value had dropped to $200,000. Helen found a buyer and then renegotiated the principal balance of her loan from $250,000 to $200,000; $10,000 of accrued but unpaid interest was also forgiven. She used the $200,000 sale proceeds to pay off the loan. Helen was not insolvent when the loan was renegotiated.

Because Helen was not insolvent when the loan was renegotiated, the full amount of the loan reduction ($50,000) is taxable income from debt discharge in 2010. No invoice is recognized for the $10,000 of forgiven interest since she is on a cash basis and no deduction had been taken for the interest expense.

Example 2B-2 Discounted payoff of low interest mortgage.

Tom and Sue purchased their vacation home in 2008 by taking out a 4% mortgage. As of July 1, 2010, the mortgage balance was $200,000. The bank offered them a $10,000 discount if they would pay off the mortgage, which Tom and Sue did (for $190,000) on July 15, 2010.

Because Tom and Sue were not insolvent or bankrupt, the $10,000 principal reduction is taxable income from debt discharge in 2010. Because it was a nonbusiness debt, the cancellation of indebtedness income is reported as "Other income" on line 21 of Form 1040.

An exception to the usual treatment of debt discharge income may apply to contested liabilities. If a party demands payment for a liability over which there is a dispute, the eventual agreement to pay a reduced amount may not give rise to debt discharge income. The Third Circuit, in *Zarin*, found that the disputed debt doctrine applied when the debt's existence was in doubt. The taxpayer incurred gambling debts of over $3,000,000 according to a casino. Eventually, he settled with the casino for $500,000. Because the gambling debt was illegal, and thus, unenforceable, the court found the excess of the original debt over the settlement amount was not taxable income. In *Earnshaw*, the taxpayer disputed the amount of interest and late fees added to his credit card balance. When he settled the debt for less than the balance on the credit card company's books, only the amount of the liquidated debt (i.e., the amount fixed by agreement or by the operation of law) over the amount paid was taxable debt discharge income. The cancellation of the disputed charges did not generate debt discharge income.

The Tenth Circuit refused to apply the disputed debt doctrine when the amount but not the existence of the debt was contested.

A loan guarantor who pays off another taxpayer's loan at a discount generally does not recognize debt discharge income because the guarantor is not the primary obligor on the debt. The Tax Court has ruled that a shareholder-

guarantor of corporate debt did not recognize debt discharge income upon payment of the debt at a reduced amount. The shareholder was merely the guarantor of the corporate debt; the debt discharge income was attributable to the corporation. Likewise, a taxpayer who transfers property to a lender to release another taxpayer from debt does not realize a gain or loss, since the transferor was not obligated under the debt. Thus, its cancellation is not consideration to the transferor. Without consideration, the court found there could be no gain.

Effect of Debt Modifications

A debtor that issues a new debt instrument in satisfaction of existing debt is treated as having paid off that debt with an amount of money equal to the "issue price" (determined under the OID rules of IRC Secs. 1273–1274) of the new debt. To avoid default, a lender will often modify the terms of a debt in favor of the debtor. Significant modification of the terms of a debt instrument is considered an exchange of old debt for new and may give rise to debt discharge income.

A modification is significant if, based on all facts and circumstances, the legal rights or obligations being changed and the degree to which they are changed are economically significant. To determine this, generally all modifications to the debt instrument are considered collectively (when a series of modifications, if considered separately, would not be significant). However, certain modifications listed in Reg. 1.1001-3(e)(2) though (6) are considered independently. The regulations also provide guidelines for determining whether these independently-considered modifications are significant. The modifications listed in the regulations are:

1. Changes in the obligation's yield.

2. Changes in the timing of payments.

3. Changes in the obligor or security.

4. Changes in the nature of the debt instrument.

5. Changes in customary accounting or financial covenants.

The new (i.e., significantly modified) debt will generate debt discharge income if its issue price is less than the balance of the old debt. Under the OID rules applicable to nonpublicly traded debt, if the new debt has an interest rate at least equal to the applicable federal rate (AFR), and interest is unconditionally payable at least annually, the debt's issue price is deemed to be its stated principal amount. Thus, the issuance of new debt (or significant modification of an existing debt) with a principal balance equal to the old debt will *not* result in debt discharge income, provided the new (or modified) debt's interest rate equals or exceeds the AFR and interest is paid at least annually. However, if the interest rate is less than the AFR or payments occur less frequently than annually, the issue price is generally the present value of all payments required under the terms of the debt discounted at the AFR, and debt discharge income will result.

Example 2B-3 New debt issued for existing debt; interest rate exceeds AFR.

John purchased machinery for his sole proprietorship business on January 1, 2006 financed with a $350,000, 12% note due in 10 years, payable monthly. The balance at January 1, 2010 was $257,000. On January 2, 2010, John and the lender agreed to refinance the note at an 8% annual rate. No other terms were modified.

Because the changed loan terms resulted in a significant modification under Reg. 1.1001-3, the old loan is considered exchanged for a new loan (with a term of six years). However, there are no tax consequences to the refinancing since the stated rate of 8% exceeded the January 2010 midterm AFR. Thus, the issue price of the new debt is deemed to be its stated principal amount ($257,000), which equals the face value of the old debt.

Example 2B-4 New debt issued for existing debt; interest rate less than AFR.

Assume the same facts as in Example 2B-3 except the refinanced rate was 2%. Here, John will be treated as satisfying the old debt with an amount equal to the imputed principal amount of the new debt, which, for this

example, assume is $250,000. The difference between the $257,000 stated principal balance and the $250,000 imputed principal amount, or $7,000, is debt discharge income. John reports the $7,000 as income in 2010 unless he is in bankruptcy or insolvent.

Additionally, John is allowed corresponding OID interest deductions of $7,000. The OID deductions are allocated over the remaining term of the note and can be deducted in the applicable tax years.

Acquisition of Debt by Related Party

The direct or indirect acquisition of indebtedness by a person related to the debtor from a person who is not related results in debt discharge income equal to the difference between the outstanding balance of the debt acquired and its FMV. A related person includes family members, more-than-50%-owned corporations, and more-than-50%-owned partnerships, as well as certain trust and beneficiary relationships. For this rule, family members include the debtor's parents, spouse, children, grandchildren, and their spouses.

A direct acquisition occurs if a person related to the debtor acquires the indebtedness from a person who is not. An indirect acquisition is generally a transaction in which the holder of outstanding debt becomes related to the debtor, if the holder is treated as having acquired the debt "in anticipation of" becoming related to the debtor.

Example 2B-5 Acquisition of debt by party related to debtor.

In 2007, Dawn borrowed $500,000 by executing a note with Last Bank. The terms provide for interest payments of 10% due each December 31 and a balloon at maturity of $500,000. The note matures on December 31, 2012. On June 1, 2010, Bloom Corp. (owned 100% by Dawn) purchased the note from Last Bank for $450,000 (its FMV at that time).

Since Bloom is a related party, Dawn recognizes $50,000 of debt discharge income in 2010. The income would be excludable under IRC Sec. 108(a) if Dawn is bankrupt or to the extent she is insolvent.

Special Rules for Farmers

In addition to bankrupt and insolvent taxpayers, farmers do not have to recognize debt discharge income if the forgiven debt is *qualified farm indebtedness*. For this exception, the following conditions must be met:

1. The debt was incurred directly in the business of farming.

2. At least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming.

3. The lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

The amount of debt discharge income excludable by farmers is limited to the total of certain tax attributes plus the aggregate bases of business property and property held for the production of income. To the extent the debt discharge exceeds these attributes, income must be recognized.

Example 2B-6 Discharge of farm indebtedness.

Bill has been in the farming business for 10 years. More than 50% of his annual gross receipts are attributable to farming. In 2007, he borrowed $75,000 from a state agricultural agency for farm operating expenses. For several years, he could not meet certain financial obligations, although he was not insolvent or in bankruptcy. In 2010, the state agency discharged the $70,000 remaining balance of its loan to Bill.

The discharge will not result in income to Bill because he meets the Section 108(g) rules for discharge of qualified farm indebtedness. However, assuming Bill has no other tax attributes that can be reduced, he must reduce his tax basis in depreciable business or income-producing property, then reduce his basis in farmland, and finally reduce his basis in other business or income-producing property to the extent of the $70,000

discharged indebtedness. This basis reduction is reported on Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness). Any debt discharge income in excess of these basis reductions is includable in gross income on the "Other income" line of Schedule F of Bill's Form 1040.

Special Rules for Real Property Business Debt

A taxpayer who is *not* insolvent or bankrupt can elect to exclude from gross income any income from the discharge of qualified real property business debt. Qualified real property business debt includes debt:

1. that was incurred or assumed in connection with real property used in a trade or business and that is secured by such real property;

2. that was incurred or assumed (a) before January 1, 1993, or (b) on or after January 1, 1993 and is qualified acquisition debt (i.e., debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and

3. with respect to which an election to invoke the special rules of IRC Sec. 108(a)(1)(D) has been made.

Qualified real property business debt does *not* include qualified farm indebtedness but does include debt incurred to refinance qualified real property business debt (to the extent refinancing proceeds do not exceed the principal amount of the qualified real property business debt being refinanced).

Example 2B-7 Determining qualified real property business debt.

George operates an auto repair shop as a sole proprietor. He purchased a tract of land in 2008 and built his own shop. The cost of the land and building was $200,000, financed by a $25,000 down payment and a $175,000 nonrecourse note obtained from a third-party lender. On July 31, 2010, when the FMV of the land and building is $100,000 and the balance of the note is $150,000, the lender agrees to reduce the principal of the note by $50,000. Since the note is qualified acquisition debt, the debt discharge income is excluded from George's gross income, if he makes the Section 108(a)(1)(D) election.

As previously stated, the debt must be incurred or assumed in connection with a trade or business. This trade or business requirement can be particularly difficult for rental properties to meet and is usually based on the extent of the taxpayer's involvement in the rental activity. In Ltr. Rul. 9426006, the IRS concluded that a taxpayer's involvement was sufficient to constitute a trade or business even though a management company was engaged as the leasing agent and handled day-to-day operations. Rentals conducted as "net leases," however, generally do not qualify as a trade or business.

The taxpayer must make a valid election to exclude income from the discharge of qualified real property business debt. It is made on Form 982 and attached to the taxpayer's return for the tax year the discharge occurs.

Limitation on Exclusion. The amount of qualified real property business debt discharge income that can be excluded cannot exceed the lesser of the following:

1. *FMV Limitation.* The excess of the outstanding principal amount (immediately before the discharge) over the FMV of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property). The outstanding principal amount is the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future.

2. *Overall Limitation.* The aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by depreciation claimed for the year of the excluded debt discharge income.

When applying the overall limitation, the adjusted basis of the taxpayer's depreciable real property must first be reduced by (1) any reduction in basis made under IRC Sec. 108(b) for reductions in tax attributes of a bankrupt or insolvent taxpayer, or (2) any reduction made under IRC Sec. 108(g) for the discharge of qualified farm debt. If

depreciable real property is acquired in contemplation of a discharge of qualified real property business debt, the property's basis is not included in applying the overall limitation.

Example 2B-8 Application of real property business debt limitations.

Joan owns a building used in her business. Its FMV is $150,000 (adjusted basis $175,000). The building secures a first mortgage of $110,000 and a second mortgage of $90,000. None of the debt is qualified farm indebtedness. Joan is not insolvent or bankrupt and owns no other depreciable real property.

On July 1, 2010, the second mortgagee agrees to reduce its debt from $90,000 to $30,000, resulting in debt discharge income of $60,000. The FMV rule limits the total amount of debt discharge income that can be excluded to $50,000, the amount by which the principal of the debt ($90,000) exceeds the FMV of the collateral property, reduced by other qualified real property business debt securing the property ($150,000 − $110,000 = $40,000). Therefore, Joan can exclude $50,000 of debt discharge income if she files an election to do so with her 2010 return. The remaining $10,000 of debt discharge income is included in her 2010 income.

Basis Adjustment Requirement. Income excluded for the discharge of qualified real property business debt reduces the basis of the taxpayer's depreciable real property. (The reduction is made under IRC Sec. 1017, except the election to treat real property inventory as depreciable property is not available.) The basis reduction is made first to the adjusted depreciable basis of the real property securing the discharged debt. Any excess reduces the depreciable bases of the taxpayer's other depreciable real property proportionately, based on each property's relative adjusted basis. The basis reduction is deemed to occur at the beginning of the tax year following the tax year during which the discharge occurs. However, if the property is disposed of before the beginning of the tax year following the discharge, the basis reduction occurs immediately before the disposition.

Example 2B-9 Reducing the basis of depreciable real property.

Bill owns Garden Apartments. On July 1, 2010, the property has an adjusted basis of $2.2 million and outstanding nonrecourse debt of $2.5 million. The property's FMV is $2 million.

On July 1, 2010, the mortgage holder reduces the principal amount of the outstanding mortgage to $2 million, resulting in debt discharge income of $500,000. Bill elects to exclude this $500,000 of income under the qualified real property business debt rules. Therefore, his depreciable basis in the apartments is reduced by $500,000 as of January 1, 2011, and depreciation calculated for periods subsequent to that date will take the $500,000 basis reduction into account.

Partnership Debt Reduced. For a discharge of partnership debt, the determination of whether debt is qualified real property business debt and the application of the FMV limitation is made at the partnership level. The election to apply the exclusion is made at the partner level on a partner-by-partner basis. When an election causes a basis reduction to the partner's allocable share of the partnership's depreciable real property, the partner's basis of his interest in the partnership and the partnership's basis of the depreciable realty allocated to the partner are reduced by such amount.

S Corporations Apply Rules at the Entity Level. The income exclusion under IRC Sec. 108 and any resulting reduction in tax attributes are applied at the S corporation level. IRC Sec. 108(d)(7)(A) clarifies that income excluded under IRC Sec. 108 does not increase a shareholder's basis in S corporation stock.

Special Rules for Certain Student Loans

Cancellations of all or part of certain student loans obtained to attend qualified educational institutions do not result in gross income to the borrower. This special rule applies only to student loans that contain a provision stating that all or part of the loan will be cancelled if the borrower works for a certain period of time in certain professions for any of a broad class of employers (i.e., a public service requirement), and the borrower satisfies such requirement. To qualify, the loan must be made by either:

1. a federal, state, or local government unit, or instrumentality, agency, or subdivision thereof;

2. a tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law; or

3. an educational institution that makes the loan under (a) an agreement with an entity described in item 1 or 2, or (b) a program of the institution to encourage students to serve in occupations or in areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or other tax-exempt organization.

Loans made by educational institutions and tax-exempt organizations to refinance loans that assist individuals in attending such educational institution also qualify, provided the refinancing is pursuant to a program as described in item 3 above. Loans from educational institutions and tax-exempt organizations do not qualify if the discharge is on account of services the individual performs for the lender organization.

Special Rules for Principal Residence Debt

Taxpayers can exclude up to $2 million from a discharge (in whole or in part) of qualified principal residence indebtedness before January 1, 2013. The exclusion does not apply if the discharge is on account of services performed for the lender (for example, an employee of the lender and the discharge relates to employment services performed) or any other factor not directly related to a decline in the value of the residence or to the taxpayer's financial condition. The exclusion also does not apply to a taxpayer in a Title 11 bankruptcy case; the regular Title 11 bankruptcy exclusion applies. And, insolvent taxpayers other than those in a Title 11 bankruptcy case can elect to not have this special exclusion apply and instead rely on the Section 108(a)(1)(B) rules for insolvent taxpayers.

Qualified Principal Residence Indebtedness. *Qualified principal residence indebtedness* is debt that meets the Section 163(h)(3)(B) definition of acquisition indebtedness for the residential interest expense rules, but only with respect to the taxpayer's principal residence (i.e., does not include second homes or vacation homes), and with a $2 million limit ($1 million for married filing separate taxpayers) on the aggregate amount of debt that can be treated as qualified principal residence indebtedness.

For purposes of these rules, a principal residence has the same meaning as under the Section 121 home sale gain exclusion rules.

Operative Rules. Most residential mortgages are classified as recourse debt. As such, a foreclosure involving recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven. Therefore, it is possible for a residential foreclosure transaction (involving recourse debt) to result in either a gain or loss from the sale of property and debt discharge income. However, only the portion of the transaction (if any) treated as debt discharge income is available for the special exclusion rule for qualified principal residence indebtedness; any income from the foreclosure treated as gain is not eligible for the exclusion rule.

Example 2B-10 Exclusion for home mortgage debt discharge.

Tim, who is not in bankruptcy and is not insolvent, owns a principal residence that is subject to a $300,000 mortgage secured by the residence. The original cost of the home was $270,000 and the lender foreclosed on the loan in 2010 when the property's FMV was $280,000.

The foreclosure results in a taxable gain of $10,000 ($280,000 less $270,000) and debt discharge income of $20,000 ($300,000 less $280,000). The $10,000 gain must be recognized, but the $20,000 of debt discharge income is excluded.

In a rare case that a residential mortgage is nonrecourse, a foreclosure transfer is treated as a sale or exchange with the full amount of the debt as the amount realized, even if it is greater than the FMV of the property at time of foreclosure. Therefore, there is no debt discharge income and the exclusion rule does not apply.

The basis of the taxpayer's principal residence must be reduced (but not below zero) by the amount of any income excluded under the special principal residence debt exclusion rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. A solvent debtor must include cancellation or forgiveness of a debt in gross income unless certain exceptions apply. Which of the following is **not** an allowable exception?

    a. The debt is qualified farm debt.

    b. The debt is qualified real property business debt.

    c. The debt is investment-related debt.

    d. The debt is a certain type of student loan.

28. Assuming that a taxpayer is not bankrupt or insolvent, what is the tax consequence to the taxpayer when a person related to the taxpayer either directly or indirectly acquires the taxpayer's debt from a person who is not related to the taxpayer?

    a. The taxpayer must recognize debt discharge income equal to the difference between the outstanding balance of the debt acquired and its fair market value.

    b. The debt discharge income is excluded from the taxpayer's gross income, but certain tax attributes must be reduced by the amount of the excluded debt discharge income.

    c. The taxpayer must recognize debt discharge income equal to the outstanding balance of the debt acquired.

    d. The taxpayer must recognize debt discharge income equal to the fair market value of the debt acquired.

29. Taxpayers in the business of farming are not required to recognize debt discharge income if the forgiven debt qualifies as *qualified farm indebtedness*. Of the following, which one is **not** a condition that must be met to qualify as qualified farm indebtedness?

    a. The forgiveness is made by a lender who is actively and regularly engaged in the business of lending money, and is not related to the taxpayer.

    b. The debt must have been incurred directly in connection with the trade or business of farming.

    c. 50% or more of the taxpayer's aggregate gross receipts for the preceding three years were from the farming business.

    d. The debt must have been incurred or assumed before 1993.

30. The fair market value limitation and the overall limitation apply in determining the amount of debt discharge income that may be excluded from what type of debt?

    a. Qualified farm indebtedness.

    b. Qualified real property business debt.

    c. Qualified principal residence indebtedness.

    d. Qualified personal indebtedness.

31. In 2010, Dan and Carol's principal residence is subject to a $500,000 mortgage that is secured by the property. Dan and Carol are not bankrupt or insolvent. As a result of nonpayment on the mortgage, the creditors foreclosed on the property when the fair market value of the property was $480,000. Dan and Carol's tax basis in the property is $450,000. How do Dan and Carol report the foreclosure on their tax return?

    a. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is excluded from income.

    b. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is included in income.

    c. The foreclosure results in discharge of indebtedness income of $50,000 that is excluded from income.

    d. The foreclosure results in discharge of indebtedness income of $50,000 that is included in income.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. A solvent debtor must include cancellation or forgiveness of a debt in gross income unless certain exceptions apply. Which of the following is **not** an allowable exception? **(Page 269)**

    a. The debt is qualified farm debt. [This answer is incorrect. Farmers do not have to recognize debt discharge income for the forgiveness of qualified debt.]

    b. The debt is qualified real property business debt. [This answer is incorrect. Cancellation of qualified real property business debt may be excluded from gross income.]

    c. The debt is investment-related debt. [This answer is correct. According to an IRS letter ruling, debt discharge income resulting from the cancellation of investment-related debt is treated as investment income for purposes of the investment interest expense limitation.]

    d. The debt is a certain type of student loan. [This answer is incorrect. The cancellation of certain student loans obtained to attend qualified educational institutions do not result in gross income to the borrower.]

28. Assuming that a taxpayer is not bankrupt or insolvent, what is the tax consequence to the taxpayer when a person related to the taxpayer either directly or indirectly acquires the taxpayer's debt from a person who is not related to the taxpayer? **(Page 269)**

    a. The taxpayer must recognize debt discharge income equal to the difference between the outstanding balance of the debt acquired and its fair market value. [This answer is correct. Under the Internal Revenue Code, these are the appropriate tax consequences in this situation. A related person includes family members, more-than-50%-owned corporations, and more-than-50%-owned partnerships, as well as certain trust and beneficiary relationships.]

    b. The debt discharge income is excluded from the taxpayer's gross income, but certain tax attributes must be reduced by the amount of the excluded debt discharge income. [This answer is incorrect. If the taxpayer is bankrupt or insolvent, the debt discharge income is excluded from gross income.]

    c. The taxpayer must recognize debt discharge income equal to the outstanding balance of the debt acquired. [This answer is incorrect. The calculation of the amount of income that must be recognized is is not correctly stated by this answer choice. The taxpayer must use more information, including its fair market value.]

    d. The taxpayer must recognize debt discharge income equal to the fair market value of the debt acquired. [This answer is incorrect. The amount of income that must be recognized is a calculation that includes the fair market value of the debt acquired. There is a better answer choice.]

29. Taxpayers in the business of farming are not required to recognize debt discharge income if the forgiven debt qualifies as *qualified farm indebtedness*. Of the following, which one is **not** a condition that must be met to qualify as qualified farm indebtedness? **(Page 269)**

    a. The forgiveness is made by a lender who is actively and regularly engaged in the business of lending money, and is not related to the taxpayer. [This answer is incorrect. This condition must be met for the debt to qualify as qualified farm indebtedness according to IRC Sec. 108(g).]

    b. The debt must have been incurred directly in connection with the trade or business of farming. [This answer is incorrect. This condition must be met for the debt to qualify under IRC Sec. 108(g) as qualified farm indebtedness.]

    c. 50% or more of the taxpayer's aggregate gross receipts for the preceding three years were from the farming business. [This answer is incorrect. To qualify as qualified farm indebtedness under IRC Sec. 108(g), this condition must be met.]

d. The debt must have been incurred or assumed before 1993. [This answer is correct. This condition relates to the Internal Revenue's Code's conditions for qualified real property debt instead of qualified farm indebtedness.]

30. The fair market value limitation and the overall limitation apply in determining the amount of debt discharge income that may be excluded from what type of debt? **(Page 269)**

a. Qualified farm indebtedness. [This answer is incorrect. Although qualified farm indebtedness is subject to certain conditions, the FMV and overall limitations apply to another type of debt.]

b. Qualified real property business debt. [This answer is correct. According to the Internal Revenue Code, the amount of qualified real property business debt discharge income that can be excluded cannot exceed the lesser of the fair market value limitation or the overall limitation.]

c. Qualified principal residence indebtedness. [This answer is incorrect. Although qualified principal residence indebtedness is subject to exclusion rules, the FMV and overall limitations apply to another type of debt.]

d. Qualified personal indebtedness. [This answer is incorrect. Although bankrupt and insolvent taxpayers can exclude debt discharge income from taxable gross income, they must reduce certain tax attributes. The FMV and overall limitations apply to another type of debt.]

31. In 2010, Dan and Carol's principal residence is subject to a $500,000 mortgage that is secured by the property. Dan and Carol are not bankrupt or insolvent. As a result of nonpayment on the mortgage, the creditors foreclosed on the property when the fair market value of the property was $480,000. Dan and Carol's tax basis in the property is $450,000. How do Dan and Carol report the foreclosure on their tax return? **(Page 269)**

a. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is excluded from income. [This answer is correct. Under the Code, this is the proper treatment. The excess of the FMV of the property over the tax basis is taxable gain from the sale of the property ($480,000 — $450,000). The excess of the debt forgiven over the FMV is debt discharge income ($500,000 — $480,000).]

b. The foreclosure results in a taxable gain of $30,000 and discharge of indebtedness income of $20,000 that is included in income. [This answer is incorrect. Including debt discharge income as income is not the proper tax treatment of the transaction.]

c. The foreclosure results in discharge of indebtedness income of $50,000 that is excluded from income. [This answer is incorrect. A foreclosure involving recourse debt is treated as a deemed sale of the property which results in a taxable gain or loss.]

d. The foreclosure results in discharge of indebtedness income of $50,000 that is included in income. [This answer is incorrect. A foreclosure involving recourse debt is treated as a deemed sale of the property which results in a taxable gain or loss. In addition, including debt discharge income as income is not the proper tax treatment for the transaction.]

Bankrupt or Insolvent Taxpayer—Debt Discharge Income

Special mandatory relief provisions apply to debt discharge income of bankrupt or insolvent taxpayers. These relief provisions allow such taxpayers to exclude debt discharge income from gross income. However, certain tax attributes are reduced by the amount of excluded debt discharge income. To the extent the excluded income exceeds the tax attributes available for reduction, the "excess" income, in effect, disappears (with no further tax consequences to the debtor). (See Example 2C-6.)

Amount Excludable from Gross Income

Bankrupt Taxpayers. *Bankrupt* taxpayers exclude all debt discharge income from taxable gross income under these rules. *Bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 (of the U.S. Bankruptcy Code) case. Title 11 encompasses the federal bankruptcy statutes and includes Chapter 7 (liquidation), Chapter 11 (business reorganization), Chapter 12 (family farmer or fisherman), and Chapter 13 (adjustment of an individual's debts) bankruptcies.

Example 2C-1 Excludable debt discharge income for taxpayer in bankruptcy.

Horton's sole proprietorship business failed in 2010. He also owns land (free and clear) worth $300,000 that he holds for investment. In November 2010, the bankruptcy judge granted Horton a discharge from $400,000 of personal indebtedness related to his failed business (in a Chapter 7 case). He had no assets other than the land and no other liabilities at the time of this debt discharge.

Horton can exclude the entire $400,000 from taxable gross income under IRC Sec. 108 because the debt discharge occurred in a Title 11 bankruptcy proceeding. (See Examples 2C-5, 2C-6, and 2C-7 for discussions of the tax attribute reduction rules.)

Insolvent Taxpayers. *Insolvent* taxpayers exclude debt discharge income from taxable gross income to the extent of insolvency before the debt discharge transaction. Any debt discharge income in excess of insolvency is taxable income. The extent of insolvency is the excess of the taxpayer's liabilities over the FMV of his assets immediately before the debt discharge.

When determining whether a taxpayer is insolvent or the extent of insolvency, the following rules apply:

- *Exempt Assets.* All assets, including assets that, by operation of state law, are exempt from creditors must be included in determining insolvency.
- *Spouse's Separate Property.* A spouse's separately-owned assets can be excluded from the determination of the insolvent spouse's net worth, even if the couple files a joint return.
- *Nonrecourse Debt.* When computing insolvency, nonrecourse debt is treated as a liability to the extent of the FMV of the property securing the debt. Nonrecourse debt in excess of the property's FMV is treated as a liability to the extent it is discharged; otherwise, it is ignored.
- *Contingent Liabilities.* Before a contingent liability can be included in the insolvency computation, taxpayers must be able to prove "it is more probable than not" that they will be called on to pay the liability. Thus, loan guarantees and disputed debts may or may not be considered, depending on the facts and circumstances.
- *Measurement Date.* IRC Sec. 108(d)(3) indicates a taxpayer's insolvency is determined immediately before a debt discharge. According to the Tax Court, this means the day before the debt forgiveness income is realized.

Example 2C-2 Excludable debt discharge income for insolvent taxpayer.

All of Max's personal assets and liabilities are from his sole proprietorship business. As of August 1, 2010, business operating debts owed to Last Bank were $500,000, and the FMV of business assets was only $350,000.

The bank discharges $200,000 of Max's debts in exchange for his promise to take no money out of the business until it becomes healthy. This debt discharge occurs outside of bankruptcy in a voluntary "workout" between the borrower and lender.

Just before the debt discharge, Max was insolvent to the extent of $150,000 ($500,000 of liabilities less $350,000 FMV of assets). Thus, he can exclude $150,000 of the $200,000 discharge from income. However, he must reduce tax attributes by up to $150,000. (See Examples 2C-6 and 2C-7.)

The remaining $50,000 of debt discharge income must be included in Max's income. After the debt discharge, his assets are still worth $350,000, and his liabilities are only $300,000. Thus, $50,000 is taxable because he has been made solvent by that amount as a result of the debt discharge transaction.

Example 2C-3 Effect of nonrecourse debt on insolvency calculations.

In 2008, Sally borrowed $200,000 from Bob to purchase land valued at $200,000. The note bore interest at a fixed market rate payable annually; no principal payments were due until 2010. The note was secured by the land and was nonrecourse to Sally.

In 2010 (when the outstanding note balance was still $200,000 and the FMV of the property had declined to $100,000), Bob agreed to reduce the note's principal balance to $150,000. At that time, Sally had other assets valued at $100,000 and other liabilities (for which she was personally liable) of $90,000. She had not declared bankruptcy. What are the tax consequences of this transaction?

Sally was discharged from $50,000 of debt in 2010. However, she will not recognize debt discharge income to the extent she was insolvent immediately before the discharge. The FMV of Sally's assets before the debt discharge was $200,000 ($100,000 land plus $100,000 other assets). In calculating Sally's insolvency, her liabilities were $240,000 ($100,000 nonrecourse financing, included to the extent of the FMV of the secured property, plus $50,000 nonrecourse financing in excess of the secured property's FMV, included to the extent discharged, plus $90,000 other recourse debt). Thus, Sally is insolvent to the extent of $40,000 ($200,000 assets − $240,000 liabilities) immediately before the discharge. She will recognize $10,000 ($50,000 debt discharged − $40,000 excluded under the insolvency rule) of debt discharge income in 2010. (See Examples 2C-6 and 2C-7 for tax attribute reduction rules that apply.)

When an insolvent taxpayer's debt is partly discharged and partly satisfied by the transfer of property, the transaction must be bifurcated between the debt discharge and the property disposition (*Gehl*). The amount of debt satisfied by the transfer of the property is treated as sales proceeds for the property, from which gain or loss is computed. The separate debt discharge amount is eligible for exclusion under IRC Sec. 108, to the extent the taxpayer is insolvent.

Example 2C-4 Property transferred by insolvent debtor.

Tad transfers a vacant lot with an FMV of $30,000 and $5,000 cash in complete settlement of a $50,000 unsecured loan from the bank. The bank forgives the remaining $15,000 of the loan. Assume Tad is insolvent both before and after the debt discharge. His basis in the lot was $25,000. The transfer of the property and the debt discharge are treated as two separate transactions. The transfer of the lot is considered a sale of the property, so Tad has a $5,000 taxable gain based on the difference between the FMV and basis ($30,000 − $25,000). The $15,000 debt discharge amount is excluded from Tad's income under the insolvency rule.

Reduction of Tax Attributes

While bankrupt and insolvent taxpayers can exclude debt discharge income from taxable gross income, they must reduce (to the extent possible) certain tax attributes. This reduction of attributes means that some or all of the excluded debt discharge income will eventually be recognized because of reduced tax attributes or basis in property.

The following tax attributes are reduced by debt discharge income (dollar for dollar, except for credits, which are reduced by 33 1/3 cents for each dollar) in the following order:

1. *NOLs.* Any NOL from the tax year of debt discharge, and any NOL carried into that year.

2. *General Business Credits.* Any credit carryover to or from the year of discharge.

3. *Minimum Tax Credit.* Any credit under IRC Sec. 53(b) as of the beginning of the year following the year of discharge.

4. *Capital Loss Carryovers.* Any net capital loss from the year of discharge, and any capital loss carryover into that year.

5. *Basis.* The tax basis of the depreciable and nondepreciable property of the taxpayer—under the rules prescribed in IRC Sec. 1017. (See "Ordering Rules for Basis Reduction" discussed later in this lesson.)

6. *Passive Activity Loss and Credit Carryovers.* Any passive activity loss or credit carryover under IRC Sec. 469(b) from the year of discharge.

7. *Foreign Tax Credit Carryovers.* Any credit carryover to or from the year of discharge.

When determining the amount of debt discharged under bankruptcy law, taxpayers need to consider that as a debtor, "all debts that arose before the date of the bankruptcy order are discharged even if the creditor did not file proof of claim on the debts. If the debt existed, such as mortgage liens, prior to the bankruptcy, and they are part of the bankruptcy estate, they can reduce the taxpayers subsequent tax attributes such as the net operating loss deduction.

Basis Reduction Elections

Two basis reduction elections are available to bankrupt and insolvent taxpayers. Instead of reducing tax attributes in the order just described, the taxpayer can elect under IRC Sec. 108(b)(5) to first reduce the basis of *depreciable* assets. Excluded debt discharge income in excess of the basis of depreciable assets is then used to reduce other attributes according to the normal ordering procedure. This "basis reduction" election can be beneficial to taxpayers with NOL or credit carryovers (that will be used in the near future) and long-lived depreciable property. Bankrupt or insolvent taxpayers who make the Section 108(b)(5) election can also elect under IRC Sec. 1017 to treat real property inventory as depreciable property.

Ordering Rules for Basis Reduction

For debt discharges that result in a reduction in the taxpayer's basis in assets due to the exclusion of debt discharge income, basis in assets is reduced in the following order:

1. Real property used in a trade or business (other than inventory) or held for investment that secured the debt.

2. Personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that secured the debt.

3. Any excess of the amount excluded from gross income over the adjustments in items 1 and 2 reduces the basis of the remaining trade or business property (other than inventory, accounts receivable, or notes receivable) and property held for investment.

4. Any excess of the amount excluded from gross income over the adjustments in items 1–3 reduces the adjusted basis of inventory (including real property held as inventory), accounts receivable, and notes receivable.

5. Any excess of the amount excluded from gross income over the adjustments in items 1–4 reduces the adjusted basis of any remaining property.

Generally, reduction resulting from adjustments in items 3–5 is allocated within each category of assets as follows:

$$\frac{\text{Adjusted basis of the property}}{\text{Adjusted basis of all property in that category}} \times \text{Excess debt discharge income}$$

Example 2C-5 Impact of basis reduction on Section 1250 property.

Rigby purchased an office-warehouse on June 5, 2006 for use as a rental property. All $500,000 of his purchase price was allocated to building. During 2010, Rigby declared Chapter 13 bankruptcy and was relieved of significant liabilities. Pursuant to IRC Sec. 1017, he reduced the basis in the office-warehouse by $80,000. At the end of 2010 (before considering the Section 1017 basis adjustment), Rigby's adjusted basis in the building was $441,772 ($500,000 cost less $58,228 straight-line depreciation). Rigby sells the building for $450,000 on January 1, 2011. The Section 1017 basis reduction occurs on the first day of 2011—see "Timing of Attribute Reduction" later in this lesson resulting in an adjusted basis of $361,772 ($441,772 − $80,000).

Rigby realizes a gain of $88,228 ($450,000 − $361,772). Straight line depreciation that would have been allowed (for computing recapture) is $58,228. Depreciation taken (including the Section 1017 basis adjustment) is $138,228. The difference between those amounts, $80,000, is recaptured as ordinary income. The remaining gain of $8,228 ($88,228 − $80,000) is Section 1231 gain.

Variation: Assume instead that Rigby sells the building nine years later for $450,000 (on January 1, 2020), realizing a $185,149 gain. His adjusted basis at that time would be $264,851 ($361,772 adjusted basis on January 1, 2011 less $96,921 additional straight line depreciation taken over nine years on $420,000 depreciable basis). Thus, total depreciation taken at the time of the sale (including the Section 1017 basis reduction) is $235,149 ($138,228 + $96,921). Total straight line depreciation that would have been allowed is $173,617 (based on the original $500,000 basis). Thus, $61,532 ($235,149 − $173,617) of the gain is recaptured as ordinary income, and the remaining gain of $123,617 ($185,149 − $61,532) is Section 1231 gain, which is taxed as Unrecaptured Section 1250 gain (25%), unless the taxpayer has any nonrecaptured Section 1231 losses.

Basis Reduction Limitation. If the basis of a taxpayer's property is reduced under the general attribute reduction ordering rules (i.e., after NOL, general business credit, minimum tax credit, and capital loss carryovers, if any, have been reduced), a special limitation on the amount of basis reduction applies. The aggregate basis of the taxpayer's assets cannot be reduced below the aggregate of the taxpayer's liabilities immediately after the discharge. This limitation does not apply to depreciable property if the election is made to first reduce its basis before other tax attributes. However, the basis of depreciable property cannot be reduced below zero. (Compare Examples 2C-6 and 2C-7.)

Timing of Attribute Reduction

When tax attributes of bankrupt or insolvent taxpayers are reduced because of excluded debt discharge income, the required attribute reductions are deemed to occur *after* taxable income for the year of discharge has been determined. This rule allows the taxpayer to use any NOL, capital loss, or credit carryovers into the year of discharge to offset other taxable income for that year before the carryovers are reduced for debt discharge income. Furthermore, the taxpayer can depreciate or amortize the full tax basis of property in computing taxable income for the year of discharge before reducing tax basis because of excludable debt discharge income. In effect, the attribute reductions occur on the first day of the tax year after the debt discharge occurs.

Example 2C-6 Attribute reduction for insolvent taxpayer.

Roxanne runs a toy distribution business as a sole proprietorship. National Bank continued to lend money to her even though she had financial problems. Roxanne stopped paying interest to the bank for most of 2010. As a result, she made a profit. At the end of 2010, the bank agreed (outside of bankruptcy proceedings) to forgive $150,000 of Roxanne's debts. Before the debt forgiveness, her liabilities were $500,000, and the FMV of her assets was $490,000. After the discharge, she had $350,000 of liabilities.

Roxanne had the following 2010 tax information:

NOL carryover into 2010	$ 60,000
Capital loss carryover into 2010	5,000
Credit carryover into 2010	1,000
Tax basis of depreciable assets at December 31, 2010	120,000
Tax basis of inventory at December 31, 2010	124,000
Tax basis of other property at December 31, 2010	100,000
2010 taxable income before any debt discharge income	25,000

The $150,000 debt discharge is treated as follows:

Roxanne can exclude only $10,000 from gross income—the amount by which her predischarge liabilities ($500,000) exceeded the FMV of her assets ($490,000). The $10,000 of excludable debt discharge income means tax attributes must be reduced by that amount, to the extent possible. The remaining $140,000 of debt discharge income is included in Roxanne's 2010 income.

Roxanne's tax attributes are reduced only after her 2010 taxable income has been computed. Thus, her NOL carryover of $60,000 into 2010 is used to offset 2010 taxable income of $165,000 ($25,000 + $140,000 of nonexcludable debt discharge income). Of her $5,000 capital loss carryover into 2010, $3,000 (the annual maximum) is used, leaving only $2,000. Finally, Roxanne can use all of her $1,000 credit carryover to reduce her 2010 tax liability. Thus, the only carryover remaining for attribute reduction after the determination of Roxanne's 2010 taxable income is the $2,000 capital loss carryover. That carryover is eliminated under the attribute reduction rules. Because her aggregate liabilities after the discharge ($350,000) exceed the aggregate tax basis of her property ($344,000), no basis reduction is required. Therefore, no further attribute reduction occurs.

In summary, Roxanne can exclude $10,000 of debt discharge from taxable gross income, and her tax attributes are reduced by only $2,000. The remaining $8,000 of excluded debt discharge income vanishes without impacting Roxanne's tax situation.

Example 2C-7 Election to reduce basis of depreciable assets.

Assume the same facts as in Example 2C-6 except Roxanne elects to first reduce the tax basis of depreciable property before reducing other tax attributes. Generally, the overall basis reduction cannot exceed the excess of the aggregate of the bases of property over liabilities immediately after the discharge. However, this limitation does not apply to depreciable property if the election to first reduce basis before other tax attributes is made. Roxanne's tax basis in her depreciable property on January 1, 2011 would be reduced from $120,000 to $110,000. This would not affect her 2010 depreciation calculation; however, only $110,000 of depreciable basis would be available going into 2011.

The difference in the tax impact on Roxanne as compared to the result in Example 2C-6 is that all $10,000 of excluded debt discharge income causes a reduction in tax attributes. In this set of facts, Roxanne should *not* make the election to first reduce the basis of depreciable property before reducing other tax attributes.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. For purposes of the tax rules involving debt discharge, *bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 case. Title 11 encompasses several types of bankruptcies, including Chapter 13 bankruptcies. Which of the following falls under Chapter 13 bankruptcies?

    a. Liquidation.

    b. Business reorganization.

    c. Adjustment of debts of a family farmer or fisherman.

    d. Adjustment of debts of an individual.

33. When the taxpayer is insolvent, the amount of debt discharge income that can be excluded from taxable income cannot exceed the amount by which the taxpayer is insolvent. In this case, *insolvency* means which of the following with respect to the taxpayer?

    a. The total balance of the taxpayer's liabilities immediately before the discharge.

    b. The excess of liabilities over the FMV of assets 180 days before the debt discharge.

    c. The excess of liabilities over the FMV of assets immediately before the debt discharge.

    d. The outstanding balance of the debt that is delinquent.

34. Bankrupt and insolvent taxpayers must reduce certain tax attributes by the amount of debt discharge income that is excluded from taxable income. The following tax attributes are reduced by debt discharge income on a dollar-for-dollar basis **except** for which one?

    a. Net operating loss carryovers.

    b. General business credits.

    c. Capital loss carryovers.

    d. Basis.

35. Jack owns an office supply company. Due to increased competition and rising costs, Jack is unable to repay all of his debt to the local bank. Since Jack has been an active community leader for a long time, the bank forgives $50,000 of his debt on the last day of the current year. Jack's liabilities were $150,000 before the discharge of the debt and $100,000 after discharge of debt. The FMV of Jack's assets before the debt discharge is $130,000. Jack has a net operating loss carryover to the current year of $60,000. At the end of the current year, the tax bases of his assets consist of $80,000 depreciable assets and $10,000 of inventory. In addition, Jack has taxable income of $25,000 before the debt discharge. Assuming that Jack does not elect to first reduce the basis of depreciable property, what is the amount of reduction to his tax attributes for the excluded debt discharge income?

    a. $50,000.

    b. $20,000.

    c. $15,000.

    d. $5,000.

36. Assuming the same facts for Jack in the above question except that Jack elects to first reduce the basis of depreciable property before reducing other tax attributes, what is the amount of reduction to his tax attributes for the excluded debt discharge income?

    a. $50,000.

    b. $20,000.

    c. $15,000.

    d. $5,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. For purposes of the tax rules involving debt discharge, *bankrupt* means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 case. Title 11 encompasses several types of bankruptcies, including Chapter 13 bankruptcies. Which of the following falls under Chapter 13 bankruptcies? **(Page 279)**

    a. Liquidation. [This answer is incorrect. Chapter 7 bankruptcies apply to liquidations.]

    b. Business reorganization. [This answer is incorrect. Chapter 11 applies to reorganizations.]

    c. Adjustment of debts of a family farmer or fisherman. [This answer is incorrect. Chapter 12 applies to this group filing for bankruptcy.]

    d. Adjustment of debts of an individual. [This answer is correct. Under the U.S. Bankruptcy Code, Chapter 13 applies to an individual's debts.]

33. When the taxpayer is insolvent, the amount of debt discharge income that can be excluded from taxable income cannot exceed the amount by which the taxpayer is insolvent. In this case, *insolvency* means which of the following with respect to the taxpayer? **(Page 279)**

    a. The total balance of the taxpayer's liabilities immediately before the discharge. [This answer is incorrect. Determining insolvency involves more than referring to the liabilities balance; a calculation is required.]

    b. The excess of liabilities over the FMV of assets 180 days before the debt discharge. [This answer is incorrect. The taxpayer's financial status immediately before the debt discharge is used in determining the insolvency amount.]

    c. The excess of liabilities over the FMV of assets immediately before the debt discharge. [This answer is correct. This statement describes insolvency under IRC Sec. 108(d)(3). For example, a taxpayer's debt to a lender is $10,000. The lender discharges the debt at which time the taxpayer's assets have a FMV of $6,000. The amount of insolvency is $4,000 ($10,000 – $6,000).]

    d. The outstanding balance of the debt that is delinquent. [This answer is incorrect. The balances of all liabilities must be compared to total assets.]

34. Bankrupt and insolvent taxpayers must reduce certain tax attributes by the amount of debt discharge income that is excluded from taxable income. The following tax attributes are reduced by debt discharge income on a dollar-for-dollar basis **except** for which one? **(Page 279)**

    a. Net operating loss carryovers. [This answer is incorrect. According to the Internal Revenue Code, this tax attribute is reduced on a dollar-for-dollar basis by the amount of the debt discharge excluded from taxable income.]

    b. General business credits. [This answer is correct. Under IRC Sec. 108(b)(2), credit carryovers are reduced by 33 ⅓ cents for each dollar.]

    c. Capital loss carryovers. [This answer is incorrect. Based on the Code, this tax attribute is reduced on a dollar-for-dollar basis by the amount of the debt discharge excluded from taxable income.]

    d. Basis. [This answer is incorrect. This tax attribute is reduced on a dollar-for-dollar basis by the amount of the debt discharge excluded from taxable income under the Code.]

35. Jack owns an office supply company. Due to increased competition and rising costs, Jack is unable to repay all of his debt to the local bank. Since Jack has been an active community leader for a long time, the bank forgives $50,000 of his debt on the last day of the current year. Jack's liabilities were $150,000 before the discharge of the debt and $100,000 after discharge of debt. The FMV of Jack's assets before the debt discharge is $130,000. Jack has a net operating loss carryover to the current year of $60,000. At the end of the current year, the tax bases of his assets consist of $80,000 depreciable assets and $10,000 of inventory. In addition, Jack has taxable income of $25,000 before the debt discharge. Assuming that Jack does not elect to first reduce the basis of depreciable property, what is the amount of reduction to his tax attributes for the excluded debt discharge income? **(Page 279)**

    a. $50,000. [This answer is incorrect. This is the amount is the gross discharge amount of which $20,000 is excludable and $30,000 is taxable.]

    b. $20,000. [This answer is incorrect. Jack's insolvency is the excess of his liabilities over the FMV of his assets immediately before the discharge, or $20,000 (150,000 − 130,000). The remaining amount of the discharge of $30,000 ($50,000 − $20,000) must be included in taxable income.]

    c. $15,000. [This answer is incorrect. This is the amount of debt discharge that is excluded from income but did not require a reduction to Jack's tax attributes after the reduction to the NOL carryover ($20,000 − $5,000).]

    d. $5,000. [This answer is correct. Since the tax bases of the assets of $90,000 ($80,000 + $10,000) is less than the liabilities of $100,000 ($150,000 − $50,000) immediately after the discharge, the only tax attribute that must be reduced is the NOL carryover. The NOL carryover of $60,000 remaining after the current year taxable income of $55,000 ($25,000 + $30,000) is $5,000. Thus, the NOL carryover is eliminated by the attribute reduction of $5,000.]

36. Assuming the same facts for Jack in the above question except that Jack elects to first reduce the basis of depreciable property before reducing other tax attributes, what is the amount of reduction to his tax attributes for the excluded debt discharge income? **(Page 279)**

    a. $50,000. [This answer is incorrect. This is the amount is the gross discharge amount of which $20,000 is excludable and $30,000 is taxable.]

    b. $20,000. [This answer is correct. Since Jack made the election to first reduce the basis of depreciable property, the amount excluded from income reduces the basis of his depreciable property to $60,000 ($80,000 − $20,000).]

    c. $15,000. [This answer is incorrect. This is the amount of debt discharge excluded from income that would not have required a reduction to tax attributes if Jack had not made the election to first reduce the basis of depreciable assets.]

    d. $5,000. [This answer is incorrect. This is the amount of debt discharge excluded from income that would have been a reduction to the tax attributes if Jack had not made the election to first reduce the basis of depreciable assets.]

Recourse Debt—Foreclosure by Lender

A foreclosure (or deed in lieu of foreclosure) transaction may result in debt discharge income to the borrower when recourse debt is involved. The taking of the property by the lender in satisfaction of the recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven.

As a result of these rules, it is possible for a foreclosure transaction involving recourse debt to result in both (1) a gain or loss from the sale of the property (because FMV is more or less than basis) and (2) debt discharge income (because the secured debt is in excess of FMV). The amount credited or received in the foreclosure sale determines sales proceeds for computing gain or loss. The character of the gain or loss depends on the character of the property subject to foreclosure.

Debt discharge income occurs in a foreclosure transaction only if the lender discharges part or all of any deficiency (excess of indebtedness over the property's FMV) upon taking the property securing it. If the lender continues to pursue the debtor for the deficiency, debt discharge income does not result until that deficiency is discharged for less than full value. If the lender fails to pursue the debtor or to discharge all the indebtedness, debt discharge income results when the statute (under state law) for enforcing the debt expires.

Nonrecourse Debt—Foreclosure by Lender

A foreclosure (or deed in lieu of foreclosure) transaction involving nonrecourse debt is treated as a deemed sale by the borrower to the lender with proceeds equal to the amount of nonrecourse debt. An abandonment of real property encumbered by nonrecourse financing is also treated as a deemed sale.

The amount realized on the deemed sale includes the full amount of the nonrecourse debt plus any additions to principal for items (such as accrued interest) that previously generated ordinary deductions for the borrower. For a cash-basis borrower, however, the amount realized on the deemed sale equals only the principal balance of the nonrecourse debt.

Treating the full amount of nonrecourse debt principal as the amount realized from a deemed sale means there can be no debt discharge income due to a foreclosure or deed in lieu transaction involving only nonrecourse debt. Unlike the treatment of foreclosures involving recourse debt, the FMV of the property is irrelevant. Also, insolvent or bankrupt status of the taxpayer does not affect the results.

Example 2E-1 Deeding back land in satisfaction of nonrecourse debt.

Frank purchased a parcel of land on July 1, 2007, for $320,000. He paid $32,000 down, with the balance due to the seller under a nonrecourse "contract for deed" arrangement. Annual payments of $10,000 of principal, plus interest, are due each July 1.

Frank made the payments on July 1, 2008, and July 1, 2009. However, he determined in July 2010 that it was not beneficial for him to continue to make payments on the land; his outstanding debt on the land was $268,000, and its value was only $200,000. Frank agreed to transfer the land back to the seller in full satisfaction of the debt on December 1, 2010. Because this is a satisfaction of *nonrecourse* indebtedness, the outstanding debt amount ($268,000) becomes the deemed sales price of the land. Since the adjusted basis is $320,000, this transaction results in a capital loss of $52,000 for Frank. There is no debt discharge income because the debt was all nonrecourse.

Example 2E-2 Deeding back depreciable real estate in satisfaction of nonrecourse debt.

Lotta purchased an apartment building in 2001. She financed the entire purchase with a $500,000 nonrecourse loan from Bucks Savings. By the end of 2010, the land and building had an adjusted tax basis of $350,000, and the building was experiencing negative cash flow.

Lotta could not continue to fund the negative cash flow, and on December 31, 2010 she deeded the building back to Bucks. At the time of the transfer, the nonrecourse loan principal balance was $497,000. Lotta was insolvent as of December 31, 2010.

The transfer to the lender is a deemed sale for $497,000—the amount of nonrecourse debt satisfied by the transfer. Thus, Lotta has a 2010 gain of $147,000 ($497,000 sales proceeds − $350,000 adjusted basis). None of the gain can be characterized as excludable debt discharge income, even though Lotta was insolvent when the property was deeded back.

Reduction of Seller-financed Debt

A special rule may apply when seller-financed (i.e., purchase money) debt of the property purchaser is reduced. This rule applies only if (1) the creditor is the original seller of the property, (2) the debt arose from the debtor's purchase of the property, and (3) the purchaser (debtor) would recognize debt discharge income except for this provision (i.e., the purchaser is not bankrupt or insolvent and did not make a qualified real property debt election).

If these conditions are satisfied, the purchaser reduces the basis in the property acquired with the seller-financed debt and does not recognize debt discharge income. This treatment is not elective; it is mandatory if the requirements of IRC Sec. 108(e)(5) are met.

Example 2F-1 Reduction of seller-financed residential mortgage.

Stella bought her residence from Fran in 2007 for $135,000. Fran financed the transaction by taking back a recourse $125,000 mortgage from Stella in addition to receiving a $10,000 cash down payment. Stella made her payments to Fran until the middle of 2010. She threatened to abandon the property unless Fran reduced the remaining mortgage debt. (The property had substantially decreased in value.)

Fran agreed to reduce the remaining balance of Stella's mortgage from $121,000 to $100,000, and Stella agreed to make payments to Fran under a revised loan amortization schedule. Stella was solvent at the time of the debt reduction.

Stella must reduce her basis in the home by $21,000 to reflect the reduction in the purchase money debt owed to Fran. Stella does not recognize any debt discharge income because (1) the debt arose from the purchase of the property, (2) the original seller of the property held the obligation that was reduced, and (3) Stella was solvent at the time.

Variation: The result would be the same even if the purchase money debt involved was nonrecourse instead of recourse. If the requirements of IRC Sec. 108(e)(5) are met, basis reduction is mandatory; whether the debt is recourse or nonrecourse is irrelevant.

The seller-financed debt basis reduction rule applies to a partially insolvent taxpayer to the extent he is solvent. Therefore, a taxpayer can exclude debt discharge income (1) to the extent he is insolvent under the general rules of IRC Sec. 108(a), and (2) in excess of his insolvency under the seller-financed debt rule discussed in this lesson—assuming the rule otherwise applies.

The reduction of undersecured nonrecourse debt by a third-party lender (i.e., a lender other than the seller) is treated as a Section 108(e)(5) purchase price reduction (i.e., resulting in a reduction of basis rather than debt discharge income) to the extent the reduction is based on an infirmity that clearly relates to the original sale (e.g., the seller's inducement of a higher purchase price by misrepresentation of a material fact or fraud). This is a limited exception to the rule that a basis adjustment (rather than income) is available only for seller-financed debt. Alternatively, if IRC Sec. 108(e)(5) does not apply but the debt is qualified real property business debt, the taxpayer may be able to elect to exclude the debt discharge income under IRC Sec. 108(a)(1)(D).

Consumer Credit Card Debt Modification

Credit card debt default and delinquencies have risen in recent years. Late payments generally result in significant penalties and higher interest rates on the unpaid balances. As a result, the fees, penalties, and interest portion of a taxpayer's credit card balance may exceed the amount originally borrowed.

Applicable Exceptions to Income Recognition. No income is realized from the discharge of indebtedness to the extent that payment of the discharged liability would have resulted in a deduction. Since consumer credit card debt is generally nonbusiness, this rule is not likely to prevent the recognition of income when this debt is modified.

A purchase-money debt reduction for a solvent debtor is treated as a reduction of the purchase price rather than a cancellation of indebtedness. However, the Tax Court has rejected the application of this rule to the modification of consumer credit card debt for accumulated interest charges that were cancelled. Thus, unless a taxpayer is in bankruptcy or insolvent, a reduction in his credit card liability will result in income.

The Measure of Income Recognition. The Tax Court has held that a credit card company's forgiveness of defaulted interest is cancellation of debt (COD) income to the cardholder. Another Tax Court decision involving a loan transaction is equally applicable to credit card debt. The Court, in *Hahn, Jr.*, ruled that COD income includes not only a cancellation of principal, but also a cancellation of an obligation to pay interest, late charges, and attorneys' fees. Consequently, solvent credit card holders generally must include in income the full amount of any credit card debt reduction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. If a lender takes property in satisfaction of the borrower's recourse debt, it is treated as a deemed sale of the property. What is the character of the gain or loss, if any, on the deemed sale of the property?

    a. Same as the character of the property subject to foreclosure.

    b. Long-term capital asset.

    c. Short-term capital asset.

    d. Based on the length of time from the origination of the debt to the foreclosure date.

38. With regard to a foreclosure transaction involving nonrecourse debt, which of the following statements is correct?

    a. The amount realized from the deemed sale is equal to the fair market value of the property.

    b. The fair market value of the property is not a factor in the transaction.

    c. There will always be debt discharge income when the foreclosure involves nonrecourse debt.

39. When seller-financed debt of property that arose from the debtor's purchase of the property is reduced and certain conditions are met, the debtor reduces the basis of the property and does not recognize debt discharge income. Which of the following is **not** a condition that must be satisfied to apply this rule?

    a. The creditor is the original seller of the property.

    b. The debt arose from the debtor's purchase of the property.

    c. The debtor would recognize debt discharge income if it were not for this exception.

    d. The debtor must have owned the property for one year or less.

40. Chris sold an office building to Carrie for $1 million. Carrie signed an unsecured note payable to State Bank, a third-party lender, for the amount of $1 million. The price Carrie paid for the building was $100,000 more than should have been paid due to Chris's material misrepresentations to support a higher price. After the sale, the fair market value of the building was $900,000. State Bank agrees to reduce the amount of the Carrie's debt from $1 million to $900,000 due to the misrepresentations. How does Carrie treat the debt discharge for tax purposes?

    a. Purchase price reduction.

    b. Taxable income.

    c. Taxable loss.

    d. No tax consequences to the debt discharge.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. If a lender takes property in satisfaction of the borrower's recourse debt, it is treated as a deemed sale of the property. What is the character of the gain or loss, if any, on the deemed sale of the property? **(Page 289)**

    a. Same as the character of the property subject to foreclosure. [This answer is correct. According to Reg. 1.1001-2(c), for the deemed sale, the proceeds are equal to the lesser of the FMV at the time of foreclosure or the amount of the secured debt. The character of the gain or loss on the deemed sale is the same as it would have been if the borrower had sold the property to a third party.]

    b. Long-term capital asset. [This answer is incorrect. According to IRS regulations and revenue rules, the character of gain or loss will not be treated as a long-term capital asset. Other treatment is required.]

    c. Short-term capital asset. [This answer is incorrect. Other treatment of the gain or loss is required under the guidance provided by the IRS regarding foreclosures by the lender.]

    d. Based on the length of time from the origination of the debt to the foreclosure date. [This answer is incorrect. The timing described above is not applicable to the determination of the character of gain or loss in the above scenario. The correct answer is found in the IRS revenue rules and regulations.]

38. With regard to a foreclosure transaction involving nonrecourse debt, which of the following statements is correct? **(Page 289)**

    a. The amount realized from the deemed sale is equal to the fair market value of the property. [This answer is incorrect. The fair market value is the amount realized for transactions involving recourse debt.]

    b. The fair market value of the property is not a factor in the transaction. [This answer is correct. As reflected in the outcomes of various court cases, the amount realized on the deemed sale is the balance of the nonrecourse debt.]

    c. There will always be debt discharge income when the foreclosure involves nonrecourse debt. [This answer is incorrect. Since the full amount of the nonrecourse debt is treated as the amount realized, there can be no debt discharge income.]

39. When seller-financed debt of property that arose from the debtor's purchase of the property is reduced and certain conditions are met, the debtor reduces the basis of the property and does not recognize debt discharge income. Which of the following is **not** a condition that must be satisfied to apply this rule? **(Page 290)**

    a. The creditor is the original seller of the property. [This answer is incorrect. This condition is one of the three conditions listed in the Internal Revenue Code that is required to reduce the basis of the property.]

    b. The debt arose from the debtor's purchase of the property. [This answer is incorrect. This condition is one of the three conditions that is required by the Code to reduce the basis of the property.]

    c. The debtor would recognize debt discharge income if it were not for this exception. [This answer is incorrect. This condition is one of the three conditions that is required to reduce the basis of the property. Under the Code, the purchaser cannot be bankrupt or insolvent and must not have made a qualified real property debt election.]

    d. The debtor must have owned the property for one year or less. [This answer is correct. This is not a condition that must be met under the Code to reduce the basis of property when the seller-financed debt is reduced. The holding period of under the Code the property does not affect the mandatory requirement to reduce the basis of property.]

40. Chris sold an office building to Carrie for $1 million. Carrie signed an unsecured note payable to State Bank, a third-party lender, for the amount of $1 million. The price Carrie paid for the building was $100,000 more than should have been paid due to Chris's material misrepresentations to support a higher price. After the sale, the fair market value of the building was $900,000. State Bank agrees to reduce the amount of the Carrie's debt from $1 million to $900,000 due to the misrepresentations. How does Carrie treat the debt discharge for tax purposes? **(Page 290)**

    a. Purchase price reduction. [This answer is correct. According to the Code, debt discharge is treated as a Section 108 (e)(5) adjustment to the purchase price (resulting in a reduction to basis) instead of income only if there is infirmity clearly relating back to the original sale such as misrepresentation or fraud by the seller.]

    b. Taxable income. [This answer is incorrect. Due to the misrepresentations made by the seller, the transaction qualifies for tax treatment other than taxable income to the buyer.]

    c. Taxable loss. [This answer is incorrect. The buyer has not suffered a taxable loss.]

    d. No tax consequences to the debt discharge. [This answer is incorrect. This transaction does have tax consequences, even though the seller misrepresented the facts.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TDBTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. For individual taxpayers, business bad debts result in what type of loss?

    a. Short-term capital losses.

    b. Long-term capital losses.

    c. Ordinary losses.

    d. Nondeductible losses.

22. For individual taxpayers, nonbusiness bad debts result in what type of loss?

    a. Short-term capital losses.

    b. Long-term capital losses.

    c. Ordinary losses.

    d. Nondeductible losses.

23. When must a taxpayer deduct a totally worthless debt?

    a. Within three years of when it becomes totally worthless.

    b. Within two years of when it become totally worthless.

    c. Only in the tax year it becomes totally worthless.

    d. In any tax year after it becomes totally worthless.

24. On which tax form is a business bad debt deduction resulting from an employee-shareholder loan to a corporation reported?

    a. Schedule A (Form 1040).

    b. Schedule C (Form 1040).

    c. Schedule D (Form 1040).

    d. Schedule F (Form 1040).

25. The statute of limitations for tax refunds relating to nonbusiness bad debt losses is which of the following?

    a. Two years.

    b. Three years.

    c. Four years.

    d. Seven years.

26. For a nonbusiness bad debt deduction, the taxpayer must attach a statement to the tax return documenting the bad debt but is **not** required to disclose which of the following information?

    a. The source of the funds that were loaned.

    b. A description of the bad debt.

    c. The debtor's name and his or her relationship to the taxpayer.

    d. The collection efforts that were made and the reason the debt is considered wholly worthless.

27. A recovery of a nonbusiness bad debt from which a taxpayer received a tax benefit is treated as which of the following?

    a. Ordinary income.

    b. Long-term capital gain.

    c. Short-term capital gain.

    d. No income tax consequences.

28. For tax purposes, the cancellation or forgiveness of a debt results in which of the following for the solvent debtor unless certain exceptions apply?

    a. Tax loss.

    b. Gross income.

    c. Tax benefit.

    d. No tax consequences.

29. When an existing debt is significantly modified to avoid default, the modification of the terms of the debt is considered an exchange of old debt for new debt and may give rise to debt discharge income. Which of the following would **not** result in debt discharge income?

    a. Modifying payment timing.

    b. Changing the security or obligor.

    c. Changing the debt instrument's nature.

    d. Applying an interest rate that equals or exceeds the AFR.

30. In order for forgiven debt to be *qualified farm indebtedness*, what percentage of a taxpayer's gross receipts from all sources for the preceding three years must be attributable to the farming business?

    a. 100%.

    b. 80%.

    c. 50%.

    d. 20%.

31. A taxpayer who is not insolvent or bankrupt may exclude income from the discharge of qualified real property business debt if the taxpayer makes a valid election for the tax year the discharge occurs. What tax form does the taxpayer file for making this election?

    a. Form 4797.

    b. Form 982.

    c. Schedule C.

    d. Schedule E.

32. The cancellation of certain student loans which were made on the condition that the student fulfill a specific public service obligation are includible in gross income only if the loan is made by any of the following **except** which one?

    a. A major commercial bank that offers private student loans.

    b. A federal, state, or local government unit, or an instrumentality, agency, or subdivision of such.

    c. A tax-exempt public benefit corporation with control of a state, county, or municipal hospital, whose employees are considered public employees under state law.

    d. A qualified educational institution that makes the loan under an agreement with a qualified entity or under a program offered by the educational institution that is designed to encourage the students to serve in occupations or areas with unmet needs.

33. For taxpayers filing a 2010 joint tax return, the maximum aggregate amount of debt that can be treated as qualified principal residence indebtedness is which of the following?

    a. $200,000.

    b. $500,000.

    c. $1,000,000.

    d. $2,000,000.

34. Hank owes $5,000 to National Bank. He also has other liabilities of $7,000 and assets with a fair market value of $9,000. Hank is insolvent by $3,000 ($9,000 assets − $12,000 liabilities). National Bank discharges Hank's debt of $5,000 in return for a payment of $1,000. Hank realizes $4,000 ($5,000 − $ 1,000) of debt discharge income. What is the amount of taxable income that Hank must recognize?

    a. $4,000.

    b. $3,000.

    c. $1,000.

    d. $500.

35. Instead of reducing tax attributes in the order specified in the Internal Revenue Code, taxpayers who are bankrupt or insolvent can elect to first reduce which of the following?

    a. Capital loss carryovers.

    b. Foreign tax credit carryover.

    c. Basis of nondepreciable assets.

    d. Basis of depreciable assets.

36. If the basis in the bankrupt or insolvent taxpayer's property is reduced under the general attribute reduction ordering rules, the aggregate basis of the taxpayer's assets cannot be reduced below which of the following?

    a. Aggregate FMV of the taxpayer's assets immediately after the discharge.

    b. Aggregate FMV of the taxpayer's assets immediately before the discharge.

    c. Aggregate liabilities immediately after the discharge.

    d. Aggregate liabilities immediately before the discharge.

37. Joan transfers to a creditor an asset with a fair market value of $6,000, and the creditor discharges $7,500 of indebtedness for which Joan is personally liable. Joan has income from the discharge of indebtedness of $1,500. The deemed sale of the asset is for what amount?

    a. 7,500.

    b. $6,000.

    c. $1,500.

    d. $2,000.

38. When property is foreclosed on due to default on a nonrecourse debt, the foreclosure is treated as a deemed sale of the property by the borrower to the lender. For a cash-basis borrower, the amount realized from the deemed sale of the property is which of the following amounts?

    a. The fair market value of the property.

    b. The tax basis of the property to the borrower.

    c. The original balance of the nonrecourse debt.

    d. The principal balance of the nonrecourse debt.

39. If debt to a seller of property that arose out of a debtor's purchase of the property meets certain conditions, which of the following describes the treatment by the debtor when the seller-financed debt is reduced?

    a. Recognize debt discharge income.

    b. Recognize gain on sale of property.

    c. Reduce the basis of the property.

    d. No tax consequences occur.

40. Which of the following is true regarding consumer credit card debt?

    a. It is usually classified as business debt.

    b. Reduction for a deductible business expense results in income.

    c. The cancellation of debt does not include interest or late charges.

    d. If a taxpayer is solvent, the reduction of liability will result in income.

GLOSSARY

Applicable Federal Rate (AFR): The IRS issues (via Revenue Rulings) prescribed rates each month to be used in determining if there is unstated interest. The AFRs are short-term, midterm, and long-term for each month with separate rates for annual, semiannual, quarterly, and monthly compounding.

Appreciated financial position: An appreciated financial position is any position relating to a stock, debt instrument, or partnership interest where there would be gain if the position were sold, assigned, or otherwise terminated at its FMV. "Position" means an interest, including a futures or forward contract, short sale, or option.

Average basis method: The average basis method may be used to determine the basis of mutual fund shares. This method may be computed using either the single-category method or the double-category method.

Bankrupt: Bankrupt means that the taxpayer's discharge from debt occurs under the jurisdiction of a court in a Title 11 (of the U.S. Bankruptcy Code) case. Title 11 encompasses the federal bankruptcy statutes and includes Chapter 7 (liquidation), Chapter 11 (business reorganization), Chapter 12 (family farmer or fisherman), and Chapter 13 (adjustment of an individual's debts) bankruptcies.

Business bad debt: A bad debt arises from a debt created or acquired in the ordinary course of the taxpayer's business, such as an account receivable, or a worthless debt, the loss from which is incurred in the taxpayer's trade or business.

Call option: An option giving the holder the right to buy at a set price on or before a specified date is referred to as a call option.

Capital asset: A capital asset is any property except inventory, depreciable or real property used in the taxpayer's trade or business, specified literary or artistic property, business accounts or notes receivable, or certain U.S. publications.

Debt discharge income: Debt discharge income is the amount of the unpaid balance of the debt that is forgiven by the lender.

Double-category method: When a taxpayer elects to use the average basis method to determine the basis of mutual fund shares, the basis may be calculated under the double-category method. Under this method, all shares of a particular mutual fund are divided (based on holding period) into two categories at the time each sale occurs: short-term and long-term. When a share is held for more than one year, the share (and its related tax basis) is transferred from the short-term to the long-term category. Average basis is calculated for each category when a share is sold.

First-in First-out (FIFO): FIFO is the method used to determine the basis and holding period of stock sold when a taxpayer does not or cannot specifically identify which shares of stock are sold. This method assumes the shares acquired first are sold first.

Forward contract: A forward contract is a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

Holding period: The period of time that a stock is held which generally begins on the day following the day of acquisition and ends on (and includes) the day of disposition.

Insolvency: For purposes of the debt discharge rules, insolvency is the amount of the excess of a taxpayer's liabilities over the fair market value of the taxpayer's assets immediately before the debt discharge.

Nonbusiness bad debts: Bad debts that do not qualify as business bad debts and are not gifts are nonbusiness bad debts.

Nonqualified stock options (NQSOs): An NQSO is any option that is not a qualified stock option, as defined in IRC Sec. 422. Generally, the excess of the stock's FMV when the option is exercised over the option price (i.e., the bargain element) is taxable as compensation in the year of exercise.

Offsetting notional principal contract: An offsetting notional principal contract is an agreement that includes: (1) a requirement to pay all or substantially all of the investment yield (including appreciation) related to the property for a specified period, and (2) a right to be reimbursed for all or substantially all of any decline in the value of the property.

Partially worthless bad debt: A debt of which the taxpayer can collect a portion but not all is a partially worthless bad debt.

Put option: A publicly traded option giving the holder the right to sell a specified stock at a set price (the strike price) on or before a specified date is called a put option.

Qualified covered call option: A qualified covered call option is any option a taxpayer grants to purchase stock he holds (or stock he acquires in connection with granting the option), but only if all of the following are true: (1) the option is traded on a national securities exchange or other market approved by the Secretary of the Treasury, (2) the option is granted more than 30 days before its expiration date, (3) the option is not a deep-in-the-money option, i.e., an option with a strike price lower than the lowest qualified benchmark (LQB), (4) the taxpayer is not an options dealer who granted the option in connection with his activity of dealing in options, and (5) gain or loss on the option is capital gain or loss.

Qualified farm indebtedness: Qualified farm indebtedness must meet the following conditions: (1) debt that was incurred directly in the business of farming; (2) at least 50% of the taxpayer's gross receipts from all sources, including farming, for the preceding three years were attributable to the business of farming; and (3) the lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

Qualified principal residence indebtedness: Qualified principal residence Indebtedness is debt that meets the Section 163(h)(3)(B) definition of acquisition indebtedness for the residential interest expense rules, but only with respect to the taxpayer's principal residence (i.e., does not include second homes or vacation homes), and with a $2 million limit ($1 million for married filing separate taxpayers) on the aggregate amount of debt that can be treated as qualified principal residence indebtedness.

Qualified real property business debt: Qualified real property business debt includes debt (1) that was incurred or assumed in connection with real property used in a trade or business and that is secured by such real property; (2) that was incurred or assumed (a) before January 1, 1993, or (b) on or after January 1, 1993 and is qualified acquisition debt (i.e., debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business); and (3) with respect to which an election to invoke the special rules of IRC Sec. 108(a)(1)(D) has been made.

Qualified Small Business Stock (QSBS): QSBS is stock originally issued after August 10, 1993, by a C corporation with aggregate gross assets not exceeding $50 million at any time from August 10, 1993, to immediately after the issuance of the stock. The taxpayer must have acquired the stock at its original issue, or in a tax-free transaction such as a gift, inheritance, or partnership distribution. In addition, the corporation must meet an active business requirement whereby 80% or more of its assets are used in one or more businesses other than those specifically excluded.

Short sale: A short sale occurs when a taxpayer borrows securities and then sells them. Economically, it amounts to a bet by the taxpayer that the price of the securities will decline. If it does, the securities can be bought (at the lower price) to replace those borrowed and sold short, and profit from the price difference.

Single-category method: When a taxpayer elects to use the average basis method to determine the basis of mutual fund shares, the basis may be calculated under the single-category method. This method includes all shares of a particular mutual fund in a single account. Each share's basis is the total basis of all shares in the account at the time of the sale, divided by the number of shares.

Small business corporation: A corporation (either C or S) is treated as a small business corporation if, when stock (Section 1244 stock) is issued, the aggregate amount of money and other property it received in exchange for stock or as a contribution to capital or paid-in-surplus does not exceed $1 million. Thus, stock associated with the first $1 million of capital (i.e., capital stock and paid-in-capital) can qualify as Section 1244 stock.

Specific identification method: When less than the entire holdings of stock is sold, a taxpayer may use the specific identification method to determine the basis and holding period of stock sold by specifically identifying which shares were sold. Adequate identification must be made by the taxpayer.

Straddle: Holding a position [including an option to buy (other than a qualified covered call as described in IRC Sec. 1092) or sell] that substantially diminishes a taxpayer's risk of loss of holding property is a straddle.

Straight debt: A straight debt is any position with respect to a debt if the position unconditionally entitles the holder to receive a specified principal amount. Interest payments are payable based on a fixed or variable rate, and the position cannot be converted (directly or indirectly) into stock of the issuer or any related person.

Tax benefit rule: If some or all of a prior year deduction provided no tax benefit because it failed to reduce tax or increase an NOL in the year deducted, the refund or recovery of the previously deducted amount is included in gross income only to the extent of the tax benefit derived from the original deduction.

Wash sale: A wash sales occurs when if, within a period beginning 30 days before the date of the sale and ending 30 days after the date of the sale, the taxpayer acquires substantially identical stock or securities. Wash sales losses from the sale or disposition of stock or securities are generally not deductible.

INDEX

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 1—Passive Activities and Pass-through Entities (TDBTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 2—The Tax Treatment of Installment Sales, Like-Kind Exchanges, Property Conversions and Personal Residence Transactions (TDBTG102)

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   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **December 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 2—The Tax Treatment of Installment Sales, Like-Kind Exchanges, Property Conversions and Personal Residence Transactions (TDBTG102)

CTEC Course No. 3039-CE-0264
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **cl.thomsonreuters.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: December 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 2—The Tax Treatment of Installment Sales, Like-Kind Exchanges, Property Conversions and Personal Residence Transactions

Course Acronym: TDBTG102

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1040 Deskbook—Course 3—Securities Transactions and Debt Transactions (TDBTG103)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   TDBTG103 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1040 Deskbook—Course 3—Securities Transactions and Debt Transactions (TDBTG103)

CTEC Course No. 3039-CE-0265
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: December 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1040 Deskbook—Course 3—Securities Transactions and Debt Transactions Course Acronym: TDBTG103

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

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(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here _____