

BUS 225H – Taxation of Property Transactions

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Week 6 Reading – Realization/Sales/Other Transfers – Part 2

- Sale of an entire business
- Deferred sales – installment sales, OID
- Loss limitations including §469
- Related parties and property transactions
- Rescissions
- Reporting obligations

In addition to the items in this reading packet, also skim at the Bus 225H Website:

- IRC Sections §1060, §453, §1038, §267, §707(b), §1239, §1091
- Form 8594 and Instructions
- Form 6252 (installment sales)

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Introduction

This reading continues that of Chapter 3 on realization, sales and other types of transfers and dispositions (such as abandonment). The rules covered in this reading relate to some part of the basic formula of §1001 on gain or loss:

Amount realized
Less: Adjusted Basis
 Realized gain or loss

For example, we'll look at how the formula works for the sale of an entire business.

Section 1001 also provides that generally, the gain or loss realized is recognized unless some other provision applies. There are a few provisions that allow a realized gain to be deferred, but several that provide that a realized loss is either deferred or permanently disallowed (such as a loss realized on the sale of a personal use asset). This reading covers these commonly encountered loss limitations: (1) related

party transfers, (2) loss realized from a passive activity, and (3) wash sales.

We will also cover special accounting method rules, such as the installment sales method of §453 (mentioned at §1001(d)). Installment sales that do not provide for adequate stated interest may be subject to special rules requiring interest to be imputed. When that occurs, the "amount realized" by the seller must be adjusted because some of it is really disguised interest. That interest income must be identified and properly accounted for by both parties so that the seller property characterizes income and buyer has the correct basis for the acquired asset.

Additional topics include the treatment of a rescinded transfer, reporting obligations a seller may have (and sometimes also the buyer) and a special accounting method rule for certain leases (§467).

Sale of an Entire Business

Williams v. McGowan, 152 F.2d 570 (2nd Cir. 1945), held that the sale of an entire business is treated as a sale of the individual assets rather than the sale of a single asset. This treatment ensures that gain or loss is properly characterized as capital and/or ordinary. Also, if the business is sold using an installment note, the installment sale method (§453) might not apply to each of the individual assets sold. Treatment of the individual assets as being sold also allows the buyer to assign basis to each so it can later determine gain or loss if any are sold.

IRC §1060 provides guidance to the buyer and seller to determine if a transfer is treated as a sale of an entire business (“applicable asset acquisition”) and if so, how the purchase price is to be allocated among the assets. These rules also provide for a residual method for determining the purchase price (and amount realized) for goodwill. Both parties are to file Form 8594, *Asset Acquisition Statement*. The purchase price allocation rules for §1060 are provided at Reg. §1.338-6 and §1.338-7.

Question 1 – Humboldt Accountancy Firm plans to purchase the customer list, accounts, files, software, and equipment of ABC Tax Prep Services for cash. Does §1060 apply? If yes, how will the purchase price be assigned to the assets acquired?

Question 2 – Widgets Plus (WP) is a manufacturer with plants in five different states. In the current year, as part of its expansion plans, WP purchased the equipment, inventory, and lease of a small manufacturer that was going out of business. Does §1060 apply? Would your answer change if WP also offered employment to the seller’s foreman? What if WP also obtained the seller’s mailing list it uses to send Christmas cards to its customers? [Also consider §1.197-2(e) below]

Sale of a Business and Legal Fees

West Covina Motors, TC Memo 2009-291

- Purchase of car dealership; legal expenses incurred.
- P argued that legal fees deductible because mostly attributable to acquired inventory. P lost, but brought case back with more evidence.
- Held –
 - (1) legal fees paid specifically for inventory financing are part of COS (taxpayer must be able to prove this)
 - (2) §1060 allocation rules n/a to the legal fees
 - (IRS wanted to allocated via §1060 residual method (so legal fees would most likely end up in the goodwill category))
 - Court - “legal fees should be allocated proportionately to the assets with which they are associated. ... Accordingly, the legal fees paid to Mr. Hoffman will be allocated to fixed assets (4.1 percent), goodwill (57.9 percent), and used vehicles and parts (38 percent).”

Reg. §1.197-2(e) Purchase of a trade or business. Several of the exceptions in section 197 apply only to property that is not acquired in (or created in connection with) a transaction or series of related transactions involving the acquisition of assets constituting a trade or business or a substantial portion thereof. Property acquired in (or created in connection with) such a transaction or series of related transactions is referred to in this section as property acquired as part of (or created in connection with) a purchase of a trade or business. For purposes of section 197 and this section, the applicability of the limitation is determined under the following rules:

(1) *Goodwill or going concern value.* An asset or group of assets constitutes a trade or business or a substantial portion thereof if their use would constitute a trade or business under section 1060 (that is, if goodwill or going concern value could under any circumstances attach to the assets). See §1.1060-1(b)(2). For this purpose, all the facts and circumstances, including any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of the assets, are taken into account in determining whether goodwill or going concern value could attach to the assets.

(2) *Franchise, trademark, or trade name.*

(i) In general. The acquisition of a franchise, trademark, or trade name constitutes the acquisition of a trade or business or a substantial portion thereof.

(ii) Exceptions. For purposes of this paragraph (e)(2)—

(A) A trademark or trade name is disregarded if it is included in computer software under paragraph (c)(4) of this section or in an interest in a film, sound recording, video tape, book, or other similar property under paragraph (c)(5) of this section;

(B) A franchise, trademark, or trade name is disregarded if its value is nominal or the taxpayer irrevocably disposes of it immediately after its acquisition; and

(C) The acquisition of a right or interest in a trademark or trade name is disregarded if the grant of the right or interest is not, under the principles of section 1253, a transfer of all substantial rights to such property or of an undivided interest in all substantial rights to such property.

(3) *Acquisitions to be included.* The assets acquired in a transaction (or series of related transactions) include only assets (including a beneficial or other indirect interest in assets where the interest is of a type described in paragraph (c)(1) of this section) acquired by the taxpayer and persons related to the taxpayer from another person and persons related to that other person. For purposes of this paragraph (e)(3), persons are related only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1).

(4) *Substantial portion.* The determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. The value of the assets acquired relative to the value of the assets retained by the transferor is not determinative of whether the acquired assets constitute a substantial portion of a trade or business.

(5) *Deemed asset purchases under section 338.* A qualified stock purchase that is treated as a purchase of assets under section 338 is treated as a transaction involving the acquisition of assets constituting a trade or business only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business or a substantial portion thereof.

(6) *Mortgage servicing rights.* Mortgage servicing rights acquired in a transaction or series of related transactions are disregarded in determining for purposes of paragraph (c)(11) of this section whether the assets acquired in the transaction or transactions constitute a trade or business or substantial portion thereof.

(7) *Computer software acquired for internal use.* Computer software acquired in a transaction or series of related transactions solely for internal use in an existing trade or business is disregarded in determining for purposes of paragraph (c)(4) of this section whether the assets acquired in the transaction or series of related transactions constitute a trade or business or substantial portion thereof.

Question 3 - ABC Corporation decides to outsource its human resources department which currently consists of 40 personnel serving 15 of ABC's locations. X Corporation, a personnel agency and consulting firm, buys ABC's human resources operations and incorporate it into X's own operations. X pays cash and acquires ABC's workforce, records, furniture, equipment, and a small office building. Does §1060 apply?

Question 4 – Ms. Smith bought a veterinary practice for \$300,000 including the fixtures, equipment and customer lists. An appraisal on the tangible assets shows a value of \$230,000. She also incurred a \$15,000 broker commission (finder's fee) on the purchase. How does the fee affect the §1060 calculations?

Covenants not to compete: When these arise in transfer of a business (which is typical), issues can arise as to their validity. Prior to the enactment of §197 in 1993, this was a bigger issue because a buyer might want to have allocated too much to a covenant in order to have less allocated to what was prior to §197, non-depreciable goodwill. However, it can still be an issue as to the worth of a covenant regarding tax treatment to the buyer and seller of the business. These issues include: covenant versus consulting agreement; covenant versus property with a life under 15 years (such as equipment); and whether the covenant arose with respect to a sale of a business.

Rev. Rul. 77-403 provides some factors for determining whether a covenant not to compete is valid.

“Whether a payment for a covenant not to compete made in connection with the purchase of real property is part of the cost of the property or is the cost of a separate asset depends on whether the covenant has any demonstrable value. In determining whether the covenant has any demonstrable value, the facts and circumstances in the particular case must be considered. The relevant factors include: (1) whether in the absence of the covenant the covenantor would desire to compete with the covenantee; (2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and (3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant.”

Contingent Sales/Purchase Price: When a taxpayer acquires a business in a taxable acquisition, both buyer and seller must determine the purchase price and the fair market value (FMV) of all assets acquired/sold so that the purchase/sales price may be allocated among each of the assets. The purchase price allocation rules of §1060 requires use of the residual method under which the purchase price in excess of the FMV of the non-goodwill assets is allocated to goodwill and going concern value.

When the consideration to acquire the business involves contingent liabilities, the task of determining the actual purchase price and allocating it among the assets acquired can be quite challenging. The true purchase price may not be known for several years after the sale of the business. Thus, the final allocation of purchase price among the acquired assets is not known upon purchase, consequently, the depreciable basis of each acquired asset is not fixed, but could change as the contingent liability is settled.

Situations where there is a contingent purchase price include where the purchase price includes a percentage of future profits or where the buyer assumes a liability, such as damages for an unsettled lawsuit or retiree medical benefits.

Buyer Perspective: Following is an overview of some of the limited guidance on the treatment of contingent liabilities in determining purchase price for the buyer.

1. §1.1060-1(e)(1)(ii)(B) – “Additional reporting requirement. When an increase or decrease in consideration is taken into account after the close of the first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.”
2. Legislative history to §197 (Revenue Reconciliation Act of 1993) : “The adjusted basis of a section 197 intangible that is acquired from another person generally is to be determined under the principles of present law that apply to tangible property that is acquired from another person. Thus, for example, if a portion of the cost of acquiring an amortizable section 197 intangible is contingent, the adjusted basis of the section 197 intangible is to be increased as of the beginning of the month that the contingent amount is paid or incurred. This additional amount is to be amortized ratably over the remaining months in the [15]-year amortization period that applies to the intangible as of the beginning of the month that the contingent amount is paid or incurred.”
3. *Magruder v. Supplee*, 316 US 394 (1942) – taxpayer purchased real estate for which the related property taxes for the year of sale had attached, but were not yet payable. Buyer and seller agreed to apportion the property taxes pro rata over the tax year. Buyer deducted the amount of property taxes he agreed to pay; the IRS disagreed. The Court held that because the tax liens had attached to the property prior to sale, they were a liability of the seller and payment of that liability by the buyer would not create a deduction, despite any agreement between the buyer and seller. “Payment by a subsequent purchaser is not the discharge of a burden which the law has placed upon him, but is actually as well as theoretically a payment of purchase price.”
4. *Albany Car Wheel Co.*, 333 F2d 653 (2nd Cir.), aff’g 40 TC 831 (1963) – buyer’s obligation for severance pay under a union contract was held to be too speculative to be included in the cost

basis of the acquired business assets. If a liability accrued in a later year, it would be taken into account then, but could not increase basis for depreciation purposes now.

5. *Pacific Transport*, 483 F.2d 209 (9th Cir.) – even where the purchase price of the assets was not discounted for a contingent liability assumed by the buyer, although the parties were aware of it, it must still be treated as part of the basis of the acquired assets rather than expensed when paid by the buyer.
6. *Webb*, 708 F.2d 1254 (7th Cir.), aff'g 77 TC 1134 (1981) – buyer agreed to pay S's liability to make pension payments (unfunded) to employee's widow. Court held that payments by buyer were not deductible under §162, but instead were capitalizable as part of the purchase price of the business. Key is to look at when buyer agreed to make the payment on the liability. Here, it was at the time the purchase price was determined. Buyer raised the point made in *F&D Rentals* (365 F.2d 34 (7th Cir.)) - "Contingent obligations, insusceptible to present valuation, which are assumed as part of a purchase agreement, are not to be included in the cost basis of assets." The court stated that that was pure dictum and the facts of that case were not like *Webb's*.
7. *Illinois Tool Works*, 2004-1 USTC ¶50,130, 93 AFTR 2d 2004-548, 355 F.3d 997 (7th Cir. 2004), affirming 117 T.C. 39 (2001) - This case involved a potential patent infringement liability that target had at the time of an acquisition. The plaintiff had tried to settle the patent infringement suit, but Target rejected the offer. Target had a \$400,000 reserve on its books for the lawsuit which was disclosed to Acquirer. Analysis by attorneys led to the conclusion that no liability would likely result from the lawsuit, and worst case it would be no more than \$3 million. For acquisition purposes, the parties considered that the potential liability was \$350,000.

Following the acquisition, a verdict was reached in the lawsuit and a verdict of about \$17 million was reached for plaintiff. A only capitalized a portion of the damages, and the IRS challenged that more of it should be capitalized. A argued that capitalization was not warranted because the payment was "highly speculative and unexpected at the time of purchase."

Both the tax court and 7th circuit court held for the IRS, relying on contingent liability cases such as *David R. Webb Co. v. Comm'r.*, 708 F.2d 1254 (7th Cir. 1983). When the contingent liability is assumed by the acquirer of a business, it is no longer an ordinary and necessary business expense, but is instead a part of the cost of acquiring the business.

On appeal, the taxpayer argued that the damages beyond \$1 million were not due to the acquisition, but to the mishandling of the lawsuit after the acquisition. The court disagreed with this view because the taxpayer assumed the liability – whatever the amount. "That a contingent liability, once fixed, exceeded the parties' expectations does not render it any less a part of the purchase price. ... In this case, protection from an aberrant jury verdict needed to be sought during contract formation, not after the fact in the form of an immediate tax deduction."

Summary of court cases – Any liability of S's that B assumes is part of the purchase price for the business because "payment of a liability by a subsequent purchaser is not the discharge of a burden which the law has placed upon him, but is actually as well as theoretically a payment of the purchase price" (TAM 8436002).

Also relevant to knowing when contingent liabilities become part of the purchase price involves application of the all events test and economic performance requirement of §461.

Question 5 – How will Dr. Smith apply §1060 if the purchase price is \$300,000 + ½% of net income over the next 5 years?

Contingencies and the Seller: §1001 and §1.1001-2 – amount realized from sale of property includes the amount of liabilities that the seller was discharged of as a result of the sale. The only exceptions to this rule are when the discharge is to be treated instead as discharge of debt under §61(a)(12) or where the debt was not taken into account in determining seller’s basis in the property (such as where the debt was not bona fide debt; see *Estate of Franklin* (9th Cir. 1976) - “an obligation, the payment of which is so speculative as to create a contingent liability, cannot be included in the basis of property,” Rev. Rul 77-110, *Albany Car Wheel* (above).

If the buyer of the business expressly assumes a liability arising out of the business that the seller has not yet deducted because the economic performance requirement has not yet been met, then EP occurs as the amount of that liability is properly included in the seller’s amount realized from the sale of the business (§1.461-4(d)(5)(i)).

Another perspective on viewing the sale of the business as the seller paying liabilities assumed by the buyer is that when the buyer assumes the liability, the seller gets less cash. In effect, that is the same as the seller getting cash from the buyer and paying his liabilities (*Pierce Corp*, 326 F2d 67 (8th Cir. 1964) and *Commercial Security Bank*, 77 TC 145 (1981); acq. 1986-2 CB 1; AOD 1986-27).

Reg. §15.453A-1(c) provides guidance on how the seller applies the installment sale method when the sales price is contingent (see next section).

Question 6 – In addition to §1060 concerns, what other tax (other than federal income tax) and non-tax concerns would a buyer and seller of a business have?

Deferred Sales

Sometimes when property is sold, the seller may allow the buyer to pay the purchase price over a period of time. In such situations, it is important to determine if it is an installment method under §453 because installment sale reporting is mandatory (unless the seller elects out of such treatment). It is also important to determine if adequate interest is being charged on the loan from the seller to the buyer. If there is not adequate stated interest, the parties will need to impute interest (such as under §483 or §1274). This is important because if adequate interest is not charged, then part of the purchase price really represents interest income to the seller and interest expense to the buyer and must be properly treated that way.

§453 Basics:

- If a transaction is an installment sale (payments for sale of property are received over more than one tax year) and the transaction is of a type not excluded from installment sale method, then the seller **MUST** use the installment sale method to account for the recognized gain. The only alternative is to elect out. One way to elect out is to report all of the recognized gain in the year of the sale. Since this is a way to elect out, it is very important to **NOT** report the entire gain from an installment sale in the year of sale by accident!
- Applies to gains, not to losses.
- Gain from depreciation recapture can not be deferred under the installment sale method.
- Form 6252 is required in the year of the sale and every year in which gain is reported from the sale.
- There are special rules for related party transactions.
- It is important to check if the property disposed of is of a type covered by §453.
- If the installment note is pledged, check to see if the special rule of §453A will require money received from the pledge to be treated as having been received from the buyer.

Question 7 – Joe sold land to Mike for \$100,000. Mike is to pay \$50,000 at the time of sale + \$10,000/year for 5 years + 9% interest. Joe's basis in the land is \$40,000. How should Joe treat this transaction on this tax return?

If Joe's transaction did not provide for any interest to be paid, it would have to be imputed. If this is not done, the seller reports too much gain and buyer reports too high of a basis in the acquired property. This interest must be imputed before the gross profit percentage for the installment method calculations are computed. If the parties in the above question did not charge adequate stated interest, §1274(c)(3)(C) would not apply because the debt instrument is \$250,000 or less. However, §483(a) would apply as it

applies if there was a sale or exchange of property and any payment is due more than 6 months after the sale date under a contract where some or all payments are due more than 1 years after the sale date and there is total unstated interest per §483(b).

Both §483 and §1274 calculate the unstated interest amount in the same manner. However, under §483, interest income and expense are recognized based on the taxpayers' normal methods of accounting. Under §1274, both parties are put on the accrual method with respect to reporting the interest income and expense (see §1272(a)), with limited exceptions:

- §1274A(c) – election by both parties if stated principal < \$2,000,000 (but look for latest revenue ruling containing the inflation adjusted amount; for 2009, it is \$5,131,700 per Rev. Rul. 2008-52) and lender is not on the accrual method. This election would be advantageous if you are the lender and don't want to report interest income before you actually receive it (assuming you sue the cash method of accounting).
- §1275(b)(2) – personal use property is involved and the borrower is on the cash method.

In the following situations, Joe would not be allowed to use the installment method to report the land sale:

- Joe is a dealer (special exceptions exist for time shares and residential lots and farm property – see §453(l))
- Joe was instead selling inventory of personal property
- Joe sold the land at a loss
- Joe was selling property where any of the gain represented depreciation recapture – per §453(i), any depreciation recapture must be recognized all in the year of disposition, regardless of when payments are received

For other exceptions, see §453(k).

Question 8 – Jacob's Hardware Store sold out to Jennifer. Jennifer will pay JH \$40,000 down and then \$40,000 per year for the next 5 years. The parties allocated the \$40,000 downpayment to the inventory transferred. How will §453 apply to JH? [Rev. Rul. 68-13]

Open Transaction Doctrine and the Cost Recovery Method:

Rev. Rul. 79-276

ISSUE

May the taxpayer use a cost recovery method of accounting for reporting income from sales of apartments that have been converted into condominiums?

FACTS

X corporation is in the business of converting rental apartment buildings into condominiums. This business consists of purchasing suitable apartment buildings, modernizing and improving the apartment units and facilities, and selling the individual units.

In January 1978, X purchased an apartment building for 50,000x dollars. X made numerous improvements to the building at a cost of 15,000x dollars and began selling apartment units in July 1978. As of December 31, 1978, X, a calendar year taxpayer, had sold nearly half the units for 40,000x dollars.

In determining the income to be reported from the sale of condominium units, X wished to adopt a cost recovery method of accounting. Under this method, no income is reported until all of the cost is recovered. Thus, X would treat the 40,000x dollars received in 1978 as a recovery of basis in the property so that no income would be reported and X would have a basis in the remaining property of 25,000x dollars (65,000x -- 40,000x = 25,000x).

LAW AND ANALYSIS

Under section 1.446-1(a)(2), no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

Under section 1.61-6(a), which concerns gain derived from dealings in property, when part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

In Rev. Rul. 74-479, the taxpayer's business consists of purchasing entire manufacturing plants that have been permanently shut down and selling the personal property and leasing the real property. The taxpayer bought a plant and equipment for 35,000x dollars, of which 6,500x dollars was allocated to personal property consisting of thousands of items. After selling 5,000x dollars of the personal property the taxpayer wished to treat the 5,000x dollars as a recovery of basis so that no income would be reported and the taxpayer would have a 1,500x dollar basis in the remaining property.

Rev. Rul. 74-479 provides that the use of such a cost recovery method of accounting is not appropriate because it was possible for the taxpayer to inventory each item on a cost basis and indicate a selling price for each item. Use of a cost recovery method of accounting is appropriate only in situations in which it is practically impossible to apportion the cost or other basis to property. See *Fasken v. Commissioner*, 71 T.C. 650 (1979); *William T. Piper v. Commissioner*, 5 T.C. 1104 (1945), *acq.*, 1946-1 C.B. 4, *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947), *acq.*, 1948-1 C.B. 2.

Example (1) of section 1.61-6(a) provides that a dealer in real estate who acquires a 10-acre tract for \$10,000 and divides it into 20 lots must equitably apportion the \$10,000 cost among the lots so that on the sale of each, the dealer can determine the taxable gain or deductible loss.

In the present situation, the purchase of an apartment building for sale as condominium units is analogous to the purchase of a large tract of real estate for subdivision. In both situations, a large parcel of real property is purchased and resold as a number of smaller parcels. Both situations are subject to similar

risks and both require that the developer accept the burdens of carrying the unsold portion during a sales period of uncertain duration. Furthermore, it is possible for X to apportion the basis of the building to each apartment unit.

HOLDING

The taxpayer may not use a cost recovery method of accounting for reporting income from sales of apartments that have been converted into condominiums.

Contingent Sales Price: §15.453A-1(c) explains how the installment sales method can still result in reporting of gain when payments are received even though the sales price is not known because of a contingency. The purpose of these regulations is to prevent taxpayers from using the open transaction doctrine for installment sales with a contingent sales price. Under the open transaction doctrine, the seller would not report any gain until the payments received exceeded the basis of the property transferred (aka the cost recovery method).

The regulations provide the following rules to avoid the open transaction approach:

- Stated maximum selling price – S is to calculate the gross profit percentage under §453 using the stated maximum selling price. If that amount is later changed, the gross profit percentage is modified going forward.
- Fixed period – basis is allocated over the stated period in order to determine gain to be recognized each year. No loss is allowed to be recognized until the final year of payments.
- No stated maximum selling price of fixed period – the first question to be addressed is whether the transaction is really a sale or is it a licensing or equity arrangement. Assuming it is a bona fide sale, S is to recover basis over a 15-year period unless S can prove a better method to the IRS. No loss is allowed in any year except the last year payments are to be received from B.
- Income forecast method – allowed for certain types of property such as films and mineral property, property which can be depreciated using the income forecast method and other situations where S obtains a ruling from the IRS.
- Special rule – S may obtain a ruling from the IRS to obtain permission for a different method where necessary to prevent substantial and inappropriate deferral of basis recovery.
- Election out of §453 – presumable, S should be able to elect out of the installment sale method and then would follow general gain realization rules, including possibly, the open transaction doctrine (*Burnet v. Logan*, 283 US 404 (1931)).

Imputed Interest Expense for Buyer: §1274 provides rules for determining imputed interest when a debt instrument (DI) issued in consideration of the sale or exchange of property does not provide for adequate stated interest (typically determined based on the term of the DI and the monthly published applicable federal rates (AFR)). A DI is defined at §1.1275-1(d) as “any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law.” Certain DIs are excepted from §1274, for example, those related to sales involving total payments of \$250,000 or less. Often, when a DI is excepted from §1274, it is subject to the imputed interest rules of §483 which operate similarly to those at §1274 except for the timing rules for reporting of imputed interest income and expense by the parties.

Question 9 – Logan sold land with ore. The parties agree on a price of \$50,000 down and 1% of the value of any metal mined from land until it is all gone. How does the installment method apply?

Question 10 – How would your answer to the last question change if the seller will only receive payments for 6 years? What if in year 3, Logan receives no payment because nothing was mined?

Question 11 – What if the arrangement is that Logan is to receive payments from buyer until she receives \$200,000?

Loss Limitations

The IRC includes several provisions that either prohibit recognition of a loss or require it to be deferred. For example, if a taxpayer sells property to a related party at a loss, the loss is not recognized (§267 and §707(b)). We have

already discussed capital loss limitations and the §165 loss limitations for individuals. Additional loss limitations we will briefly discuss include §469 the limits loss from passive activities and wash sales (§1091).

Question 12 – ABC Partnership is a limited partnership that owns and manages two apartment complexes. In 2009, it sold one generating a \$250,000 gain. Limited partner Jed’s share of the gain is \$2,000. Jed has a suspended passive activity loss from this partnership of \$32,000. How should Jed treat the \$2,000 gain?

Wash Sales: Basically, the wash sale rule of §1091 prevent taxpayers from currently claiming a loss on the sale of stock or securities if they have purchased substantially identical stock or securities in the 30 days before or 30 days after the sale at a loss. The disallowed loss is deferred by adding it to the basis of the securities purchased in the 61 day period (see the regulations for the ordering rule).

The holding period associated with the loss also carries over. Per Reg. §1.1223-1(d) “If the acquisition of stock or securities resulted in the nondeductibility (under section 1091, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, the holding period of the newly acquired securities shall include the period for which the taxpayer held the securities with respect to which the loss was not allowable.”

IRS Publication 550, *Investment Income and Expenses*, includes the following explanation on wash sales.

“A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

- Buy substantially identical stock or securities,
- Acquire substantially identical stock or securities in a fully taxable trade,
- Acquire a contract or option to buy substantially identical stock or securities, or
- Acquire substantially identical stock for your individual retirement account (IRA) or Roth IRA.

If you sell stock and your spouse or a corporation you control buys substantially identical stock, you also have a wash sale.

If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities (except in (4) above). The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or

securities. Your holding period for the new stock or securities begins on the same day as the holding period of the stock or securities sold.

Example 1.

You buy 100 shares of X stock for \$1,000. You sell these shares for \$750 and within 30 days from the sale you buy 100 shares of the same stock for \$800. Because you bought substantially identical stock, you cannot deduct your loss of \$250 on the sale. However, you add the disallowed loss of \$250 to the cost of the new stock, \$800, to obtain your basis in the new stock, which is \$1,050.

Example 2.

You are an employee of a corporation that has an incentive pay plan. Under this plan, you are given 10 shares of the corporation's stock as a bonus award. You include the fair market value of the stock in your gross income as additional pay. You later sell these shares at a loss. If you receive another bonus award of substantially identical stock within 30 days of the sale, you cannot deduct your loss on the sale.”

Rev. Rul. 2008-5 – An individual sold stock at a loss and within 30 days after the sale, his IRA purchased substantially identical shares. The IRS held that the loss is disallowed under §1091. Per the IRS: “The loss on the sale of stock is disallowed under §1091. A's basis in the individual retirement account or Roth IRA is not increased by virtue of §1091(d).” It is not clear why the IRS ruled that there was no basis adjustment to the shares held by the IRA.

Question 13 – Sam had the following stock transactions:

5/12/2008	Sam buys 50 shares of A Corp	\$2,500	(\$50/share)
8/12/2008	Sam buys 25 shares of A Corp	\$1,375	(\$55/share)
8/27/2008	Sam buys 10 shares of A Corp	\$500	(\$50/share)
9/3/2008	Sam sells 50 shares of A Corp for	\$2,000	(\$40/share)

Assuming Sam uses FIFO, he has a \$500 loss (\$2,000 less \$2,500).

Does the wash sale rule of §1091 apply to Sam for the 9/3 sale?

Question 14 – Christine had the following stock transactions:

- 9/15 buys 100 share at \$5,000
- 2/1 sells 100 shares for \$4,000
- 2/15 buys 50 shares for \$2,000
- 2/16 buys 50 shares for \$2,000
- 2/17 buys 50 shares for \$2,000
- 2/18 buys 50 shares for \$2,000

Does the wash sale rule of §1091 apply to Christine?

Question 15 – What other loss limitation rules might apply in a disposition of property?

Related Parties and Property Transactions

IRC §267 disallows recognition of a loss when property is sold to a related party. The loss though transfers to the buyer.

IRC §1239 prevents the treatment of a gain as capital gain when depreciable property is sold to certain related parties.

Reminders:

- In any transaction where you think the parties are related, review the rules of §267, §707(b) and §1239 (and perhaps others) to see if there is a different tax treatment applicable.
- Related parties are not always defined similarly under all of the rules that provide a special tax treatment for related parties.

Question 16 – Karen sold stock to her mother generating a \$2,000 loss. What is the tax effect to the parties?

Question 17 – Jane sold a truck to her brother who plans to use it in his sole proprietorship business. How should Jane report the \$4,000 gain? If Jane had a \$2,000 loss instead, how would it be reported?

Question 18 – Provide an example where §1239 applies.

Rescission

Rev. Rul. 80-58 [minor editing]

ISSUE

In the situations described below, what are the federal income tax consequences of a reconveyance to a taxpayer of property previously sold by the taxpayer?

FACTS

Situation 1: In February 1978, *A*, a calendar year taxpayer, sold a tract of land to *B* and received cash for the entire purchase price. The contract of sale obligated *A*, at the request of *B*, to accept reconveyance of the land from *B* if at any time within nine months of the date of sale, *B* was unable to have the land rezoned for *B*'s business purposes. If there were a reconveyance under the contract, *A* and *B* would be placed in the same positions they were prior to the sale.

In October 1978, *B* determined that it was not possible to have the land rezoned and notified *A* of its intention to reconvey the land pursuant to the terms of the contract of sale. The reconveyance was consummated during October 1978, and the tract of land was returned to *A*, and *B* received back all amounts expended in connection with the transaction.

Situation 2: Same as above, except that the period within which *B* could reconvey the property to *A* was one year. In January 1979, *B* determined that it was not possible to have the land rezoned and notified *A* of its intention to reconvey the land pursuant to the terms of the contract of sale. The reconveyance was consummated during February 1979, and the tract of land was returned to *A*. *B* received back all amounts expended in connection with the transaction.

LAW AND ANALYSIS

Section 61(a)(3) provides that, except as otherwise provided, gross income means all income from whatever source derived, including gains derived from dealings in property.

Section 1001(c) provides that, except as otherwise provided, the entire amount of gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.

The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes. See *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944), Ct. D. 1603, 1944 C.B. 526.

In *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940), the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company without the approval of the shareholders. Under the plan the taxpayer was credited with earnings from the fund for the years 1930 and 1931. In 1931, as a result of suits filed by a shareholder, the directors of the company passed a resolution whereby the plan would be rescinded as to all participants in the plan who agreed to relinquish their previous credits and rights. The Court of Appeals held that although the plan was rescinded for 1930, the annual accounting period principle required the determination of income at the close of the taxable year without regard to subsequent events. That is, the rescission in 1931 was disregarded for purposes of determining 1930 taxable income.

With regard to whether the 1931 income should be taxed, the Court of Appeals said in the *Penn* case that the rescission in 1931 extinguished what otherwise would have been taxable income for that year.

The facts of the *Penn* case are similar to those in *Situation 1* and *Situation 2*. In *Penn*, earnings were credited in 1930 and 1931 and there was a rescission in 1931 (that was intended to affect both years). *Situation 1* relates to the earnings credited in 1931, the year of the rescission; and *Situation 2* relates to the earnings credited in 1930, that is, a year different from the year of the rescission.

In *Situation 1* the rescission of the sale during 1978 placed *A* and *B* at the end of the taxable year in the same positions as they were prior to the sale. Thus, in light of the *Penn* case, the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction. See Rev. Rul. 74- 501, which holds that there is no adjustment to the basis of the old stock where a shareholder exercised stock rights and paid the subscription price for the new stock, which subscription price was later returned to the shareholder in the same taxable year in which the rights were issued because the market price of the stock had depreciated to a price below the subscription offer.

In *Situation 2*, as in *Situation 1*, there was a completed sale in 1978. However, unlike *Situation 1*, because only the sale and not the rescission occurred in 1978, at the end of 1978 *A* and *B* were not in the same positions as they were prior to the sale. Again, in light of the *Penn* case, the rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.

In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

HOLDINGS

In *Situation 1*, no gain on the sale will be recognized by *A* under section 1001.

In *Situation 2*, *A* must report the sale for 1978. In 1979, when the property was reconveyed to *A*, *A* acquired a new basis in the property, which was the price paid to *B* for such reconveyance.

See section 1038 for treatment of reacquisition of real property where a secured indebtedness to the original seller is involved.

Erroneous stock sale: *Hutcheson*, TC Memo 1996-127, involved the proper tax treatment of an erroneous stock sale in January 1989. The taxpayer wanted to sell \$100,000 of WalMart stock, but the stock broker thought T wanted to sell 100,000 shares of WalMart. The mistake was “corrected” with the purchase of 96,600 shares in December 1989. Efforts were undertaken in 1989 to resolve the misunderstanding and actions. The court held that T must recognize the gain from the January sale. The doctrine of rescission (Rev. Rul. 80-58) was not applicable because the buyer and seller of the January transaction were not returned to their original positions. Also, because the transaction was just a mutual mistake of fact, it did not meet the definition of an involuntary conversion under §1033.

Reporting Obligations

Various reporting obligations exist in the IRC to report transfers of property. Some of these, such as §6045 on broker reporting and §6050J regarding foreclosures and abandonment of security were mentioned in earlier readings. In addition, some transfers may require withholding. For example:

“§1445 Withholding of tax on dispositions of United States real property interests

(a) General rule. Except as otherwise provided in this section, in the case of any disposition of a United States real property interest (as defined in section 897(c)) by a foreign person, the transferee shall be required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.”

A specific reporting obligation (form 1099) for real property transfers is at §6045(e):

“(e) Return required in the case of real estate transactions.

- (1) In general. In the case of a real estate transaction, the real estate reporting person shall file a return under subsection (a) and a statement under subsection (b) with respect to such transaction.
- (2) Real estate reporting person. For purposes of this subsection, the term “real estate reporting person” means any of the following persons involved in a real estate transaction in the following order:
 - (A) the person (including any attorney or title company) responsible for closing the transaction,
 - (B) the mortgage lender,
 - (C) the seller's broker,
 - (D) the buyer's broker, or
 - (E) such other person designated in regulations prescribed by the Secretary.

Any person treated as a real estate reporting person under the preceding sentence shall be treated as a broker for purposes of subsection (c)(1).”

It is wise to always check if a party to a property transaction has any reporting obligation because when they exist, there are due dates and penalties for non-compliance. The details of the rules should also be examined carefully to determine which party (if any) has the reporting obligation and if there are any exemptions.

Question 19 – What is the filing procedure for Form 8594?