Taxation of Corporations and their Shareholders

Documents for Lecture on Chapter 3

Property Dispositions

UNC Charlotte MACC Program

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Note from Instructor.

Tax rules in this chapter were probably covered in an earlier tax class, and should be considered a review.

However, the rules explained on pages 3-9 through 3-18 of the textbook are often the most challenging material covered in the first tax course. Many students continue to find the material to be challenging in the corporate course.

The material is challenging, because there are general rules, exceptions to those general rules, and exceptions to the exceptions.

You will find a summary analysis of the recent sale of the Charlotte NASCAR Plaza Office Building on Page 4 of these lecture materials. The building was sold for $100 million, and experts believe the selling entity had paid about $50 million for the building about 4 years earlier. The analysis (using some assumptions adopted by the instructor) shows that the total income tax burden would be $15 million higher if sold by a corporation, compared to a partnership. This shows the critical importance of the tax rules affecting capital gains and losses. In a case like this, the owners would want to take advantage of lower tax rates for long-term capital gains.

The situation is quite different for Lowe's, and its experience with its investment in Australia.

"In the fourth quarter of fiscal year 2015, we made the decision to exit our Australian joint venture investment with Woolworths Limited (Woolworths) and recorded a <u>$530 million impairment</u> of our investment due to a determination that there was a decrease in value that was other than temporary." We learn in the Lowe's annual report that this anticipated loss will be a capital loss, and the loss is not expected to be deductible, because the company will not realize capital gains in the 5-year carry forward.

The deduction is expected to be lost, because Lowe's is selling an interest in a partnership, which is a capital asset. Capital losses may only be deducted from capital gains, on a corporate tax return.

A sale of excess inventory or store buildings and land would generate a fully deductible ordinary loss.

We follow a winding path as we study the tax law related to capital gains and losses. I recommend that you begin your study of these materials on page 4, which has assumed details of the real estate sale described above for the NASCAR building.

Next, I suggest that you read page 5, which has a summary of these capital gain and loss rules. It can be difficult to understand these rules by simply reading this page once. I recommend reading these rules several times. Page 6 has a summary of the summary, which can be helpful as we look at the big picture.

Page 7 contains a chart showing a business asset purchased for $400,000, on which depreciation of $100,000 was claimed, leaving a book value or basis of $300,000. The chart will be used to analyze the impact of selling the asset for $300,000, or $400,000, or $430,000.

Pages 8 and 9 provide PowerPoint slides containing key rules. These rules will be covered in class and fully explained. Those rules are worthy of being memorized. Actually, they should be learned.

Pages 10 and 11 contain problems that demonstrate the carryforward of capital losses and the netting of those losses against capital gains. Page 12 demonstrates the carryback and carryforward of corporate capital losses, and the interplay of the rules under Section 1231 and Section 1221 which defines capital assets. Additional pages provide cases that illustrate the application of the depreciation recapture rules.

Pages 16 through 20 contain illustrations and notes related to: (1) like-kind exchanges, (2) involuntary conversions, (3) installment sales, and (4) losses on related party sales of assets.

Big Picture-Learning Objectives

Calculate amount of gain or loss recognized on the disposition of assets used in a trade or business.

- Dispositions occur in the form of sales, trades, or other realization events.
- Gain realized is equal to: (1) the amount realized less (2) the adjusted basis of an asset. (Sec. 1001)
- Amount realized is everything of value received in the transaction, less any selling costs.
- Adjusted basis is the historical cost or basis of an asset less any cost recovery deductions claimed.
- Gain realized on asset dispositions is not always recognized.

Describe the general character types of gain or loss recognized on property dispositions.

- Recognized gains must be characterized as ordinary, capital, or §1231.
  An asset's character is a function of the asset's use and holding period.
- Ordinary assets are derived from normal transactions of the business (revenues and accounts receivable), sale of short-term trade or business assets, and depreciation recapture.
- Capital assets are assets that are held either for investment or for personal use (a taxpayer's principal residence). (Sec. 1221)
- §1231 assets consist of property used in a taxpayer's trade or business that has been held for more than one year.
- Net §1231 gains are treated as long-term capital gains and net §1231 losses are treated as ordinary losses.

Explain the rationale for and calculate depreciation recapture.

- §1231 assets may be subject to cost recovery deductions (depreciation), which generate ordinary deductions.
- Gains that are created through depreciation deductions are subject to depreciation recapture. (Section 1245 and Section 1250). Any remaining gain is §1231 gain.
- Depreciation recapture does not change the amount of the gain but simply converts or recharacterizes the gain **from** §1231 gain(which is treated as a capital gain) -- **to** ordinary gain.
- Different recapture rules apply to tangible personal property (§1245) and real property (§291 for corporations only and §1250).

Describe the tax treatment of unrecaptured §1250 gains and determine the character of gains on property sold to related parties.

- When individuals sell §1250 property at a gain, the portion of the gain generated by depreciation deductions is called unrecaptured §1250 gain.
- This gain is a §1231 gain that, if treated as a capital gain after the §1231 netting process, flows into the capital gain/loss process and is taxed at a maximum rate of 25 percent.
- If a taxpayer sells an asset at a gain to a related person and the asset is a depreciable asset to the related person, the seller must characterize the entire gain as ordinary income.

Describe the tax treatment of §1231 gains or losses, including the §1231 netting process.

- After applying the depreciation recapture rules, taxpayers calculate the net §1231 gain or loss.
- If a net §1231 loss results, the loss will become ordinary (deduct from ordinary income).
- If a net §1231 gain results, the §1231 look-back rule must be applied (identify 1231 losses in last 5 years).
- After applying the look-back rule, any remaining net §1231 gain is a long-term capital gain.

Explain common exceptions to general rule that realized gains and losses are recognized currently.

- Like-kind exchanges involve trading or exchanging business assets for similar business assets.
  The gain is deferred unless boot or non-like-kind property is received.
- Involuntary conversions are the losses on property through circumstances beyond taxpayers' control. Reasons include natural disasters, accidents, theft, or condemnation.
- Installment sales occur when any portion of the amount realized is received in a year subsequent to the disposition. Amount of gain that is depreciation recapture income is recognized immediately.
- §267 related-person losses are disallowed but the related-person buyer may be able to deduct the disallowed loss if he or she subsequently sells the property at a gain.

Choice of Entity for Real Estate Investment

Did you read the Business Journal report some time ago, that indicated the Charlotte NASCAR Plaza office building sold for $100 million? The seller did not disclose the amount paid for the property earlier, but real estate sources told the Business Journal the seller likely had paid about $50 million for the property in 2010.

WOW!!! How much income tax was likely paid on the estimated $50 million gain? It makes a ton of difference if the seller is a limited liability company, rather than a regular corporation.

Top federal corporate income tax rate is 35%.
Assume state has corporate income tax rate of 5%.
Top federal individual capital gain tax rate is 20%
Assume state has an individual income tax rate of 5%.

Assume Seller is a Corporation.	
Corporate Tax Liability	
Selling price	$100,000,000
Estimated cost of the property	$50,000,000
Profit	$50,000,000
Combined corporate tax rate of 35% and 5%	40%
Federal and state corporate income tax liability	$20,000,000
Corporate net income after tax	$30,000,000
Individual income tax liability	
Net after-tax income distributed to shareholders	
Dividend income	$30,000,000
Individual income tax rate - Fed. and state capital gain rate	25%
Individual income tax liability - Federal and State	$7,500,000
After-tax cash flow for owners (on profit distribution)	**$22,500,000**
Assume Seller is a Limited Liability	
Company taxed as a Partnership.	
Sellling price	$100,000,000
Estimated cost	$50,000,000
Profit (flows through to owners)	$50,000,000
Tax paid by LLC	$0
Individual income tax rate - Fed. and state capital gain rate	25%
Individual income tax liability - Federal and State	$12,500,000
After-tax cash flow for owners (on profit distribution)	**$37,500,000**
Tax Savings by using a flow-through entity	**$15,000,000**

Technical note: State income taxes are deductible in computing federal income tax. So we have a minor omission here.
Ignores fact that some gain might be unrecaptured Sec. 1250 gain.
Ignores the net investment income tax of 3.8% under ObamaCare.

We Like Capital Gains and Hate Capital Losses

Corporations may get no current tax benefit from losses (often incurred in recessions and depressions) if those **losses** are classified as capital losses. A corporate capital loss deduction is limited to the amount of capital gains. Capital loss deductions for individuals are also limited.

Congress was helpful, by stating in Section 1221 that land, buildings, equipment, etc. used in a business are not capital assets. This means that losses on those assets are fully deductible, because those losses are not capital losses.

Of course corporations have a different view in good times when they are **realizing gains** on sale of such assets. They would like for those assets to be considered capital gains, so that capital gains can be offset by their accumulated capital loss carryovers from other years. [Classification as a capital assets is also significant when making an installment sale, or a charitable contribution of the property. Reg. 1.170A-1(c), Sec. 170(e), Sec. 453(i)]

Individuals have essentially the same concerns, **and in addition individuals use low tax rates on long-term capital gains. Corporation do not have low capital gains rates.**

Congress to the Rescue

Congress made both individuals and corporations happy, by saying you **can "have your cake and eat it too!"**

[Be Patient. Section 1221 defines capital assets to exclude business property. Section 1231 makes an exception to Section 1221 (by allowing capital gain treatment on sale or exchange of that property). Sections 1245 (business personal property) and 1250 (generally depreciable business real estate) make exceptions to Section 1231 – (which cause the some of the gain NOT to be capital gain after all).]

Section 1231 says that you get to treat net gains from sale of this business property (buildings, land, equipment, etc.) as capital gains - if you have a net gain from all such sales. (This is an exception to Section 1221.)

If you have a net loss from all sales of business property, you stay under Section 1221 which says such a loss is not a capital loss – but rather an ordinary loss. Section 1231 does not apply in this case.

A great loophole. A **proprietorship** (individual) buys a machine, uses it and sells it.

Cost of Machine	$400,000
Depreciation claimed	100,000
Book Value of machine	300,000
Savings - Deprec. (40% tax rate)	**40,000**
Machine is later sold for	$400,000

The proprietorship sells the machine for $400,000 after one year. Selling price is $400,000. Book value is $300,000. The gain is $100,000. Section 1231 will cause this gain to be treated as a capital gain.

Using a capital gains rate of 20%, the tax paid back to the government is **only $20,000**. Here, an individual taxpayer actually broke-even. However, the taxpayer **saved $40,000** and then only had to **repay $20,000** when the property was sold. The government lost $20,000.

Congress fixed that loophole, by adding **Section 1245**, which says that any gain on the sale of depreciable business personal property (not real estate, except in rare cases) is ordinary income to the extent that prior depreciation is "recaptured." This means in the case above, **Section 1245** will cause any gain up to $100,000 to be ordinary income.

What happens if the machine is sold for $415,000?

The gain is $115,000 [$100,000 ordinary gain (Section 1245) and $15,000 capital gain (Section 1231)]. If you sell the property at a loss, recapture is not an issue. If your selling price is between $300,000 and $400,000, all gain is treated as depreciation recapture. Recapture means that some gain which might otherwise be capital gain is reclassified as ordinary income.

Congress was more generous with buildings. There is no recapture of depreciation on the sale of real estate under Section 1250 as long as the building was depreciated using the straight-line method. Only excess depreciation (amount exceeding straight-line amount) is recaptured. The law has only allowed straight-line depreciation for buildings since the mid-1980s. (Section 291 provides an exception for corporations – see below.)

Lets repeat the problem above, except assume the asset is a building (and is sold for $415,000). Since straight-line depreciation has been claimed, none of the past depreciation expense is recaptured. This means that the entire gain of $115,000 is capital gain. **However,** the past depreciation is called "unrecaptured depreciation" and the related gain is called "Unrecaptured Section 1250 Gain." It is subject to a special capital gains rate of 25% under Section 1(h)(1)(D). [This is for individuals. Corporations do not have special capital gains rates.]

That means that a gain of $100,000 is taxed at 25% and the remaining gain is taxed at 15% or 20% tax rate.

Additional Special Rules

1. There are special rules for netting gains and losses from casualty losses.

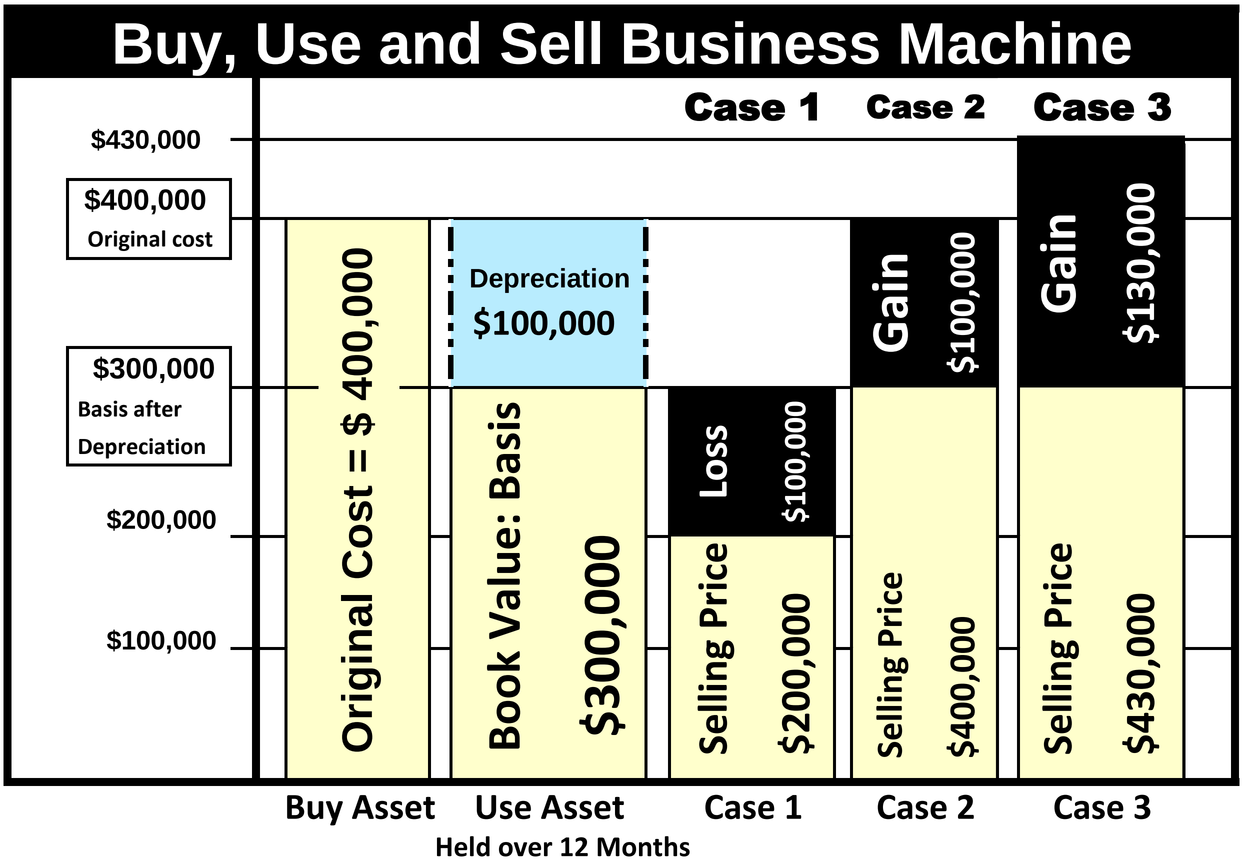
2. Section 291 provides that a corporation recaptures depreciation to the extent that its 1250 recapture (probably zero) would be higher if you used the rules under Section 1245.) Specifically, 20% of unrecaptured depreciation under section 1250 is recaptured if the taxpayer is a corporation.

A corporation buys a building for $400,000 and claims (S/L) depreciation of $100,000 on that building. Then it is sold for $415,000. Twenty percent of the $100,000 unrecaptured depreciation under Section 1250 is recaptured under Section 291 – only for corporations. Recaptured depreciation is $20,000.

3. If you sell property on the installment basis and collect nothing in the year of sale, any depreciation recapture is recognized as if you sold the property for cash. See Section 453(i).

4. Section Look-Back Rules - Sec. 1231(c) recapture of net ordinary losses.

RECAPTURE OF DEPRECIATION	
1221	**Depreciable property used in a trade or business, and real property used in a trade or business are** not capital assets.
1231	Capital gain treatment **is** <u>given</u> **to sales, exchanges, or involuntary conversions of:** **(1) depreciable or** **(2) real property used in a business,** if there is a net gain **from such property during the year.** **(but note the rule on non-recaptured Sec. 1231 losses)**
1245	**(Exception to Sec. 1231)** <u>All depreciation</u> expense **taken in past is** recaptured **(treated as** ordinary gain**) up to the** amount of gain. **<u>Depreciation recapture cannot exceed the amount of the gain.</u>** **Applies generally to depreciable personal property.** **Non-residential real property (building) is also covered if accelerated depreciation is used. However, straight-line has been required for buildings for the last 3 decades.**
1250	**Generally applies to depreciable real estate.** **Only** <u>excess depreciation</u> **is recaptured.** **(<u>Excess Depreciation</u> is the excess of actual expense depreciation claimed over straight-line depreciation.)** **If S/L is taken, no depreciation is recaptured.** **(Note the rule on non-recaptured sec. 1250 gains)** **(Gain up to unrecaptured depreciation has 25% tax rate.)**
291	<u>Section 291</u> **is an exception to Sec. 1250.** **Compare: (1) depreciation recaptured under sec. 1250 with (2) deprec. that would be recaptured under 1245, if that applied.** Recapture 20% **of the excess of: (1) what would be recaptured under 1245, over (2) actual 1250 recapture.** **Sec. 291 only applies to corporations.**



Indivduals can use preferential tax rates for long-term capital gains. Corporations cannot!!!
Section 1001: gain or loss is computed by subtracting basis from amount realized (price).
Chap. 3 instructor PowerPoints have key sentences from code sections mentioned below.

Case 1. See Textbook Exhibit 3-4 on page 3-8 for another rule summary.

Section 165: A taxpayer may deduct a loss. (Individuals have limits on loss deductions.)
An individual taxpayer may only deduct three types of losses. Section 165 (c).
[Losses in: (1) trade or business, (2) transaction entered into for profit, and (3) a casualty loss.]
If a loss is a capital loss, taxpayer must consider capital loss limits in Sections 1211 & 1212.
Section 1211: Corporation may deduct capital losses, but only from capital gains.
Section 1211: Individual may deduct capital losses only from capital gains, plus $3,000.
Section 1212: Corporations can carry net capital losses back 3 years and forward 5 years.
Section 1212: Individuals may carry net capital losses forward to future years - unlimited.
Section 1221: A capital asset is any asset **other than** inventory, depreciable property, or real estate used in a trade or business -- and several items which are not relevant here.
Solution: Loss in Case 1 is an ordinary loss for a corporation or an indivdual. (Sec. 1221 def. above.)

Case 2. See Textbook Exhibit 3-5 on page 3-10 for more on Section 1231.

[Sec. 1221 gives general rule, Sec. 1231 gives an exception, Sec. 1245 is an exception to 1231.]
Section 1221 (above): The depreciable asset is not a capital asset, so this is not a true capital gain.
Section 1231: **Treat** gains from sale of such assets as capital gains if taxpayer has a net gain from all sales of all such assets in the year. What opportunity for abuse does this provide?
Solution: Sec. 1245 provides that a gain from sale of depreciable personal property is ordinary income to the extent that the gain was caused by the company claiming depreciation ($100,000).

Case 3

Case involves a gain of $130,000, and the company has taken depreciation of $100,000.
Solution: Sec. 1245 carves out $100,000 of the gain and treats it as ordinary income (of $100,000).
Solution: Sec. 1231 controls the remaining gain. Individual or Corp. has L.T. capital gain of $30,000.

Sec. 165. Losses

(a) General Rule. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of Deduction. …the **basis for determining the amount** of the deduction for any loss shall be the **adjusted basis** provided in section 1011 for determining the loss from the sale or other disposition of property.

Sec. 165. Losses

(c) Limit on Losses of Individuals. In the case of an individual, the deduction …limited to-

- **(1)** losses incurred in a **trade or business;**
- **(2)** losses incurred in any **transaction entered into for profit**, though not connected with a trade or business; and
- **(3)** except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from **fire, storm**, shipwreck, .. or from theft.

(f) Capital Losses. Losses from **sales or exchanges of capital assets** shall be allowed only to the extent allowed in **sections 1211 and 1212**.

Sec. 1211. Limit on Capital Losses

(a) Corporations. In the case of a corporation, **losses from sales or exchanges of capital assets shall be allowed only to the extent of gains** from such sales or exchanges.

(b) Other Taxpayers. In the case of a taxpayer other than a corporation, **losses** from ..capital assets shall be allowed only **to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of- (1) $3,000** ($1,500 in the case of …a separate return), or …

Sec. 1212. Capital Loss Carrybacks…

(a) Corporations.

(1) In general. If corporation has a net capital loss..amount …shall be-

- **(A)** a capital loss **carryback to each of the 3 taxable years preceding the loss year**, ..and **…**
- **(B)** … a capital loss **carryover to each of the 5 taxable years succeeding the loss year;** and

Sec. 1212. Capital Loss Carrybacks…

(b) Other Taxpayers.

(1) In general. If a taxpayer other than corporation has a net capital loss for any taxable year-

- **(A)** the excess of the net short-term capital loss over the net long-term capital gain for such year **shall be a short-term capital loss in the succeeding taxable year**, and
- **(B)** the excess of the net long-term capital loss over the net short-term capital gain for such year **shall be a long-term capital loss in the succeeding taxable year**.

Sec. 1221. Capital Asset Defined.

(a) In General. …. **"capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include-**

- **(1)** … property of a kind which would properly be included in inventory …, or property held by the taxpayer primarily for sale to customers..
- **(2)** property, used in his trade or business, … subject to the allowance for depreciation provided in section 167, or real property used in his trade or business…..

Sec. 1221. Capital Asset Defined.

(a) In General. …. "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include…

(3) a copyright, a literary, musical, or artistic composition, **a letter or memorandum**, …by

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or.…

Sec. 1231. Property Used in the Trade or Business….

(a) General Rule.

(1) Gains exceed losses. If-

(A) the section **1231 gains for any taxable year, exceed**

(B) the section 1231 losses for such taxable year,

such gains and losses shall be **treated as long-term capital gains** or long-term capital losses, as the case may be.

Sec. 1231. Property Used in the Trade or Business….

(2) Gains do not exceed losses. If-

(A) the **section 1231 gains for any taxable year, do not exceed**

(B) the section 1231 losses for such taxable year, such gains and losses shall **not be treated as gains and losses from sales or exchanges of capital assets.**

Sec. 1231. Property Used in the Trade or Business….

(3) Section Gains and Losses. For purposes of this subsection-

(A) **Section gain.** The term " section gain" means-

(i) any recognized gain on the sale or exchange of **property used in the trade or business**, and.….

Capital Gains and Losses

A capital asset is "any asset other than inventory, receivables, copyrights, assets created by the taxpayer, and depreciable or real property used in a trade or business."

A collectible gain or loss results from the sale or exchange of works of art, gems, metals, antiques, rugs, stamps, wine, etc. held more than 12 months.

Capital Gains and Losse Holding Period

The holding period for capital assets is how long the taxpayer owned the asset.

– **Long-term means the asset was held for more than 12 months.**

– **Short-term means the asset was held for ≤ 12 months.**

Determining holding period is the first step in determining tax treatment.

1 Individual capital gains and losses for Susan and John (joint return)

Started investing in stock in 2014	2014	2015	2016	2017
Salaries for Susan and John	$70,000	$70,000	$70,000	$70,000
S.T. gain (loss) sale of IBM stock	(12,000)		(3,000)	
L.T. gain (loss) sale of ABC stock		4,000	4,000	2,000
Subtotal (may not be relevant)	58,000	74,000	71,000	72,000
Net gain or (loss) realized-current year	**(12,000)**	**4,000**	**1,000**	**2,000**
Loss carryforward [C/F] to this year	0	(9,000)	(2,000)	0
Net current gain (or loss) & C/F (loss)	(12,000)	(5,000)	(1,000)	2,000
Net gain or loss on current tax return	**(3,000)**	**(3,000)**	**(1,000)**	2,000
Salaries from above	**70,000**	**70,000**	**70,000**	**70,000**
Adjusted Gross Income- Form 1040	**$67,000**	**$67,000**	**$69,000**	**$72,000**

2 Continue # 1.What is the amount federal income tax before credits for 2017?
They have exemptions and itemized deductions totaling $20,000. Use 2016 law

Ordinary income	**$70,000**		
Exemptions and deductions	**(20,000)**		
Income taxed at ordinary rates	**$50,000**		
Top full layer in tax table	**18,550**		**1,855**
Next layer	**31,450**	**15%**	**$4,718**
Income taxed at ordinary rates	**$50,000**		
Income tax at ordinary rates			**$6,573**
Net Capital Gains & Cap. Gain Tax	**$2,000**	**0%**	**0**
Taxable income & tax before credits	**52,000**		**$6,573**

3 Gold Corporation-started in 2016

	2016	2017	2018
Sales	$200,000	$200,000	$200,000
Cost of Sales	(120,000)	(120,000)	(120,000)
Gross Margin	80,000	80,000	80,000
Operating Expenses	(20,000)	(20,000)	(20,000)
Net operating income	60,000	60,000	60,000
Current year gains and losses			
Short-term gain (loss) sale of IBM stock	(9,000)		7,000
Long-term gain (loss) sale of ABC stock		4,000	
GAAP net income before tax	**51,000**	**64,000**	**67,000**
Loss Carryforward		(9,000)	(5,000)
Amount of carryforward used on current return		(4,000)	(5,000)
Taxable Income on Form 1120	**$60,000**	**$60,000**	**$62,000**

4 What is the amount of federal income tax before credits for Good Corp. for 2016?

	$50,000	15%	$7,500
	10,000	25%	2,500
Taxable income & Tax	**$60,000**		**$10,000**

5 What is the amount of federal taxable income for Good Corporation for 2017?

Net operating income		$60,000	
Long-term gain sale of ABC stock		4,000	
Deduction of Loss carryforward.	(9,000)	(4,000)	Deduction is Limited to g
Taxable Income on Form 1120		**$60,000**	

Capital Gains Rates for Individuals - 2016

Single Taxpayer

Taxable Income	Regular Tax Rates	Long-Term Capital Gain Tax Rates
> $415,050	39.6%	20%
$415,050	35%	15%
$413,350	33%	
$190,150	28%	
$91,150	25%	
$37,650	15%	0%
$9,275	10%	

Textbook Page ___	
Code Section	1(h)
(difficult to read)	
Code Section	1211(b)
Code Section	1212(b)
Code Section	1221(a)
Code Section	1222
Special rates:	
Unrecaptured Gain 25%	Text__
Collectibles-28%	Text__

Susan is single and has no dependent. She started investing in stock in 2015.
Susan has salary of $70,000 and total exemptions and itemized deductions of $20,000 per year.
She has no other deduction, except for any allowable capital loss deduction
Assume: Current tax law and current tax rates are in effect in all years.

	2015	2016	2017	2018
Salary and lottery winnings	$70,000	$70,000	$90,000	$500,000
Short-term gain (loss) sale of IBM stock	(5,000)	0	0	0
Long-term gain (loss) sale of ABC stock	1,000	7,000	10,000	10,000
Net Capital gain (or net loss) - realized this year	(4,000)	7,000	10,000	10,000
Loss Carry-Forward from last year	0	(1,000)	0	0
Loss available this year-Include Carry-Forward	(4,000)	(1,000)	0	0
Net gain reported (net loss deducted) Form 1040	(3,000)	6,000	10,000	10,000
AGI (Adjusted Gross Income)	$67,000	$76,000	$100,000	$510,000
Exemptions and Itemized Deductions	($20,000)	($20,000)	($20,000)	($20,000)
Taxable income	$47,000	$56,000	$80,000	$490,000
Tax Rate for Long-term Capital Gains		15%	15%	20%

What is the amount federal income tax before credits for 2016?

			Income Tax
Ordinary income (Salary)	$70,000		
Exemptions and deductions	(20,000)		
Income taxed at ordinary rates	$50,000		
Amount taxed at lower rates & tax	37,650		$5,183.75
Top layer at marginal rate & tax	12,350	25%	4,822.50
Income taxed at ordinary rates	$50,000		
Income tax at ordinary rates			10,006.25
Net Capital Gains & Tax	$6,000	15%	900.00
Total Income Tax before Credits			10,906.25

1 Corporate capital gains & losses: 2013-2017:

Corporation had no capital gain or loss before 2013. Sec. 1211 and 1212.

Year	2013	2014	2015	2016	2017
Operating revenue	400,000	400,000	400,000	400,000	400,000
Operating expenses	100,000	100,000	100,000	100,000	100,000
Net operating income	300,000	300,000	300,000	300,000	300,000
Capital Gains (Losses)	30,000	(20,000)	15,000	(30,000)	60,000
2014 loss back	~~(20,000)~~	~~20,000~~			
Remaining gain	10,000				
2016 loss back	~~(10,000)~~	←		~~10,000~~	
to 2013 & 2015			~~(15,000)~~	~~15,000~~	
2016 to 2017				~~5,000~~	~~(5,000)~~
Corporate net capital gain for 2017 is:					55,000

2 Jill had AGI of $100,000 in 2017, before these transactions.

In 2017, Jill has AGI (before transactions below) of:	$100,000	$100,000
Long-term capital gain (loss) on sale of IBM stock	$2,000	$2,000
Short-term capital gain (loss) on sale of ATT stock	($8,000)	($8,000)
Gain (Loss) on sale of business land (parking lot) - held 2 years.	($4,000)	$4,000
Adjusted gross income for 2017?	$93,000	$98,000

3 Local Corporation - First year of operations. [§1211, §1212, §1221, §1231]

Please review answers in the blank, shaded cells below for Local Corporation under
5 different cases, which are independent. There is no carryover from one case to another.
All assets had been owned for 15 months before they were sold.

	Case 1	Case 2	Case 3	Case 4	Case 5
Revenue	100,000	100,000	100,000	100,000	100,000
Operating Expenses	(40,000)	(40,000)	(40,000)	(40,000)	(40,000)
Net operating income	60,000	60,000	60,000	60,000	60,000
Gain (loss) on sale of:					
IBM Stock §1221, §1211, §1212		10,000	(10,000)	(10,000)	(10,000)
Land (customer parking) §1231				(20,000)	30,000
Total from above (GAAP)	60,000	70,000	50,000	30,000	80,000
Taxable Income	60,000	70,000	60,000	40,000	80,000

Tax Table		Case 1	Case 2	Case 3	Case 4	Case 5
		Federal Income Tax Computations Below				
$50,000	15%	50,000	50,000	50,000	40,000	50,000
$25,000	25%	10,000	20,000	10,000		25,000
$25,000	34%					5,000
Taxable Income		60,000	70,000	60,000	40,000	80,000
Income Tax §11		10,000	12,500	10,000	6,000	15,450
Capital Gains Rate?		N/A	N/A	N/A	N/A	N/A

Code: §11, 1201(a), 1211, 1212, 1221, 1231, 1.1231-1(old) **Case 4, if bus. is a proprietorship?**

Suppose <u>Case 4 is for 2016</u> & <u>Case 5 is for 2017</u> for a corp. Explain §1231(c) lookback.

Depreciation Recapture - Individuals

Problem I. Straight-Line Depreciation

Selling Price				$430,000
			Total	
Original Cost			$400,000	
	St.-Line	Excess		
Accum. Depreciation	100,000		100,000	
Book Value				300,000
Gain -or-				$130,000
Loss				$0

	Recapture based on asset type		
	Case 1	Case 2	Case 3
	1245	1250	1250
	Machine	Apartment	Office Bldg.
Ordinary income - 1245		N/A	N/A
Ordinary income - 1250	N/A	N/A	N/A
Cap. gain - Unrecaptured (25% rate)	N/A		
Cap. gain - Regular Cap. Gain Rate			

Problem II. Accelerated Depreciation (Individual Taxpayer)

Selling Price				$430,000
			Total	
Original Cost			$400,000	
	St.-Line	Excess		
Accum. Depreciation	220,000	180,000	400,000	
Book Value				0
Gain -or-				$430,000
Loss				$0

	Recapture based on asset type		
	Case 4	Case 5	Case 6
	1245	1250	1245
	Machine	Apartment	Office Bldg.
Ordinary income - 1245			
Ordinary income - 1250	N/A		
Capital gain - Unrecaptured (25%)	N/A		
Capital gain - Regular CG Rates			

Note: Accelerated Depreciation was only allowed for buildings that were acquired in 1986 or before. [fully depreciated by now]

So, Cases 5 and 6 involve property acquired in 1986 or before.

Note: Corporations have additional recapture under section 291.

Depreciation Recapture - Individuals

Problem I. Straight-Line Depreciation

	St.-Line	Excess	Total	
Selling Price				$430,000
Original Cost			$400,000	
Accum. Depreciation	100,000		100,000	
Book Value				300,000
Gain -or-				$130,000
Loss				$0

	Case 1	Case 2	Case 3
Recapture based on asset type			
	1245	1250	1250
	Machine	Apartment	Office Bldg.
Ordinary income - 1245	$100,000	N/A	N/A
Ordinary income - 1250	N/A	N/A	N/A
Cap. gain - Unrecaptured (25% rate)	N/A	$100,000	$100,000
Cap. gain - Regular Cap. Gain Rate	$30,000	$30,000	$30,000

Problem II. Accelerated Depreciation (Individual Taxpayer)

	St.-Line	Excess	Total	
Selling Price				$430,000
Original Cost			$400,000	
Accum. Depreciation	220,000	180,000	400,000	
Book Value				$0
Gain -or-				$430,000
Loss				$0

	Case 4	Case 5	Case 6
Recapture based on asset type			
	1245	1250	1245
	Machine	Apartment	Office Bldg.
Ordinary income - 1245	$400,000		$400,000
Ordinary income - 1250	N/A	$180,000	
Capital gain - Unrecaptured (25%)	N/A	$220,000	
Capital gain - Regular CG Rates	$30,000	$30,000	$30,000

Note: Accelerated Depreciation was only allowed for buildings that were acquired in 1986 or before. [fully depreciated by now]

Cases 5 and 6 involve property acquired in 1986 or before.

[Due to short depreciation lives, assets would be fully depreciated.]

Note: Corporations have additional recapture under section 291.

Please review answers in the blank, shaded cells below for Local Corporation under three different cases, which are independent.

Sale of Depreciable Property	Case 1	Case 2	Case 3	
Asset Owner	Machine Individual	Machine Individual	Machine Individual	
Recapture Section?	§1245	§1245	§1245	
Cost of Machine	300,000	300,000	400,000	
Accumulated Depreciation (S/L)	(200,000)	(200,000)	(300,000)	
Extra Depreciation	0	0	0	
Adjusted Basis	**100,000**	**100,000**	**100,000**	
Selling Price	**80,000**	**120,000**	**450,000**	
Gain (Loss)	(20,000)	20,000	350,000	
Recapture under §1245		20,000	300,000	§1245
Recapture under §1250				
Section 1231 gain (Capital Gain)		0	50,000	Tax rate?
Ordinary gain or (loss)	(20,000)	20,000	300,000	[§1(h)(1)(D)]

Modifications:

§453(i). Machine in Case 3 is sold, with $50,000 to be received each year for 9 years.

§170(e)(1)(A). Machine in Case 3 is actually given to a local charity.

What is the significance of the information above, if

the taxpayer is a C corporation?

the taxpayer is an S corporation?

Like-Kind Exchanges (Sec. 1031, 61, 1001)

Black Corporation and Gold Corporation exchange real estate in a like-kind exchange.
Black Corporation gives land with a basis (tax cost) of $300,000 and a value of $400,000.
Gold Corporation gives a building (like-kind property) worth $400,000 to Black Corp.

1. **Black's realized gain?** **$100,000**   2. **Black's recognized gain?** **$0**
3. **Black's basis in the building?** **$300,000**

Part 1. How much gain is realized by Black Corporation?

Sec. 61. Gross Income Defined. **Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) … (3) Gains derived from dealings in property;…**

Section 1001 (a) provides that the gain realized is the excess of the amount realized over the basis of property given.

Section 1001(b) provides that the amount realized includes money and FMV of other property received.

Reg. 1.1001-2 provides that amount realized from sale or exchange of property includes debt of the transferor that is discharged.

		Case B	Case C
FMV of all Property (Consideration) Received:			
Value of Like-Kind Property Received	$400,000		
Other property, include our Debt assumed by other party	0		
Total Value Received	400,000		
Less: Basis of all property (Consideration) Given:			
Basis of Like-Kind property (and other property given)	300,000		
Gain Realized	**100,000**		
Boot Received (Property-not-like-kind)	**0**		
Gain Recognized (lesser of gain realized or boot received)	**$0**		

Part 2. How much gain is recognized by Black Corporation?

Section 1001 (c) provides that the gain realized is generally recognized.

Section 1031 (a) provides that no gain or loss is recognized on an exchange of property held for productive use or investment solely for like-kind property.

Section 1031 (b) provides that gain is recognized in a like-kind exchange to the extent of boot (cash and other non-like-kind property) received.

Section 1.1031(b)-1(c) provides that assumption of debt of a transferor is treated as other property being received by the transferor.

Part 3. Black Corporation's Basis in new property Section 1031(d).

1	Basis of property given to other party	$300,000		
2	Plus amount of gain recognized	0		
3	Less money, etc. received (include debt discharged			
4	**Basis of new Property**	**$300,000**		

Section 1031(d). **If property was acquired on an exchange described in this section …, then the basis shall be the same as that of the property exchanged, *increased* in the amount of gain, *decreased* by any money received by the taxpayer, and or *decreased* in the amount of loss to the taxpayer that was recognized on such exchange.**

Part 4. Now assume Gold pays cash of $400,000 to Black Corp. for the land.

Case B. (Gold gives building worth $340,000 and cash of $60,000 for the land.)

Case C (Gold gives building worth $280,000 & $120,000 cash.) (Or Apple stock worth $400,000)

JanCorp wants a warehouse that is at a more convenient location.

Case 1, Jan Corp will sell its current warehouse and buy a another warehouse.

Cases 2 & 3, Jan Corp will trade its warehouse for another warehouse.

JanCorp's Current Warehouse	Case 1	Case 2	Case 3	Code		
Bought in 1990 at a cost of:	$400,000	$400,000	$400,000	1012		
Depreciation claimed	$180,000	$180,000	$180,000	1016	a	2
Adjusted Basis	**$220,000**	**$220,000**	**$220,000**			
Current market value	$500,000	$500,000	$500,000			
Mortgage on JanCorp's building			$100,000			

What Jan Corp. will receive:	Case 1	Case 2	Case 3	
Cash received, if building is sold:	$500,000			
Jan corp will buy a building for:	$500,000			
Trade for a building with FMV of:		$500,000	$400,000	
Other party assumes JanCorp's mortgage			$100,000	
Jan Corp's gain realized	$280,000	$280,000	$280,000	1001
Jan Corp's gain recognized	$280,000	$0	$100,000	1031 a,b
Jan Corp's basis in new building	$500,000	$220,000	$220,000	1031 d

What are the tax results of each alternatives above. Address these issues:
(1) gain realized, (2) gain recognized (3) basis of new building.

Example. Herman exchanged equipment with FMV of $100,000 and a basis of $90,000 for:
(1) $14,000 cash and (2) like-kind business equipment with a FMV of $86,000.

FMV of Consideration Received		**Amount**
Value of Like-Kind Property Received	$86,000	
Other Assets Received	$14,000	$100,000
Basis of Consideration Given		
Cost of Like-Kind property given	**?**	
Accumulated Depreciation	**?**	
Basis of "Like-Kind" property given	$90,000	
Cash and Basis of Other Assets Given	$0	$90,000
Gain Realized		$10,000
Gain Recognized (lesser of gain realized or boot received)		**$10,000**
Basis of acquired asset		**Amount**
Basis of like-kind asset given:	$90,000	
Add: Boot given (non-like-kind property)	$0	
Less: Boot Received (non-like-kind property)	($14,000)	
Add: Gain Recognized	$10,000	
Basis of Acquired Like-Kind Asset		**$86,000**
Basis - New Asset- Method 2		**Amount**
FMV of Asset Received		$86,000
Less: Gain not Recognized on exchange		$0
Add: Loss not Recognized on exchange		$0
Basis - New Asset		**$86,000**

If two assets (other than cash) are received, allocate basis to those assets in proportion to Fair Market Value.

Involuntary Conversions under Section 1033.

Property taken by city under eminent domain.
Or property is destroyed by fire and is covered by insurance, etc.
Deferral of Gain: Section 1033(a)(2)(A).
Basis of New Asset: Section 1033(b).
Good Basis Examples: Reg. 1.1033(b)-1

1. Deferral under Section 1033 applies only to Gains [not Losses].
2. Deferral under Section 1033 must be elected - it is optional.
3. Sec. 1033 is not applicable to losses. Losses are deductible under Section 165.
4. Under Sec. 1033(a)(2)(A),
Gain Realized is <u>"Recognized"</u> to extent proceeds from conversion [insurance payments, government payments, etc.] **are not spent on replacement property. [Reg. 1.1033(a)-2(c)]**
5. Gain recognized cannot exceed the amount of gain realized.
6. Gain realized, but not recognized, is referred to as "Deferred Gain."
7. Basis of replacement property is its cost, less the amount of the gain that is deferred. [Sec. 1033(b)(2), Reg. 1.1033(b)-1(b)]

In Case 1 below, the taxpayer had an old building with a basis (book value) of $70,000.
The old building had a fair market value of $200,000.
The City condemned the property and paid the taxpayer $180,000 for the property.
The taxpayer bought a new building for $230,000, using the $180,000 received from the City and $50,000 which it had in a savings account.

Column 6 shows the amount of payment received from the City, that was not spent on a new building, if any. You need to know that number to compute the amount of gain recognized.

Col-1	Column-2	Column-3	Column-4	Column-5	Column-6	Column-7	Column-8	Column-9	Column-10
Case	Basis of Old Building	FMV of Old Building	Cash Received	Cost of new Building	Proceeds Not Spent	Gain (loss) Realized	Gain (loss) Deferred	Gain (loss) Recognized	Basis of New Building
1	70,000	200,000	180,000	230,000		110,000	110,000	0	120,000
2	70,000	200,000	180,000	150,000	30,000	110,000	80,000	30,000	70,000
3	95,000	115,000	115,000	140,000	-	20,000	20,000	0	120,000
4	100,000	80,000	80,000	70,000	10,000	(20,000)	-	(20,000)	70,000

What do you recommend if taxpayer in Case 3 has a $40,000 capital loss carryforward to this year?

1. **Raleigh had GAAP income before tax of $200,000 in 2016, not counting gain on asset sale.**
   Raleigh bought land for $60,000 in 2005 as a investment.
   Raleigh sold the land to Miami Corporation on December 31, 2016, for $100,000.
   Miami Corp. paid $25,000 on 12-31-2016.
   Miami will make 3 payments of $25,000 (plus interest) on last day of 2017, 2018 and 2019.
   Raleigh prepares GAAP financial statements and recognizes the entire gain in 2016.
   GAAP net income before tax will be $200,000 in 2017, 2018, and 2019.
   Raleigh is in the 40% income tax bracket in 2016 and will be in that bracket in future years.
   There is no state income tax. Installment sales method is used on income tax return.
   What is Raleigh 's capital gain reported on the 2016 federal income tax return? **$10,000**

	GAAP-2016	Return-2016
Revenue	$800,000	$800,000
Operating Expenses	($600,000)	($600,000)
Net income before taxes-before gain	$200,000	$200,000
Gain (Cost $60,000, Sold for $100,000)	$40,000	$10,000
Net income before taxes	$240,000	$210,000
Income tax expense	**$96,000**	
Income tax payable - per tax return		**$84,000**

Prepare journal entries for income tax expense?

	2016		2017		2018		2019	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Income Tax Expense	96,000		80,000		80,000		80,000	
Deferred Tax Liability		12,000	4,000		4,000		4,000	
Tax Payable Currently		84,000		84,000		84,000		84,000

Income tax expense is $16,000 higher in 2016 than later.

2. **Continue question. Deferred tax liability balance at end of 2018?** **$4,000**

	GAAP [Credits are in parenthesis "( )"]					Tax: Debits & Credits [Credits are in parenthesis "( )"]						
	Cash	Note Receiv.	Land	Gain Recognized	Bk. Value Note Rec	Cash	Note Receiv.	Land	Deferred Revenue	Gain: 1120	Tax Basis Note Rec	Basis Difference
Sale		$100,000	($60,000)	($40,000)	$100,000		$100,000	($60,000)	($40,000)		$60,000	$40,000
Payment-2016	$25,000	($25,000)			($25,000)	$25,000	($25,000)		$10,000	$10,000		
Balance		$75,000			$75,000		$75,000		($30,000)		$45,000	$30,000
Payment-2017	$25,000	($25,000)			($25,000)	$25,000	($25,000)		$10,000	$10,000		
Balance		$50,000			$50,000		$50,000		($20,000)		$30,000	$20,000
Payment-2018	$25,000	($25,000)			($25,000)	$25,000	($25,000)		$10,000	$10,000		
Balance		$25,000			$25,000		$25,000		($10,000)		$15,000	$10,000
Payment-2019	$25,000	($25,000)			($25,000)	$25,000	($25,000)		$10,000	$10,000		
Balance		$0			$0		$0		$0		$0	$0

Deferred tax asset is 40% of ending "difference in basis." 40% of $10,000 (2018). See FASB.
How does your answer change if you learn in 2018 that the tax rate in 2019 is reduced to 25%?

Loss on Sale of Property to Related Party

Loss on Sale of Property to Related Party is not deductible. Gain recognized by the related party on a later sale of the property is reduced by the earlier disallowed loss.

Ann bought some stock for $500.
Ann is thinking about selling the stock to her sister, Betty.
What are the tax consequences to Ann when she sells the stock to Betty in each of the four cases below?
Later, Betty may sell the stock to Carla, who is unrelated.
What are the tax consequences to Betty when she sells to Carla in each of the four cases below?

References Code: Section 267

Transactions Between Related Parties

Sec. 267(a)(1), (d). Reg. 1.267(d)-(1)(a)(4)	Case 1	Case 2	Case 3	Case 4
1 Ann				
Bought Stock for:	**$500**	**$500**	**$500**	**$500**
2 Ann sells stock to Betty				
(Betty is Ann's sister)				
Ann sold stock to Betty for:	**$600**	**$300**	**$300**	**$300**
Effect on **Ann's** Tax Return				
Gain recognized on return	**$100**	**$0**	**$0**	**$0**
Loss recognized on return	**$0**	**$0**	**$0**	**$0**
3 Betty sells to Carla (unrelated)				
Betty sold stock to Carla for:	**$800**	**$180**	**$450**	**$600**
Betty' cost of the stock	**$600**	**$300**	**$300**	**$300**
Effect on **Betty's** Tax Return				
Gain recognized on return	**$200**		**$0**	**$100**
Loss recognized on return		**($120)**		

What other deduction limits are found in Sec. 267?

TAX BRIEF

INDIVIDUAL

Instructor note. This is a summary of a 7-page case. This is an edited version of an article appearing in the Journal of Accountancy. Editing consists of adding some code sections and highlighting some items.

Capital Loss vs. Ordinary Loss – Journal of Accountancy - February 1999.

When taxpayers realize losses, they generally prefer to classify them as ordinary business losses rather than capital losses. In the case of the financial misadventures of Richard L. Matz, this was not to be.

Matz claimed **ordinary business losses and interest deductions totaling over $4 million for failed start-up companies and real estate ventures.** The IRS denied the business deductions and determined instead that he underpaid his taxes by approximately **$900,000**
(*Richard L. Matz, et ux.* v. *Commissioner*, TC Memo 1998-334).

Matz was primarily a real estate broker, but he also invested in real estate, from which he reported losses of several million dollars. **He had bought and sold 45 real estate properties over a period of three decades**. Matz claimed that he was in the business of acquiring, developing and selling real estate for profit and that he held the real estate for sale to customers in the ordinary course of business. **This reasoning would support the classification of his current real estate losses as ordinary business losses rather than capital losses. (Sec. 1001, 165(f), 1221, 1211)**

The Tax Court, however, disagreed. It determined that the sales were not frequent and substantial enough to qualify the activity as a trade or business.
Accordingly, the court deemed Matz's real estate losses capital losses.

In its decision, the court listed seven factors that determine whether a sale of land is considered to be a sale of a capital asset or a sale of property held primarily for sale to customers in the ordinary course of business. **(Sec. 1221).** The frequency and substantiality of sales are the most important factors. No precise number of sales is needed to be in a trade or business, and one court held that a single real estate transaction could qualify an activity as a trade or business.

Matz also invested in six start-up businesses, including a commuter airline, from the 1960s through the late 1980s. He asked for a refund of his investment in the airline stock and received a $325,000 note, which became worthless. He deducted the loss as an ordinary loss under IRC section 165(a) and (c)(1) and as a **business bad debt** under IRC section 166(a). He claimed he was in the business of promoting, developing, organizing and financing start-up businesses.

To be engaged in a trade or business, an individual must be involved in an activity with continuity and regularity and for the primary purpose of earning income or profit. The Tax Court determined that Matz's business development activity was sporadic and not a regular trade or business that would generate an ordinary loss under section 165(c)(1). **The loss was a nonbusiness bad debt** treated as a capital loss under **section 166(d)** rather than a fully deductible business bad debt under **section 166(a).**

Observation: When an entrepreneur or real estate developer seeks to deduct a loss from a small business or a real estate venture, it is critically important to have documentation that supports classifying the activity as a trade or business.

—Howard Godfrey, CPA, PhD,
professor of accounting, University of North Carolina at Charlotte.

Azar Nut Company

Capital loss: Business expense deduction: Capital assets definition: "Used in" exception (May 15, 1991),

91-1 USTC ¶50,257], U.S. Court of Appeals, Fifth Circuit, (May 15, 1991)

(CA-5), U.S. Court of Appeals, 5th Circuit, 90-4462, 5/15/91, **Affirming the Tax Court, 94 TC 455**, Dec. 46,470 [*Code Secs. 162 , 165 and 1221*]

Davis, Circuit Judge:

Azar Nut Company ("Azar") incurred a loss when it sold a house purchased from an employee pursuant to an employment contract. The Tax Court rejected Azar's attempt to deduct the loss as an ordinary loss under I.R.C. §165 or as an ordinary and necessary business expense under I.R.C. §162. **We affirm.**

Azar processes, packages, and markets nuts in El Paso, Texas. As the owners approached retirement age, they decided to gradually lessen their management participation in Azar. After a search for a high level executive to succeed them, they hired Thomas L. Frankovic as Executive V-P and COO.

During contract negotiations, Frankovic insisted that he would not accept employment with Azar unless Azar agreed to purchase his El Paso residence for its fair market value upon termination of his employment. The Azar brothers were told by other corporate executives in their industry that they would not be able to hire a qualified high-level executive without first agreeing to purchase his residence at fair market value. Azar ultimately agreed to purchase Frankovic's El Paso residence for its fair market value upon termination of his employment, and incorporated that agreement into Frankovic's employment contract. [1]

After two years, Azar fired Frankovic and purchased his house for $285,000. Azar immediately listed the house, but did not sell it for almost two years.

Azar realized about $185,000 on the sale and incurred a loss of $111,366.

Azar deducted $111,366 as an ordinary and necessary business expense on its 1984 tax return.

The Commissioner disallowed the deduction and assessed a deficiency after recharacterizing the loss as a capital loss. Azar petitioned the United States Tax Court for a redetermination of the deficiency. **The Tax Court held that Azar had incurred a capital loss, thus limiting Azar's deduction to the extent of Azar's capital gains. I.R.C. §1211. Azar had no capital gains in 1984.**

Azar appeals.

Some text omitted by instructor

Section 165(a) of the Internal Revenue Code allows taxpayers to **deduct "any loss sustained** during the taxable year and not compensated for by insurance or otherwise," unless the loss was incurred from the disposition of a capital asset. **When a capital asset is incurred, corporate taxpayers may deduct the loss "only to the extent of [capital] gains."** **I.R.C. §1211** ; **see I.R.C. §§165(f), 1212.**

The deductibility of Azar's loss under §165(a) depends, therefore, on whether the house was a capital asset or an ordinary asset.

Azar concedes that the house falls within the general statutory definition of "capital asset": "property held by the taxpayer (whether or not connected with his trade or business)." I.R.C. §1221. But Azar urges this Court to exempt the house from capital asset treatment based on §1221(2), which excepts from the definition of "capital asset" any property **"used in [the taxpayer's] trade or business."** Azar argues that this "used in" exception includes any asset acquired by a taxpayer under the terms of a contract or similar agreement that is an integral part of the taxpayer's business, even if the asset never plays a role in business operations after its acquisition.

Azar's interpretation of the "used in" exception essentially excludes from capital-asset treatment any asset purchased with a "business purpose," as that term was used under the *Corn Products* Doctrine. *See Corn Products Refining Co. v. Commissioner* [55-2 USTC ¶9746], 350 U.S. 46, 76 S.Ct. 20, 100 L.Ed. 29 (1955); *[some citations omitted by instructor]* In *Corn Products,* a taxpayer purchased corn futures on a commodities exchange to "hedge" against shortages and price increases in the raw corn market. The Court treated the corn futures as ordinary assets under §1221(1), but did not state explicitly whether its holding was predicated on a broad reading of the inventory exception or on a narrow reading of the definition of a capital asset. This ambiguity in *Corn Products* and the apparent willingness of the Court to depart from the literal language of §1221 allowed courts in subsequent decisions to create a general, nonstatutory exception from the definition of "capital asset" for all assets acquired with a business purpose beyond mere investment. *E.g., Campbell Taggart* [84-2 USTC ¶9869], 744 F.2d at 456-58.

The Supreme Court recently renounced the *Corn Products* Doctrine in *Arkansas Best Corp. v.* *Commissioner* [88-1 USTC ¶9210], 485 U.S. 212, 108 S.Ct. 971, holding that **business purpose is irrelevant** to determining whether an asset falls within the general definition of "capital asset." Azar urges us to consider business purpose in analyzing the "used in" exception.

We conclude that the plain language of §1221(2) precludes consideration of business purpose in all but the most exceptional circumstances. [2]

The words "used in" clearly require ordinary asset treatment for properties that, once acquired, play a role in the taxpayer's business operations. Those words do not suggest that an asset may be excepted from capital-asset treatment simply because the asset is **acquired with a business purpose.** To qualify under the "used in" exception, an asset must be "used in" the taxpayer's business, and an asset that has no meaningful association with the taxpayer's business operations after it is acquired cannot reasonably fall within the plain words of the statute.

If we accepted Azar's argument that acquisition of an asset for a business purpose meets the "used in" exception, we would be returning to the *Corn Products* Doctrine. The Supreme Court abandoned the *Corn Products* Doctrine not only because it created a nonstatutory exception to the definition of "capital asset," but because it led to abuse of the tax laws**. The Court in *Arkansas Best* expressed concern that the business-purpose doctrine allowed taxpayers to manipulate the tax laws, and those concerns adhere with equal force to this case:**

> [I]f capital stock purchased and held for a business purpose is an ordinary asset, whereas the same stock purchased and held with an investment motive is a capital asset, a taxpayer such as Arkansas Best could have significant influence over whether the asset would receive capital or ordinary treatment. Because stock is most naturally viewed as a capital asset, the Internal Revenue Service would be hard pressed to challenge a taxpayer's claim that stock was acquired as an investment, and that a gain arising from the sale of such stock was therefore a capital gain.

[88-1 USTC ¶9210], 485 U.S. at 222, 108 S.Ct. at 977.]

Some material omitted by Instructor here.

We conclude, therefore, that §1221(2) requires us to consider an asset's *post-acquisition* role in the taxpayer's business. The taxpayer's purpose for acquiring the asset and the method of acquisition are irrelevant to this inquiry. **After it had been acquired, the house in this case played *no role* in Azar's business of processing, packaging, and marketing nuts.** Although *Corn Products,* and other cases [citations and case names omitted by instructor], suggest that an asset must play an "integral" role or be an "essential ingredient" in the taxpayer's business before it can qualify as an ordinary asset under the "used in" exception, we need not decide in this case how central a role an asset must play before the asset has been "used in" the taxpayer's business. No matter how tenuous the bond between the asset and the business, Azar's house cannot qualify.

Azar contends in the alternative that the loss it incurred on the sale of the house is fully deductible under §162(a). Section 162(a) of the Internal Revenue Code allows taxpayers to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Even if Azar's loss were "ordinary and necessary" and were "paid or incurred during the taxable year in carrying on any trade or business," the loss is not deductible under §162(a) **because it is not an "expense."** Azar spent money to acquire a house. That expenditure "is capital by nature and not an expense." *Commissioner v. Lincoln Savings & Loan Assoc.* [71-1 USTC ¶9476], 403 U.S. 345. We reject, therefore, Azar's claim for an ordinary deduction under §162(a) .

For the foregoing reasons, we AFFIRM the decision of the Tax Court.

AFFIRMED.

Footnotes

[1] Frankovic's employment contract contained the following provision:

In the event Frankovic's employment with Azar is terminated, Azar agrees to buy the house in El Paso purchased by Frankovic at the time he began his employment with Azar and agrees to pay the packing and moving expenses incurred by Frankovic in connection with his relocation to a state within the 48 contiguous states of the United States. In the event the parties cannot agree upon the value of such residence, each party shall select an MAI appraiser . . . to make an appraisal of the residence. The average of the two appraisals shall be considered the value of the residence.

[2] The Tax Court has considered business purpose in deciding that a taxpayer who purchases an asset for use in the taxpayer's trade or business may be allowed ordinary-asset treatment under §1221(2) if the asset was "devoted to" the trade or business, even if post-acquisition events have prevented the taxpayer from actually using the asset in the manner intended. *E.g. Alamo Broadcasting Co. v. Commissioner*. This Court has not yet decided a case with these special characteristics, and our disposition of this case neither forecloses nor mandates a decision in harmony with the Tax Court.

Homework-Chapter 03. Assume the depreciation computations provided in these questions are accurate, even where there are special tax rules that may require other answers (rules for year of acquisition or disposal). The current year is **2017.**

Questions about material in Chapter 3 that will not be covered in this class have been moved to a separate file that will be posted on the course webpage in the same area.

1. Cathy owns property subject to a mortgage of $5,000. Annual real estate taxes are $1,000 and are due and payable on December 31. Cathy sells her property on **July 1.** The buyer assumes her $5,000 mortgage, and Cathy agrees to finance the sale by taking a mortgage note of $50,000 and property valued at $7,500. The buyer agrees to pay the seller's portion of the property taxes. What is Cathy's amount realized?

a. $72,000 **b.** $63,500 **c.** $63,000 **d.** $62,500 **e.** $57,500 ☐

2. On December 20, 2016, Beth sold land for $35,000. Beth inherited the land from Ann (Beth's mother) upon Ann's death **on June 1, 2016**, when the property was worth $30,000. Ann acquired the land for $20,000 in 1990. Beth reports a:

a. Short-term capital gain of $15,000 **b.** Short-term capital gain of $5,000 ☐
c. Long-term capital gain of $15,000 **d.** Long-term capital gain of $5,000

3. Terry received investment property from her mother as a gift in 2013.
Her mother paid $15,000 for the property in 2005, and it was valued at $18,000 on the date of gift. Terry sold the property eight months later for $16,000. Terry's gain or loss is

a. Short-term ordinary loss. **b.** Short-term capital gain. ☐
c. Short-term capital loss. **d.** Long-term capital gain.
e. Long-term ordinary gain

4. In 1995, your Father bought 20,000 shares of Duke Energy stock at a total cost of $200,000.
On January 1, 2015, your father gave you one-half of his Duke Energy stock (10,000 shares) having a value of $250,000 on the date of the gift. No gift tax was paid.
On August 1, 2015, your father died and left you the remaining 10,000 shares of Duke Energy stock having a value at date of death of $300,000.
On December 31, 2015, you sold all 20,000 shares of Duke Energy for $600,000. What is your gain?

a. $0 **b.** $50,000 **c.** $200,000 **d.** $250,000 **e.** $400,000 ☐

5. Bob Rich purchased a tract of land for $20,000 in 2005 when he heard that a new highway was going to be constructed through the property and that the land would soon be worth $200,000. Highway engineers surveyed the property and indicated that he would probably get $175,000. The highway project was abandoned in **2016** and the land's value fell to $15,000. Rich can claim a loss in **2016** of:

a. Zero **b.** $185,000 **c.** $180,000 **d.** $160,000 **e.** $5,000 ☐

6. Which of the following is a capital asset?

a. Business auto. **b.** Machinery used in manufacturing a product. ☐
c. Business building. **d.** Family auto.

7. An individual had AGI of $100,000 for the current year, before considering the following:

Long-term capital gain of	$3,000
Short-term capital loss of	(9,000)
Loss from sale of business auto (owned 2 years)	(1,000)

What is her adjusted gross income for the current year?

a. $96,000 **b.** $97,000 **c.** $98,000 **d.** $93,000 **e.** $94,000 ☐

8. Sue is single and earns a salary of $200,000 per year. Sue claims the standard deduction and one personal exemption for **2016.** She had short-term capital gain of $10,000 and a short-term capital loss of $8,000. What tax rate will apply to her net capital gain?

a. 5% **b.** 10% **c.** 15% **d.** 25% **e.** 33%

9. Cook Corp., a calendar year C corporation, had taxable income of $50,000 from its regular business operations for **2016**. In addition, Cook had a long-term capital gain of $10,000. Cook did not have any other capital gains or losses since it began operations. What is Cook's federal income tax liability before credits?

a. $7,500 **b.** $9,000 **c.** $10,000 **d.** Other CPA

10. Baker Corp., a calendar year C corporation, realized taxable income of $36,000 from its regular business operations for **2016**. In addition, Baker had a short-term capital gain of $8,000 and a long-term capital loss of $12,000. Baker did not realize any other capital gains or losses since it began operations. What is Baker's taxable income for **2016**?

a. $35,000 **b.** $33,000 **c.** $36,000 **d.** $32,000 CPA

11. Matthew has the following capital gains and losses for the current tax year

Short-term capital gains	$12,000
Long-term capital gains	5,000
Short-term capital losses	(7,000)
Long-term capital losses	(6,000)

What is Matthew's net capital gain or loss position for the year?

a. $4,000 net short-term capital gain **b.** $2,000 net long-term capital loss.
c. $2,000 net short-term capital gain. **d.** $4,000 net long-term capital loss.

12. O'Donnell Corporation had the following capital gains and losses for 2012 through **2016**:

2012	**2013**	**2014**	**2015**	**2016**
$30,000	$(20,000)	$15,000	$(30,000)	$60,000

O'Donnell's net capital gain for **2016** is:

a. $25,000 **b.** $30,000 **c.** $35,000 **d.** $55,000 **e.** $60,000

13. On September 2, **2016**, Arthur sold stock he bought in **October 2015** at a gain of $5,000. Arthur is in the 25% marginal tax rate bracket. He has no other capital asset sales in **2016**. What is his tax on the stock sale?

a. $ - 0 - **b.** $ 500 **c.** $ 750 **d.** $1,000 **e.** $1,250

14. Section 1231 assets include

a. Inventory. **b.** Stocks and bonds.
c. Personal residence. **d.** Business-use realty.
e. Personal automobile.

15. Sally owns 700 shares of *Fashion Clothing* common stock. Sally bought the stock as follows:

Purchase Date	Number of Shares	Total Cost
March 2007	200	$ 2,000
August 2007	300	$ 3,600
January 2008	200	$ 3,000

As of December 29, 2016, Sally has not sold any securities. She needs $5,200 for her daughter's tuition before year-end. Fashion Clothing stock is selling for $13 per share. Sally will sell 400 shares to cover the tuition. Ignoring commissions and transaction costs, what is the optimal tax result of selling 400 shares?

a. $- 0 - gain or loss. **b.** $200 long-term capital loss.
c. $100 long-term capital gain. **d.** $800 long-term capital gain

16. Barbara has taxable income of $200,000 before considering these Section 1231 gains and losses:

Section 1231	Year 1	Year 2	Year 3	Year 4
gain (loss)	$50,000	(45,000)	$20,000	$15,000

How will Barbara treat the $15,000 gain in year 4?

	Ordinary Income	Capital Gain		Ordinary Income	Capital Gain
a.	$5,000	$10,000	**c.**	$15,000	$0
b.	$10,000	$5,000	**d.**	$0	$15,000

17. In 2016, Stan sold land (bought in 2005) which he used in his auto repair business. He realized at a gain of $9,000 in **2016**. In addition, Stan sold equipment for $8,000 which he purchased in 2007. He had paid $20,000 for the equipment and it had an adjusted basis of $12,000 when it was sold. He also sold some stock in **2016** at a loss of $11,000. No losses on the disposition of assets were recognized in prior years. The effect of these transactions on Stan's **2016** taxable income is:

a. Decrease of $ 6,000. **b.** Zero, with a long-term capital loss carryback of $2,000.
c. Decrease of $ 3,000. **d.** Zero, with a long-term capital loss carryback of $6,000.

18. Arch Corp. bought some equipment for $68,000 in 2006. **In 2016,** Arch sold that equipment for $80,000, when the balance of accumulated depreciation was $28,000. Arch should report the sale as:

	Ordinary Income	Sec. 1231 Gain		Ordinary Income	Sec. 1231 Gain
a.	$12,000	$28,000	**c.**	$40,000	
b.	$28,000	$12,000	**d.**		$40,000

19. A corporation bought some equipment for $250,000 in 2006.
In 2016, the company sold that equipment for $240,000, when accumulated depreciation was $30,000. The company should report the sale as:

a. Ordinary income of $20,000. **b.** Sec. 1231 gain of $20,000.
c. Capital gain of $20,000. **d.** Sec. 1231 gain of $30,000.

20. Gail bought an apartment building for $400,000 in six years ago. **In 2016,** Gail sold that apartment building to an unrelated party for $390,000. Accumulated Depreciation (straight-line) was $60,000 on date of the sale. Gail had taxable income of $400,000 before considering this sale. What is Gail's tax rate on the gain from this sale?

a. 5% **b.** 10% **c.** 15% **d.** 25% **d** 33%

21. Jane bought an apartment building for $400,000 in **2006. In 2016,** Jane sold the building to an unrelated party for $425,000. Accumulated Depreciation (straight-line) was $60,000. What is the tax result of this sale?

	Ordinary Income	Capital Gain		Ordinary Income	Capital Gain
a.	$0	$85,000	**c.**	$60,000	$25,000
b.	$85,000	$0	**d.**	$30,000	$55,000

22. Angel Corporation bought the warehouse in 1994 for $600,000. **In 2016,** Angel sold the warehouse for $500,000, when the balance in accumulated depreciation was $200,000. Angel should report the sale as:

	Sec. 291 recapture	Sec. 1231 Capital Gain		Sec. 291 recapture	Sec. 1231 Capital Gain
a.	$20,000	$80,000	**c.**	$100,000	$0
b.	$0	$100,000	**d.**	$20,000	$0

23. Katy and Nikki each own investment realty that they would like to trade.

Katy's property has a FMV of $25,000, and is subject to mortgage debt of $10,000.
Nikki's property has a FMV of $25,000 and is subject to mortgage debt of $17,000.

Katy and Nikki agree to exchange the properties and assume each other's debt.
To complete the exchange, who pays cash and how much will that person have to pay?

a. Katy pays $15,000 **b.** Nikki pays $7,000.
c. Nikki pays $8,000. **d.** Katy pays $7,000.
e. Neither person pays anything.

24. In April of 2015, **Pam** sold stock with a basis of $15,000 to **Lisa** (her sister) for $10,000 (FMV). How much loss does **Pam** deduct?

a. $0 **b.** $2,000 **c.** $5,000 **d.** $7,000

25. Continue preceding question. Later in the year, **Lisa** sold this stock to her neighbor, **Niki**, for $16,000. How much gain does **Lisa** report?

a. $6,000 **b.** $5,000 **c.** $1,000 **d.** $0

26. Lisa sold stock (she bought 5 years ago) for $10,000 to her brother Bart for $8,000. Later Bart sold the stock for $12,000. The tax consequences to Lisa and Bart are:

	Lisa	Bart
a.	$2,000 loss	$4,000 gain
b.	No gain or loss	$4,000 gain
c.	No gain or loss	$2,000 gain
d.	$2,000 gain	No gain or loss
e.	$2,000 loss	$2,000 gain

27. Georgia Corporation sold stock (that had been purchased for $20,000) to Ms. Rich, who owns Georgia Company, for $18,000. Two months later, Ms. Rich sold the stock to Allie, an unrelated individual, for $21,000. What is Georgia Corporation's recognized gain or loss?

a. $ 0 **b.** $ 2,000 gain **c.** $10,000 gain **d.** $ 8,000 loss **e.** $ 6,000 loss

28. Georgia Corporation sold stock (that had been purchased for $20,000) to Ms. Rich, who owns Georgia Company, for $18,000. Two months later, Ms. Rich sold the stock to Allie, an unrelated individual, for $21,000. What is Ms. Rich's recognized gain or loss?

a. $ 0 **b.** $ 1,000 gain **c.** $10,000 gain **d.** $ 8,000 loss **e.** $ 6,000 loss

Federal IncomeTax Rates-Single - 2016.

Taxable income		Total Federal Income Tax			
Over	But not over	Tax on all Previous Layers		Plus	of Taxable Income over:
0	9,275	0.00	+	10%	0
9,275	37,650	927.50	+	15%	9,275
37,650	91,150	5,183.75	+	25%	37,650
91,150	190,150	18,558.75	+	28%	91,150
190,150	413,350	46,278.75	+	33%	190,150
413,350	415,050	119,934.75	+	35%	413,350
415,050		120,529.75	+	39.6%	415,050

Example: with taxable income of $9,375, rate is 10% on $9,275 and 15% on $100.

Federal Income Tax Rates: Joint - 2016.

Taxable income		Total Federal Income Tax			
Over	But not over	Tax on all Previous Layers		Plus	of Taxable Income over:
0	18,550	0.00	+	10%	0
18,550	75,300	1,855.00	+	15%	18,550
75,300	151,900	10,367.50	+	25%	75,300
151,900	231,450	29,517.50	+	28%	151,900
231,450	413,350	51,791.50	+	33%	231,450
413,350	466,950	111,818.50	+	35%	413,350
466,950		130,578.50	+	39.6%	466,950

Income Tax Rates - Separate - 2016.

Taxable income		Total Federal Income Tax			
Over	But not over	Tax on all Previous Layers		Plus	of Taxable Income over:
0	9,275	0.00	+	10%	0
9,275	37,650	927.50	+	15%	9,275
37,650	75,950	5,183.75	+	25%	37,650
75,950	115,725	14,758.75	+	28%	75,950
115,725	206,675	25,895.75	+	33%	115,725
206,675	233,475	55,909.25	+	35%	206,675
233,475		65,289.25	+	39.6%	233,475

AGI Phase-out Thresholds

Filing Status	Exemptions	Itemized Deduct.
Married, Joint	311,300	311,300
Head-of-Household	285,350	285,350
Single	259,400	259,400
Married, Separate	155,650	155,650

Exemptions reduced by:

2% for each $2,500 layer above AGI Threshhold above
(for married filing separately, layer is $1,250)

Itemized Deductions reduced by lesser of:

3% of excess of AGI over AGI Threshhold above
80% of deductions otherwise allowable, except for Medical Exp., Investment Interest and Casualty losses.

Income Tax Rates - Head of Household - 2016.

Taxable income		Total Federal Income Tax			
Over	But not over	Tax on all Previous Layers		Plus	of Taxable Income over:
0	13,250	0.00	+	10%	0
13,250	50,400	1,325.00	+	15%	13,250
50,400	130,150	6,897.50	+	25%	50,400
130,150	210,800	26,835.00	+	28%	130,150
210,800	413,350	49,417.00	+	33%	210,800
413,350	441,000	116,258.50	+	35%	413,350
441,000		125,936.00	+	39.6%	441,000

Standard Deduction	Basic	Age/ Blindness
Single	6,300	1,550
Married-Joint	12,600	1,250
Married - File Separately	6,300	1,250
Head of Household	9,300	1,550
Standard deduction for child who is a dependent of another	1,050	
Or: Earned income +	350	
Personal Exemption Amount	4,050	

AMT Exemption	Amount	Phase-out	
Joint Return	83,800	159,700	494,900
Separate Return	41,900	79,850	247,450
H-of-H and Single	53,900	119,700	335,300
AMT Rates (Joint, Head of H.,Single)		Amount	Rate
Rate on AMT base up to		186,300	26%
Rate on AMT base above		186,300	28%

OASDI rate on salary up to	$118,500	6.20%
Medicare rate on salary up to	$118,500	1.45%
Medicare rate on excess	Excess	1.45%
Extra Medicare - .9%. (Single & HH) Wages above		$200,000
Extra Medicare - .9%. (Joint) Wages above		$250,000
NII tax (3.8%) on lesser of NII or AGI (Single & HH) above		$200,000
NII tax (3.8%) on lesser of NII or AGI (Joint) above		$250,000

Federal Corporate Income Tax Rates

Taxable Income over	but not over	The tax is:			of the amount over:
0	50,000	0	+	15%	0
50,000	75,000	7,500	+	25%	50,000
75,000	100,000	13,750	+	34%	75,000
100,000	335,000	22,250	+	39%	100,000
335,000	10,000,000	113,900	+	34%	335,000
10,000,000	15,000,000	3,400,000	+	35%	10,000,000
15,000,000	18,333,333	5,150,000	+	38%	15,000,000
18,333,333				35%	