Chapter 12

Property Transactions: 
Determination of Gain or Loss, Basis 
Considerations, and Nontaxable Exchanges

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Determination of Gain or Loss
(slide 1 of 7)

• Realized gain or loss
  – Difference between amount realized from sale or other disposition of the asset and its adjusted basis
  – Sale or other disposition
    • Includes trade-ins, casualties, condemnations, thefts, bond retirements
Determination of Gain or Loss
(slide 2 of 7)

• Amount realized from disposition
  – Total consideration received, including cash, FMV of property received, mortgages/loans transferred to buyer
    • Fair market value (FMV): Value of asset determined by arms-length transaction, i.e., amount set by transaction between willing buyer and seller with neither obligated to enter into transaction
  – Reduced by any selling expenses
Determination of Gain or Loss
(slide 3 of 7)

• Adjusted basis
  – Original cost (or other adjusted basis) plus capital additions less capital recoveries
Determination of Gain or Loss
(slide 4 of 7)

- Capital additions
  - Cost of improvements and betterments to the property that are capital in nature and not currently deductible
Determination of Gain or Loss
(slide 5 of 7)

• Capital recoveries
  – Amount of basis recovered through:
    • Depreciation or cost recovery allowances
    • Casualty and theft losses (and insurance proceeds)
    • Certain corporate distributions
    • Amortizable bond premium
• Recognized gain or loss
  – Amount of realized gain (loss) that is included in (deducted from) gross income
Determination of Gain or Loss
(slide 7 of 7)

- Realized gains and losses are not always recognized
  - Realized gains may be deferred or excluded
  - Realized losses may be deferred or disallowed
Capital Recovery Doctrine
(slide 1 of 2)

• Taxpayers is entitled to recover cost or other original basis of property acquired and is not taxed on that amount

• To extent receive only investment back upon disposition of an asset, taxpayer has no gain
Capital Recovery Doctrine
(slide 2 of 2)

• Example:
  – Taxpayer buys asset for $5,000
  – If asset is sold for $5,000, taxpayer has simply recovered the basis and no gain (loss) is realized
Basis Considerations
(slide 1 of 6)

• Original basis of an asset is generally its cost
• Bargain purchase assets have a basis equal to their FMV
  – Bargain amount may be income to purchaser
    (e.g., employee = compensation; shareholder = dividend)
• Identification problems
  – Security sales where specific identification not possible, use FIFO to compute basis
• Allocation problems: lump-sum purchase
  – Must allocate basis to each asset obtained
  – Allocation usually based on relative FMV of assets
• Allocation problems: Going concern purchase
  – Assign purchase price to assets (excluding goodwill) to extent of their total FMV
  – Then allocate among assets based on FMV
  – Residual amount is goodwill
  • Goodwill is an amortizable § 197 asset
  – Allocation applies to both purchaser and seller
Basis Considerations
(slide 5 of 6)

• Allocation problems: Nontaxable stock dividends
  – Basis of original shares is allocated over the original and new shares
    • Based on number of shares (common on common), or
    • Based on relative FMV (preferred on common)
Basis Considerations
(slide 6 of 6)

• Allocation problems: Nontaxable stock rights
  – Basis in rights is zero unless taxpayer is required or elects to allocate basis from stock
    • Required to allocate if FMV of rights is at least 15% of the FMV of the stock
    • Allocation is based on relative FMV of rights and stock
Gift Basis (slide 1 of 10)

- Gift property may have a dual basis, i.e., basis for gain and loss may differ
- Basis is dependent on relationship between FMV at date of gift and donor’s adjusted basis
Gift Basis (slide 2 of 10)

• Gift basis for cost recovery
  – The donee's basis for cost recovery is the donor’s basis (donee's gain basis)
Gift Basis (slide 3 of 10)

• Gift basis for subsequent gain
  – When a gifted asset is disposed of by the donee, the basis for calculating any gain is the donor’s adjusted basis (carryover basis)
  – This basis is called the “gain basis”
    • Gain basis may be increased if donor incurred gift tax on gift
  – Holding period for donee includes that of donor
Gift Basis (slide 4 of 10)

• Gift basis for subsequent loss
  – When a gifted asset is disposed of by a donee, the basis for calculating any loss is the lesser of FMV at the date of gift or the donor’s adjusted basis
  – This basis is called the “loss basis”
Gift Basis (slide 5 of 10)

- Gift basis for subsequent loss
  - If FMV < donor’s basis on the date of the gift, a dual basis will exist for the asset
    - Gain basis = donor’s basis
    - Loss basis = FMV on date of gift
  - If dual basis and sold for loss, holding period for donee starts on date of gift
Gift Basis (slide 6 of 10)

- Gift basis when no gain or loss
  - If a dual basis exists and the amount realized from the disposition of a gifted asset falls between the gain basis and the loss basis
    - Basis of gifted asset is equal to the amount realized, and
    - No gain or loss is realized
  - Holding period for donee is not needed since there is no gain or loss
Gift Basis  (slide 7 of 10)

- Example of gift basis determination
  - Alex received a gift from Beth on June 15 this year
  - FMV of asset on June 15 was $8,000
  - Beth bought the asset on May 5, 1985 for $10,000
Example of gift basis determination (cont’d)

- If Alex sells the asset for $11,000, there is a $1,000 gain ($11,000-$10,000)
- If Alex sells the asset for $7,000, there is a $1,000 loss ($7,000-$8,000)
- If Alex sells the asset for $9,000, there is no gain or loss ($9,000-$9,000)
Gift Basis (slide 9 of 10)

• Adjustment for gift taxes
  – The proportion of gift tax paid (on gifts after 1976) by the donor on appreciation of asset can be added to basis of donee
  – The donee's basis is equal to: Donor’s basis + [(unrealized appreciation/FMV at date of gift) x gift tax]
• Example of gift tax:
  – Cathy received a gift from Darren on June 15 of this year
  – FMV on June 15 was $20,000
  – Darren had a basis in the asset of $15,000
  – Darren paid gift tax of $800
  – Cathy’s basis in the gifted property is $15,200
    \[ \$15,000 + \left( \frac{\$5,000}{\$20,000} \times \$800 \right) \]
Inherited property is always treated as long-term property.

Generally, beneficiary’s basis in inherited assets will be the FMV of the asset at decedent’s date of death.

- Exception: If the executor/administrator of estate elects alternate valuation date, basis is FMV on such date.
Property Acquired from a Decedent (slide 2 of 7)

• Inherited property valuation date
  – Date assets valued for estate tax is either:
    • Date of decedent’s death, which is called the primary valuation date (PVD), or
    • 6 months after date of decedent’s death, which is called the alternate valuation date (AVD)
      – Can only be elected if value of gross estate and estate tax liability are lower than if PVD was used
Property Acquired from a Decedent (slide 3 of 7)

- Inherited property valuation date
  - When PVD is used, beneficiary’s basis will be the FMV at date of decedent’s death
  - When AVD is used, beneficiary’s basis will be the FMV at the earliest of:
    - Date asset is distributed from estate, or
    - 6 months after date of decedent’s death
Property Acquired from a Decedent (slide 4 of 7)

- Example of inherited property valuation:
  - At Rex’s date of death, April 30 of this year, his assets had an adjusted basis of $200,000, and a FMV of $700,000
  - PVD selected and assets distributed June 30; beneficiary’s basis is $700,000
Property Acquired from a Decedent (slide 5 of 7)

• Example of inherited property valuation (cont’d)
  – October 30 this year (six months after date of Rex’s death), the assets had a FMV of $650,000
    • AVD selected and assets distributed November 10; beneficiary’s basis is $650,000
    • AVD selected and assets distributed June 30 when FMV of assets is $670,000; beneficiary’s basis is $670,000
Property Acquired from a Decedent (slide 6 of 7)

• Deathbed gifts
  – Property inherited by taxpayer (or spouse) which was both appreciated and gifted by same taxpayer to decedent within 1 year of decedent's death
  – Beneficiary’s basis in property is carryover of decedent’s basis (not date of death FMV)
    – Generally the same basis taxpayer had on date of gift
Property Acquired from a Decedent (slide 7 of 7)

- Survivor’s share of property
  - Both decedent’s share and surviving spouse’s share of community property receives basis of FMV on date of death
  - Surviving spouse’s share deemed to be acquired from a decedent
Disallowed Losses
(slide 1 of 5)

• Related parties (§ 267)
  – Losses on sale of assets between related parties are disallowed
  – For income-producing or business property, any loss disallowed can be used to reduce gain recognition on subsequent disposition of asset to unrelated party
    • Only available to original transferee
    • Not available for sales of personal use assets
Disallowed Losses
(slide 2 of 5)

• Related parties include:
  – Family members,
  – Corporation and a shareholder who owns greater than 50% (directly or indirectly) of the corporation, and
  – Partnership and a partner who owns greater than 50% (directly or indirectly) of the partnership
Disallowed Losses
(slide 3 of 5)

• Wash sales
  – Losses from wash sales are disallowed
  – Wash sale occurs when taxpayer disposes of securities at loss and acquires substantially identical securities within 30 days before or after the date of the loss sale
Disallowed Losses
(slide 4 of 5)

- Wash sales
  - Disallowed loss is added to the basis of the substantially identical securities that caused the disallowance
  - Does not apply to gains realized on disposition of securities
Disallowed Losses
(slide 5 of 5)

• Personal use assets
  – Loss on the disposition of personal use assets is disallowed
  – Personal use asset loss cannot be converted into a business (or production of income) use deductible loss
    • Original loss basis for an asset converted is the lower of personal use basis or FMV at date of conversion
    • Cost recovery basis similarly limited
Nontaxable Transactions
(slide 1 of 4)

- In a nontaxable transaction, realized gain or loss is not currently recognized
  - Recognition is postponed to a future date (via a carryover basis) rather than eliminated
Nontaxable Transactions
(slide 2 of 4)

• In a tax-free transaction, nonrecognition of realized gain is permanent
Nontaxable Transactions
(slide 3 of 4)

• Holding period for new asset
  – The holding period of the asset surrendered in a nontaxable transaction carries over to the new asset acquired
Nontaxable Transactions
(slide 4 of 4)

• Depreciation recapture
  – Potential recapture from the asset surrendered carries over to the new asset acquired in the transaction
Like-Kind Exchanges
(slide 1 of 8)

• §1031 requires nontaxable treatment for gains and losses when:
  – Form of transaction is an exchange
  – Assets involved are used in trade or business or held for production of income
    • However, inventory, securities, and partnership interests do not qualify
  – Asset exchanged must be like-kind in nature or character as replacement property
Like-Kind Exchanges
(slide 2 of 8)

• Like-kind property defined
  – Interpreted very broadly
    • Real estate for real estate
      – Improved for unimproved realty qualifies
      – U.S. realty for foreign realty does not qualify
    • Tangible personalty for tangible personalty
      – Must be within the same general business asset or product class
      – Livestock of different sexes does not qualify
Like-Kind Exchanges
(slide 3 of 8)

• Boot
  – Any property involved in the exchange that is not like-kind property is “boot”
  – The receipt of boot causes gain recognition equal to the lesser of boot received (FMV) or gain realized
  • No loss is recognized even when boot is received
Like-Kind Exchanges
(slide 4 of 8)

• Boot
  – The transferor of boot property may recognize gain or loss on that property
    • Treat as if boot property sold for its FMV
Like-Kind Exchanges
(slide 5 of 8)

• Basis in like-kind asset received:
  FMV of new asset
  - Gain not recognized
  + Loss not recognized
  = Basis in new asset

• Basis in boot received is FMV of property
Like-Kind Exchanges
(slide 6 of 8)

• Basis in like-kind property using Code approach
  
  Adjusted basis of like-kind asset given
  
  + Adjusted basis of boot given
  
  + Gain recognized
  
  - FMV of boot received
  
  - Loss recognized

  = Basis in new asset
Like-Kind Exchanges
(slide 7 of 8)

- Example of an exchange with boot:
  - Zak and Vira exchange equipment of same general business asset class
  - Zak: Basis = $25,000; FMV = $40,000
  - Vira: Basis = $20,000; FMV = $30,000
  - Vira also gives securities: Basis = $7,000; FMV = $10,000
Like-Kind Exchanges
(slide 8 of 8)

- Example of an exchange with boot (cont’d):
  - Zak has a $10,000 recognized gain; $25,000 basis in the equipment, $10,000 in the securities
  - Vira has a $3,000 recognized gain; $30,000 basis in the equipment
Involuntary Conversions
(slide 1 of 13)

• §1033 permits (i.e., not mandatory) nontaxable treatment of gains if the following requirement is met:
  – Amount of reinvestment in replacement property must equal or exceed the amount realized
Involuntary Conversions
(slide 2 of 13)

• §1033 requirements
  – Replacement property must be similar in function or use as involuntarily converted property
  – Replacement property must be acquired within a specified time period
Involuntary Conversions
(slide 3 of 13)

• Involuntary conversion defined
  – The destruction, theft, seizure, condemnation, or sale or exchange under threat of condemnation of property
  • A voluntary act by taxpayer is not an involuntary conversion
Involuntary Conversions
(slide 4 of 13)

- Replacement property defined
  - Must be similar in use or function as the converted property
  - Definition is interpreted very narrowly and differently for owner-investor than for owner-user
  - For business or investment real estate that is condemned, replacement property has same meaning as for like-kind exchanges
Involuntary Conversions
(slide 5 of 13)

- Taxpayer use test (owner-investor)
  - The property must have the same use to the owner as the converted property
    - Example: Rental apartment building can be replaced with a rental office building because both have same use to owner (the production of rental income)
Involuntary Conversions
(slide 6 of 13)

• Functional use test (owner-user)
  – The property must have the same use to the owner as the converted property
    • Example: A manufacturing plant is not replacement property for a wholesale grocery warehouse because each has a different function to the owner-user
Involuntary Conversions
(slide 7 of 13)

• Time period for replacement
  – Replacement time period starts when involuntary conversion or threat of condemnation occurs
  – Replacement time period ends 2 years (3 years for condemnation of realty) from the year-end of year that gain is realized
Involuntary Conversions
(slide 8 of 13)

• Example of time period for replacement
  – Taxpayer’s office is destroyed on November 4, 2002
  – Taxpayer receives insurance proceeds on February 10, 2003
  – Taxpayer is a calendar-year taxpayer
  – Taxpayer’s replacement period is from November 4, 2002 to December 31, 2005
Involuntary Conversions
(slide 9 of 13)

- Nonrecognition of gain: Direct conversions
  - Involuntary conversion rules mandatory
  - Basis and holding period in replacement property same as converted property
• Nonrecognition of gain: Indirect conversions
  – Involuntary conversion rules elective
  – Gain recognized to extent amount realized (usually insurance proceeds) exceeds investment in replacement property
Involuntary Conversions
(slide 11 of 13)

• Nonrecognition of gain: Indirect conversions
  – Basis in replacement property is its cost less deferred gain
  – Holding period includes that of converted property
Involuntary conversion rules do not apply to losses
- Loss related to business and production of income properties are recognized
- Personal casualty and theft losses are recognized (subject to $100 floor and 10% AGI limit); personal condemnation losses are not recognized
• Involuntary conversion of personal residence
  – Gain from casualty, theft, or condemnation may be deferred as involuntary conversion (§1033) or excluded as sale of residence (§121)
  – Loss from casualty recognized (limited); loss from condemnation not recognized
Sale of Residence
(slide 1 of 6)

• Loss on sale
  – As with other personal use assets, a realized loss on the sale of a personal residence is not recognized
Sale of Residence
(slide 2 of 6)

• Gain on sale
  – Realized gain on sale of principal residence is subject to taxation
  – Realized gain may be partly or wholly excluded under §121
Sale of Residence
(slide 3 of 6)

• §121 provides for exclusion of up to $250,000 of gain on the sale of a principal residence
  • Taxpayer must own and use as principal residence for at least 2 years during the 5 year period ending on date of sale
Sale of Residence
(slide 4 of 6)

- **Amount of Exclusion**
  - $250,000 maximum
  - Realized gain is calculated in normal manner
  - Amount realized on sale is reduced by selling expenses such as advertising, broker’s commissions, and legal fees
Sale of Residence
(slide 5 of 6)

• Amount of Exclusion (cont’d)
  - For a married couple filing jointly, the $250,000 max is increased to $500,000 if the following requirements are met:
    • Either spouse meets the 2 year ownership req’t,
    • Both spouses meet the 2 year use req’t,
    • Neither spouse is ineligible due to the sale of another principal residence within the prior 2 years
§121 cannot be used within 2 years of its last use except in special situations:

- Change in place of employment,
- Health,
- Other unforeseen circumstances

Under these circumstances, only a portion of the exclusion is available, calculated as follows:

Max Exclusion amount \( \times \) number of qualifying months

24 months
Other Nonrecognition Provisions
(slide 1 of 7)

• Several additional nonrecognition provisions are available:
  – Under §1032, a corporation does not recognize gain or loss on the receipt of money or other property in exchange for its stock (including treasury stock)
• Under §1035, no gain or loss is recognized from the exchange of certain insurance contracts or policies
• Under §1036, a shareholder does not recognize gain or loss on the exchange of common stock for common stock or preferred stock for preferred stock in same corporation
• Under §1038, no loss is recognized from the repossession of real property sold on an installment basis
  – Gain is recognized to a limited extent
• Under §1041, transfers of property between spouses or former spouses incident to divorce are nontaxable
Other Nonrecognition Provisions
(slide 6 of 7)

- Under §1044, if the amount realized from the sale of publicly traded securities is reinvested in common stock or a partnership interest of a specialized small business investment company, realized gain is not recognized.
  - Amounts not reinvested will trigger recognition of gain to extent of deficiency.
  - Statutory limits are imposed on the amount of gain qualified for this treatment.
  - Only individuals and C corporations qualify.

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Other Nonrecognition Provisions
(slide 7 of 7)

- Under §1045, realized gain from sale of qualified small business stock held > 6 months may be postponed if other qualified small business stock is acquired within 60 days
- Qualified small business stock is stock acquired at its original issue for money, other property, or services from a domestic corp with assets that do not exceed $50 million before or after the issuance of small business stock
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