

Federal Income Tax II outline

- 1) Sections that determine basis in property **basis** in property
 - a) 1012: basis of the property is the cost of the property
 - i) property acquired by **gift** retains the basis of the original owner (so-called "cost basis"), something that is acquired with reference to another person's basis is an "exchange basis"
 - (1) method of computing gain (important to do it in this order)
 - (a) Steps
 - (i) § 1015(a): if the property was acquired by gift, the basis will be the same
 - (ii) if the basis is greater than the fmv at the time of the gift than for LOSS ONLY the basis will be the fmv
 1. § 1.105-1(a)(2): example of how there can be no gain or loss
 - (iii) then compute loss § 1001(a) (actually an exception to § 1015(a)):
 - (b) if the basis at the time of transfer of the gift was LESS than the value of the gift, the basis is the cost at the time of transfer.
 - (c) Courts struggle to find why something isn't a gift, so as not to give the donee a carryover basis.¹ (even applying a quantum meruit notion)
 - (d) transfers between (married) spouses do not result in realization
 - (2) If the donor had to pay a **gift tax** (or it was transferred due to devise), the basis is as follows²:

$$\text{basis} = \text{original basis} + (\text{gift tax}) \times \frac{\text{amount of appreciation}}{\text{value of property}} \text{ not to exceed the fair market value (upheld by } \textit{Taft v. Bowers})$$
- (3) Any consideration paid for property renders it not a gift, and there is no longer any carryover basis
- (4) Dealing with part-gift part sale transactions³
 - (a) Donor realizes difference between amount received and adjust basis, or zero (whichever is greater). A.k.a. **donor's realized amount = max(amount received – donor's adjusted basis, 0**
 - (b) Donee takes with a basis of the larger of either the amount that the donee paid for the property or the transferee's basis in the property (if later taking a loss, it is limited to the date of gift fmv) a.k.a.

¹ International Freighting Corporation

² **1015(d)(2)** For purposes of paragraph (1), the amount of gift tax paid with respect to any gift is an amount which bears the same ratio to the amount of gift tax paid under chapter 12 with respect to all gifts made by the donor for the calendar year (or preceding calendar period) in which such gift is made as the amount of such gift bears to the taxable gifts (as defined in section 2503(a) but computed without the deduction allowed by section 2521) made by the donor during such calendar year or period.z

³ 1.1001-1(e)(1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis.

1.1015-4 (a) General rule. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of--

- (1) Whichever of the following is the greater:
 - (i) The amount paid by the transferee for the property, or
 - (ii) The transferor's adjusted basis for the property at the time of the transfer, and
- (2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015-5).

- (i) *donee's unadjusted basis if taking a gain on later disposition* = max(amount paid by transferee, transferor's adjusted basis) + any gift tax paid 1.1001-1(e)(2)
 - (ii) *donee's unadjusted basis if taking a loss on later disposition* = max(amount paid by transferee, transferor's adjusted basis) + any gift tax paid NOT TO EXCEED fmv of property at date of gift 1.1015-4(b)
 - (c) only when gifting to charities can you allocate basis between the gift and sale
 - ii) even if property is acquired with a debt secured by the property, the basis in the property is its fmv
 - iii) options: price of a call option is considered to be part of the basis (but the option itself can be property)
 - iv) separate portions: if there are separate tracts of land (or property, or whatever), the basis is allocated ratably at the time of the purchase. 1.61-6(a). This may result in hardship.
 - v) can increase basis by adding improvement to a property
 - (1) § 109: improvements by a leasee do not count
 - vi) limited by Estate of Franklin:
 - (1) usually encumbered property that is disposed of decreases the amount realized, but if the encumbrance is significantly less than the actual value of the property, the debt should not have been included in the basis (and should not produce income or depreciation deductions)
- b) 1014: property acquired from a decedent is fair market value at the time of death
- c) adjusted basis provisions
- i) 1011: basis is reduced by any depreciation deductions
 - ii) 1015: debt assumed is taken into account as an amount paid by the taxpayer under the part-gift part sale rule Estate of Franklin
 - iii) 1016 (taxes paid on property increase its basis)
 - iv) 1041: transfers of property between spouses incident to divorce
 - v) 83: property transferred in connection with services
- 2) while holding property it is subject to a depreciation or amortization deductions if it 1) used in a trade or business and 2) not of a type that cannot be depreciated or amortized (such as land, stock, or a partnership interest)
- a) 167 (depreciation): even if a limit on the applicability of a deduction applies, a reduction in basis is still possible
 - b) 168 (ACRS): even if a limit on the applicability of a deduction applies, a reduction in basis is still possible
 - c) 197 (amortization of intangibles): even if a limit on the applicability of a deduction applies, a reduction in basis is still possible
- 3) reductions in basis due to amortization or depreciation deductions that are currently taken under § 101
- a) limits
 - i) hobby loss limitation
 - (1) hobby losses limited to income from property
 - (2) even so, the applicability of the hobby loss limitation doesn't prevent your loss from being reduced under 167, 168, 197
 - ii) passive loss limitation: even so, the applicability of the hobby loss limitation doesn't prevent your loss from being reduced under 167, 168, 197
 - b) Amortization (for intangibles) and depreciation (for tangibles): business expenditures with a useful life beyond the current year must be capitalized as opposed to deducted in the current year. § 263.
 - i) Guidelines for telling whether something can be deducted as an expense or capitalized
 - (1) Must be (completely) used in a trade or business (No deduction possible if part of the property was used for business and part for pleasure)
 - (a) Must be held for production of income
 - (2) There must be some deterioration in the property (e. g. violin bow changed its characteristics over time Simon)
 - (a) Unimproved realty is not subject to depreciation
 - (b) So long as the part of the property that the taxpayer uses deteriorates (Sharp)
 - ii) Steps in calculating depreciation

- (1) First step: can it be depreciated: is it **1) used in a trade or business (§ 167(a) and 2) held for production of income § 168(a)** (if it is partially used in a trade or business, the portion which is used can be deducted Sharp) **3) does it have some useful life.** (e. g. does it deteriorate or change form, so unimproved realty is not eligible)
- (2) Second step: **determine "tax useful life"**
- (3) 3rd step: add **9/11 depreciation** (§ 167(k)): NEW depreciable personal property acquired after 9/10/01 and 9/11/04 gets an extra 30% depreciation, and the basis of the property is adjusted downward before applying normal ACRS rules. Taxpayer can elect out of this
- (4) 4th step: **bonus depreciation of 168(k) which can be elected out of)**
 - (a) **bonus 179 depreciation only applies to ACRS (§ 1245 property) that is acquired by purchase**
 - (b) (§ 179) taxpayer can write off a portion of the cost of some of their property as ordinary expenses subject to a maximum. (§ 179) – (2000=20k, 2001-2=25k, 2003+=25000)
 - (c) applies to the sum total of all property placed in service
 - (d) limit is reduced by one dollar for each dollar of personal property placed in service over 200,000
 - (e) **§ 179 deductions may not exceed** the amount of taxable income derived from trade or business
 - (f) basis of property must be reduced before further depreciation deductions are done: but, if the property is not going to be used until the end of the recovery life, this deduction must be done in the year of conversion
- (5) 5th step: see if limits on perks apply page 436 (computers, cellphones, and things used less than 50% get a longer depreciation)
- (6) 6th step: **select depreciation method** (of course, the total amount of depreciation will ultimately be the same under all of the methods)
 - (a) ACRS (mandatory, if property falls within it)
 - (i) Eligible v. not eligible
 1. Things that are eligible for ACRS
 - a. tangible depreciable property
 - b. property depreciated under a method (such as units of production) that are not determined to life of property
 2. things that ACRS does not apply to (§ 167 applies)
 - a. intangible property does not apply
 - b. property depreciated under a method (such as units of production) that are not determined to life of property
 - (ii) determine possible recovery period for item (§ 168(a) taxpayer may elect to use different depreciation method if it is in the formative years of a business).
 1. 3 year: class life of under 4 and all race horses over 2 years old (qualifies for 200% declining balance method, but taxpayer may elect 150% declining balance method, or straight line depreciation, but any election applies to everything in this class year)
 - a. switch to straight line method in the first year in which the straight line method would have produced a greater amount of depreciation than the declining method
 2. 5 year: class life between 5-9 year class life (qualifies for 200% declining balance method, but taxpayer may elect 150% declining balance method, or straight line depreciation, but any election applies to everything in this class year)
 - a. switch to straight line method in the first year in which the straight line method would have produced a greater amount of depreciation than the declining method
 3. 7 year: 10-15 year class life (qualifies for 200% declining balance method, but taxpayer may elect 150% declining balance method, or straight line depreciation, but any election applies to everything in this class year)

This is really the hierarchy of allocation

- a. switch to straight line method in the first year in which the straight line method would have produced a greater amount of depreciation than the declining method
 4. 10 year: 16-19 year class life (qualifies for 200% declining balance method, but taxpayer may elect 150% declining balance method, or straight line depreciation, but any election applies to everything in this class year)
 - a. switch to straight line method in the first year in which the straight line method would have produced a greater amount of depreciation than the declining method
 5. 15 year property: 20-24 year class life (qualifies for 150% declining balance method, or straight line depreciation, but any election applies to everything in this class year)
 - a. switch to straight line method in the first year in which the straight line method would have produced a greater amount of depreciation than the declining method
 6. 15 year "179 intangibles" rule – acquired (not self-created) intangibles (self created intangibles are ordinary income)
 - a. goodwill
 - b. going concern value
 - c. intangibles inherent (e. g. composition of workforce)
 - d. information basis
 - e. software (if customers come with it)
 - f. non-compete agreements
 - g. patents
 - h. know-how
 - i. does not include
 - i. financial interest in a corporation or other entity (page 438)
 - j. special rules about 197 intangibles
 - i. if part of a 197 intangible is disposed of at a loss, the loss is not recognized and the basis is allocated to the adjusted basis of the remaining 197 intangible
 7. 20 year: 25 or more (can still elect straight line method, but any election applies to everything in this class year)
 8. 25: water utility property (can still elect straight line method, but any election applies to everything in this class year)
 9. 27.5 year: residential rental property (can still elect straight line method, but any election applies to everything in this class year)
 10. 39 year: nonresidential real property (can still elect straight line method, but any election applies to everything in this class year)
 11. 50 years: railroad grating, tunnel bore (can still elect straight line method, but any election applies to everything in this class year)
- (iii) determine convention for when property is deemed to have been placed in service, or taken out of service (e. g. sold)
1. in general, ½ year convention: treats property as if it were placed in service midyear for determining how old it is (so in the first year of service a property only results in ½ of its deduction)
 2. mid-quarter convention: if more than 40% of all ACRS property is acquired during the 4th quarter of the year (that is everything but non-residential real estate and residential real estate), everything is deemed to have been acquired in the 4th quarter, and therefore it is only eligible for 25% of the depreciation deduction for that year
- (iv) determine whether ACRS's anti-churning rules apply
1. churning rules apply ONLY IF the is a great deduction in the first year the property is placed in service, than the related person was able to take for it

- a. related person = family members, spouses, brothers, sisters, ancestors, descendants, and entities such as corporations that the taxpayer has an interest,
 - 2. if they do apply, then must use old method of depreciation
 - (b) if ACRS does not apply § 167
 - (c) intangible property is amortized over its life (see page 437)
 - (7) 7th step: **Add depreciated amount to the property's basis** 1016(a)(2)
 - (a) Basis is reduced downward even if the taxpayer doesn't claim a depreciation deduction
 - c) If the taxpayer claims no depreciation the basis is increased as per the straight line method
 - d) Deductions are limited to the "amounts at risk" rules. § 435 limits activity loss to the amount that the taxpayer is personally "at risk" in the activity (c.f. old rule where the basis was the only limit, and the basis included nonrecourse loans)
 - iii) General rules for determining the amount at risk
 - (1) Amounts that are at risk
 - (a) To the extent of the cash and adjusted basis of what was contributed
 - (b) Amounts that the taxpayer borrowed for which he is **personally liable**
 - (c) Property that is pledged is considered to be at risk
 - (d) loans from related people can be considered to be at risk, if the terms of the loan are substantially similar
 - (2) Amounts that are not at risk
 - (a) Non-recourse loans
 - (b) other guarantees
 - (c) amounts borrowed from related persons or the seller of the property
 - (i) loans from related people can be considered to be at risk, if the terms of the loan are substantially similar
 - (3) even though an amount might not be at risk, the basis of the asset may still be increased
 - iv) this does not apply directly to pass-through entities, but these limitations apply directly to the parties that they are passed through to
 - v) § 465(e)(1)(A): if amount at risk becomes negative, it must be **recaptured as ordinary income**
- b) deductions are limited by hobby loss rules
 - i) activities for fun (not for profit): can only deduct expenses up to the amount of expenses (can't take a loss) 1.183-2(a)
 - (1) presumption that activities are actually engaged in for profit
- c) deductions limited by passive loss (this applies to both closely held corporations, personal service corporations, and individuals – as to pass-through entities, the limitations are passed through to the individual)
 - i) the effect is that the deductions are only postponed, not disallowed
 - ii) put assets into three baskets: losses and gains may only be offset against each other
 - (1) passive
 - (2) investment (portfolio)
 - (3) active (everything else)
 - iii) grouping rules
 - (1) if two activities are part of the same activity, then the taxpayer need only establish that he participates in one to avoid passive classification
 - (2) if they are separate must materially participate in both no regrouping allowed unless there is a material change or a mistake in the original grouping 1.469-4(e)
 - iv) safe harbors that create active activities under 1.469-5T(a)
 - (1) by time
 - (a) 100 or more (and no one else involved)
 - (b) more than 500 hours per year
 - (2) by nature of taxpayer's activity
 - (a) taxpayer's activity is substantially all of the participation (including non-owners)
 - (b) significantly participates in enumerated significant participation activities 1.459-5T(c)

- (c) personal service activity
- (3) rental activities (with one exception is per se passive)
 - v) if you spend enough time in the real estate business, the per se rule doesn't apply 469(c)(7)
 - vi) small time real estate activities 469(i)(6)(A) which will generate active activities -- can use up to 25% of the passive activity losses in the activity to offset active gains
 - (1) must actively participate (make decisions about rent) in the year that the deduction and the credit arose
 - (2) have 10% of your losses in the basket
 - (3) have at least a 10% interest in the business
 - (4) agi less than 100k
 - (i) not an LLP
- (5) by historical nature of the taxpayer's activity
 - (a) material participation for 5 of the past 10 years
- (6) 100 hours or more and a regular, contiguous or substantial basis
- (7) LLCs (according to the D. Oregon)
 - (a) limited partners: 469(h)(2): and 1.469-5t, if one participates as a limited partner, one will only be a material participant only if the follow under 1.469-5t--2,3,4, and 7 (and none of the other safe harbors) (substantially all, enumerated activities, 100 hours or more and alone, 100 hours and on a continuous and substantial basis
 - (b) hybrids (LLCs): according to the D. Oregon, people in LLCs will have to follow the same rules as the people in LLPs
- vii) obviously, suspended losses are released at the time of the disposition of the property
 - (1) limits
 - (a) in an installment sale, the suspended losses are released as each installment is made
 - (b) a disposition of a passive activity to a related party will not unsuspend the losses until the related party gets rid of them (page 435)
 - (c) disposition of passive activities by gift: the basis is increased by the passive losses allocated to it
 - (d) death results in suspended losses being released on the final return of the decedant
- 4) realization of gain by selling property
 - a) non-recognition rules
 - i) § 1031: like-kind exchanges
 - ii) § 351: Transference to corporation
 - iii) § 721: putting money in a partnership
 - iv) § 165(c): there are limitations on the ability of individuals to deduct losses: must be incurred as part of a trade or business, or for profit, or shipwreck type loss (no deduction for losses on personal property)
 - b) realization events:
 - i) sales: conversions of the property into cash⁴ unless an exception applies
 - ii) change in form:
 - (1) passage of ownership is based on a shift of the **opportunity for gain** and the **risk of loss**
 - (2) Changes in the form are realization: Cottage Savings: whether the properties exchanged embody distinctly different entitlements (bar is quite low to taxable transactions)
 - (a) properties are "materially different" if their respective possessors enjoy legal entitlements that are different in kind or extent so 90% participation interest in savings association's mortgages was materially different from 90% mortgage participation interest received by savings association from other savings associations.
 - iii) encumbrances: encumbrances are generally not taxable events

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Treas. Reg. 1.1001-1(a)	(a) General rule. Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.....
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- iv) Discharge of indebtedness (remember general rule that amounts received in a loan are not taxable, but income from the discharge if indebtedness generally is taxable)
 - (1) Things that look don't look like discharge, but really are discharge:
 - (a) Statutes of limitations expiring (doesn't matter whether or not the state bars collection or extinguishes debt)... but make sure that running of statute of limitations is not of donative intent, or was a devise (because devises of COD count as devises, not COD)
 - (b) purchasing back notes for less than their value is considered to be a discharge Kirby
 - (i) exceptions to Kirby:
 - 1. solvent farmers can pretend that they are insolvent 108(g)(2)(A)
 - 2. election to treated "qualified real property indebtedness" (after the bankruptcy or insolvency exceptions apply) (page 179)
 - 3. Rail Joint: where there was never any real obligation to pay the debt anyway (cancellation of bonds distributed as dividends)
 - (2) Things that look like discharge, but are not discharge
 - (a) any discharge need not be included in gross income if debtor has filed an **bankruptcy** petition § 108(a)(1)(a)
 - (b) **purchase money** adjustments: where a creditor is not bankrupt or insolvent, 108(e)(5), a purchase money adjustment may be used and it is treated as a price reduction. However, when the adjusted basis is less than the purchase money reduction, then the difference must be realized.
 - (c) compromises of **good faith disagreements** need not be included in income
 - (d) if the amount would have been **deductible when it was paid**, it need not be included in gross income (e.g. discharge to pay compensation to an employee) § 108
 - (e) cancellation of a debt as a **gift** doesn't need to be included
 - (f) payment of a debt by performing services really is prepayment of a debt --- this is considered to be prepaid services (same goes for prepayment by employers which might be compensation)
 - (3) character of discharge is ordinary
 - (4) calculation of amount realized in cancellation of indebtedness

$$realized amount_{recourse\ debt} \equiv fmv\ value\ of\ property\ surrendered$$

$$(a)\ recognized amount_{nonrecourse\ debt} \equiv realized amount_{recourse\ debt} - basis$$

$$COD\ income_{ordinary} = amount\ of\ debt - fmv\ value\ of\ property\ surrendered$$

Figure 1: Recourse debt. COD income is reduced by exclusions

$$(b)\ realized\ amount_{nonrecourse\ debt} \equiv amount\ of\ indebtedness\ before\ discharge$$

$$recognized\ amount_{nonrecourse\ debt} \equiv amount\ of\ original\ indebtedness - basis$$

Figure 2: If the mortgage debt is nonrecourse, the amount of the debt is amount realized under Tufts and Regulations §§ 1.1001-2(a) and (b) even if it exceeds the value of Lot 1.

- (5) Exclusion of discharge is allowed when the taxpayer is insolvent, but they recapture it reducing (in order) the following tax attributes (not ratably). Within each category may recapture it to highest rate first.
 - (a) Insolvency now includes claims against exempt assets
 - (b) Normal circumstances: adjust tax
 - (i) nol, and carryovers
 - (ii) carryovers of general business credit
 - (iii) alternative minimum tax credit
 - (iv) capital losses
 - (v) basis of the taxpayer's assets
 - (vi) carryovers of passive activity losses or credits
 - (vii) carryovers of the foreign tax credit

- (c) election: If the taxpayer elects to do this, under § 108(b)(5) (no limits)
 - (6) If taxpayer is bankrupt : GI doesn't include income from discharge of indebtedness
 - v) Assumptions of indebtedness.
 - (1) Personal liability (or personal combined with non-recourse liability) that was assumed as part of a transaction
 - (a) Donor realizes his relief of indebtedness (Crane and § 465)
 - (i) Fair market value is really irrelevant to the calculation
 - (b) Donee takes as a part-gift part sale under 1.1015-4
 - vi) Goods given to employees for less than fmv are considered to be a form of compensation (up the amount below the fmv)⁵
 - c) Recognition of **original issue discount (see other outline)**
 - i) Installment sales (see other outline)
 - d) general rule: § 1001: the difference between the basis and gain or loss
 - e) limits to recognition: 1.1001-2 (Estate of Franklin provision): usually encumbered property that is disposed of decreases the amount realized, but if the encumbrance is significantly less than the actual value of the property, the debt should not have been included in the basis (and should not produce income or depreciation deductions)
- 5) determine applicable rates based on character of gain
- a) ordinary income (sale of a cap. asset.). Capital assets are defined negatively. These things are ordinary
 - i) general criteria for ordinary gain from Biendenham
 - (1) frequent or numerous sales generates ordinary income
 - (2) significant improvements generates ordinary income
 - (3) brokerage activities advertising
 - (4) purchase and retention with a goal to short-term resale
 - (5) relation of the property to the taxpayers other activities
 - ii) **inventory**⁶ held for sale to customers in the ordinary course of business: cannot be a capital asset
 - (1) Mauldin: appeared to be a **casual seller** of real estate, but court held that once he began to buy and sell the land as **part of a trade or business**, and therefore become ordinary income
 - iii) issues of rental properties
 - (1) safe harbor: (§ 1237): for people **who never traded in real estate before** they can engaged in limited real estate dealings
 - (a) Hort: income received to **cancel a lease** is ordinary income not a capital gain (and the lessor couldn't reduce the monies received by his basis in the property). Court viewed penalty as advance rent.
 - (b) Metropolitan Building⁷ (codified in 1241⁸): But, payment to a lessee to **terminate** lease is a capital gain, since he has an interest in it

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1.61-2(d)(2)(i)	(i) Except as otherwise provided in section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income
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⁶ stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

- iv) **Supplies** used in the ordinary course of business (that could be expensed)
- (1) **depreciable or real property** used in trade or business subject to depreciation (equipment)⁹
 - (2) **copyrights or literary assets**
 - (a) amortizable Sec. 197 intangibles are not capital assets
 - (b) but, patents are considered to be capital assets
 - (3) **self-created intellectual property** created by the person¹⁰: still an open question as to whether or not a corporation can exert personal efforts¹¹
 - (a) letters produced for the holder
 - (b) intellectual property that is inventory
 - (c) *theory is that something that a corporation creates may still be a capital asset because it isn't created with the personal efforts of the corporation*
 - (i) however, the service will respect the way that a taxpayer treated the development of software¹² (so there is some flexibility, as to whether the costs of developing software can be expensed or can be treated as a capital asset)
 - (d) self-created goodwill and client is intellectual property (i.e. they start as a 197 intangible)
 - (e) **accounts receivable**
 - (f) **US government publications**
 - (g) **Commodities and derivatives** sold by dealers (ie they might be capital assets in the hands of dealers)\

⁷ Facts

- payment of money from subtenant to tenant
- subtenant paid money to tenant to deal directly with landlord
- tenant took the position that the payment was capital gain
- court held that there was a transfer of a valuable right

⁸ **1241**: Amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement⁹ property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

¹⁰ (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held 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
- (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

¹¹ 1223(a)(3)

¹² Rev. Proc 2000-50: The costs of developing computer software (whether or not the particular software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of § 174 as to warrant similar accounting treatment. Accordingly, the Service will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where:

- (1) All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under § 174(a); or
- (2) All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by § 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in § 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.

- (i) exception: § 1234A: derivatives can be treated as a capital asset if they cancel lapse, expire, etc.
- (ii) securities held by brokers will generate ordinary income Van Suetendael
- (iii) but, hedging transactions (that are identified must be identified as a hedging transaction when it was entered into in order not to be a capital assets)
 1. Arkansas Best: Net proceeds from hedging transactions that are an integral part of the business inventory purchase system are treated as proceeds from the sale of inventory and generate ordinary gain or loss. This refined Corn Products which held that all hedging transactions generate ordinary gain or loss
 2. Might have to look at whether it was a real substitute for a widget, so buying stock in a corporation that produces something won't count
- b) Everything else is a capital asset (which can either be long or short term)
 - i) Determine if the capital loss is long term or short term
 - (1) basics
 - (a) timing
 - (i) **Long term** is more than a year
 - (ii) **Short term** is one year or less
 - (a) caveats (consistency in characterization)
 - (i) **Claim of Right** and the "**Arrowsmith**" doctrine. If taxpayer received a payment with no amounts currently owing, but at some point they may owe money (e. g. liability from a dissolved corporation) then the payment is characterized as reducing the gain from that payment.
 - (iii) **Skelly Oil**: if one has to give back money, they are only entitled to an offset in the amount that it was originally characterized as (oil company had to refund money – it could only take a loss to the extent that it originally characterized the stuff as income)
 - (2) Timing issues
 - (a) Special deemed holding periods
 - (i) § 1223(b): **short sales** are always short term capital gains and losses
 - (ii) grantees of options always take short term capital losses (deemed under 1 year)
 - (iii) individuals not in lending business who take a worthless debt get short term capital losses
 1. **Bunches of stock**: regulations say that if the customer can ID which stocks are to be sold when, they can pick and choose
 - (iv) § 1223(11): property acquired from a **decendent** that is **quickly** sold is deemed to be sold after one year for long term capital gain purposes
 - (v) § 1235: **patents**: imputes a one year holding period to patents that might be held as inventory
 - (vi) § 1259: **short sales**: closing out short sales: the holding period shall be determines as if such position were originally acquired on the sate of the constructive sale (check this)
 - (vii) § 1234A: **derivatives** can be treated as a capital asset if they cancellation lapse, expire, etc.
 - (b) Beginning and end
 - (i) Begins day after acquisition (Rev. Rule 66-7)
 - (ii) Use fractions of calendar months, not days (Rev. Rule 66-7)
 - (iii) Trade date, not settlement date is what matters (Rev. Rule 66-97)
 - (c) **Bunches of stock**: regulations say that if the customer can ID which stocks are to be sold when, they can pick and choose
 - (d) Options
 - (ii) 1223(6): holding period for option begins at time of acquisition of option
 - (iii) but if option is extremely in the money it can be viewed as an outright sale Rev. Rul 82-150 (look at time the option is acquired) – works with non-securities
 - (e) tacking

- (i) Non-recognition transactions result in tacking of holding period (in general, if basis is determined in whole or in part with regard to another property, you get to take that property's holding period)
- (ii) § 1223(2) holding period includes a donor's holding period
- (iii) but in a part-sale part gift, where they take the lesser holding period (check this – it would seem that it should be distributed)
- (f) Imputed realizations
 - (i) Extinguishment (Judicial Doctrine) of extinguishment: when there is a sale or exchange that destroys the instrument it is considered to a realization event. **Glavin Hudson** (Property (judgment) ceased to exist, evidenced by some paperwork (Nonsensical that because the property disappeared it was prevented from being a sale or exchange) of **Kenan** (where securities were delivered to the taxpayer before they would have passed to them by will this was realizable gain, since the will and the trust still existed)
 - 1. Caveat § 1271: if something is a real debt instrument amounts received on its retirement will be considered an exchange (note: see 1271(a): if there was an early call date, realized gained will be ordinary income as determined by OID-portion that was previous included as income)
 - 2. Caveat § 1276: ordinary income for everything below market discount (where price of bond on a market is less than face value) Market discount *accrues ratably*
 - a. can elect to have market discount accrue on basis of *constant interest rate* (as if the bond had been issued on the date that it was acquired for the basis that the taxpayer had in it immediately after acquisition)
 - (ii) § 1241: tenant v. **landlord buyout** imputes realization
 - (iii) § 165(g): sale or exchange imputed when things become **worthless**
- c) **recapture depreciation as ordinary income (rather than capital gain)**
 - i) recapture of depreciation above straight line depreciation 1250 converts that amount of capital gain to ordinary income
 - (1) (only really applies to property placed in service before 1986) since depreciable real property recapture is limited to the excess of straight line depreciation, and depreciable real property is limited to straight line depreciation
 - ii) depreciable personal property 1245 recapture by 1245 (any recognized gain must be treated as OI to the extent of previously allowed depreciation deductions)
 - (1) rule: : treat **MIN(“recomputed basis” in the property, amount realized) – adjusted basis as ordinary income**
 - (2) recomputed basis is defined as **basis + all deductions allowed (including to properties acquired in a like-kind exchange), and deductions to damage or loss**
 - (3) no requirement to recapture if property disposed of by gift (donee must recapture) or at death
- d) recharacterization of assets for businesses but the hotchpot § 1231 hotchpot principles (to virtually all non-inventory property) of business property
 - i) 1231 hotchpots that recharacterize things as ordinary or capital losses
 - (1) exceptions to hotchpot for related party transactions (disallowance of loss because of related party transaction)
 - (a) no netting rule: so if the transaction included some losses, they simply evaporate
 - (b) attribution (*McWilliams*: can't create a fictitious open-market transaction by buying and selling at the same time)
 - (i) family members
 - 1. siblings (whether by the whole or half blood)
 - 2. spouse
 - 3. ancestors, and lineal descendants
 - (ii) corporate
 - 1. An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

2. Two corporations which are members of the same controlled group
- (iii) Trusts
1. A grantor and a fiduciary of any trust;
 2. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
 3. A fiduciary of a trust and a beneficiary of such trust;
 4. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
 5. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- (iv) Corporation attribution rules for hotchpot purposes
1. A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership;
 2. A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- (v) Steps in hotchpot
1. step one: determine the adjusted basis of each asset
 2. step two: determine what property may even begin to go into the hotchpot (must allocate things in the hotchpot **Williams v. McGowan**)
 - a. property, held for more than one year, and used in a trade or business (business is given a wide definition (Wasnok) that are not considered capital assets)
 - i. things not included (so, inventory, copyrights, accounts receivable)
 - ii. real property held for more than one year
 - b. property that is not held for more than one year but IS used in a trade or business entered into for profit
 - i. **recognized gain or loss** from **sale** or exchange of **depreciable business property** held for more than **one year**
 - ii. or any recognized gain or loss resulting from **involuntary conversion**
 3. step three: apply 1231(c)(4) subhotchpot (involuntary gains and losses)
 - a. defining involuntary gains
 - i. condemnations not included
 - ii. fire storm, etc.
 - b. (be sure to back out insurance compensation)
 - c. if *losses exceed gains*: § 1231 doesn't apply, and these assets remain ordinary losses
 - d. if subhotchpot *gains exceed losses*, all of these properties continue into the main hotchpot
 4. step the fourth: apply main § 1231 hotchpot principles
 - a. any recognized gain from the sale or exchange of depreciable business property held for more than one year (for business or profit-seeking activity) and anything from involuntary conversion (subhotchpot, above)
 - b. exceptions
 - i. gains are included in the 1231 hotchpot only to the extent that they have not been already treated as ordinary income under 1239 (between related taxpayers, 1245 or 1250 (depreciable realty))
 - c. if the gains in the hotchpot exceed the losses, then each of the gains are considered to be **long term capital gains**

- d. if the losses exceed the gains, than all each of the losses are considered **deemed ordinary losses**
- 5. step the fourth: apply the main 1231(c) lookback rule, which potentially reduces the size of the hotchpot
 - a. if there are current hotchpot gains, subtract from it the pervious five years losses (that have not been subject to this rule yet). Take that amount and **reclassify it** as ordinary income
 - b. when assets are sold at a loss there is not requirement to recapture

6) rate settings

a) Net the longs and the shots

- i) net long term capital gain or loss = (Long Term Capital Gain– long term capital loss)
- ii) net short term capital gain or loss = (Short Term Capital Gain– short term capital loss)
- iii) net the long term capital gain or loss and the short term capital loss against each sother, meaning that everything in the previous step should be netted against each other

b) Differences with corporations

- i) an be carried back 3 years and forward 5
- ii) No preferential capital gain rates -- generally all the same

c) apply the rates in § 1(h) (see table)

- i) strategy: Want to eliminate short term capital gains first because **net losses can be carried forward but not back**

ii) Application

- (1) If there are capital gains, they are considered to be taxed at the highest increment of taxable income – so, as a practical matter it will be 20%
 - (a) 28% rate will be imposed on collectible
 - (b) startup incentive: 28% rate for § 1202 gain
- (2) exclude 50% of the gain on small business stock NOT TO EXCEED (max(10 times the taxpayer basis in the stock disposed of, or 10 million) anything remaining is subject to tax at a 28% rate
- (3) 25% for 1250 capital gain from sale of depreciable real property to the extent that the depreciation has been previous allowed
- (4) adjusted net capital gain: 20% gain from stocks bonds – for long term stuff
- (5) 18% rate if assets were acuire after 12/31 2000 and held for more than 5 years – incentive for real long term holding
- (6) if the taxpayer has inadequate ordinary income the lower 10-15 rates will apply

Character			Result
NLTCL	>	NSTCL	Tax on whatever is left gets determined under § 1(h) § 1222
NSTCG	>	NLTCL	Taxed at ordinary income rates, but it is not ordinary income
NLTCL	And	NSTCG	NLTCL is under § 1(h), NSTCG is ordinary income
NLTCL	>	NSTCG	<ul style="list-style-type: none"> • Capital losses can offset, and remainder will carry forward indefinitely § 1212 • For individuals \$3k/year can be used as ordinary income
NSTCL	>	NLTCL	3,000 can be used against ordinary income remainder can be carried forward as a short term capital loss
NLTCL	And	NSTCL	(loser year) 3,000 can be used against ordinary income balance can be carried forward balance is applied first against the net short term capital loss

Contingent payment streams

Year	Interest	Gain/loss
0	0 since payments are deferred until fixed 1.1275-4(c)(4)	<ol style="list-style-type: none"> 1) Capped payment; set period <ol style="list-style-type: none"> a) Determine GPR: <ol style="list-style-type: none"> i) $SP = \text{current payments plus present value of maximum future payments}$ ii) $GP = SP - \text{Adjusted Basis in property}$ iii) $CP = SP - QI$ to extent not in excess of AB iv) $GPR = GP/CP$ b) Identify what actually is a payment in current year (cash or cash equivalent is a payments, and NOT interest or escrow) c) Multiply payment by GPR for gain 2) No cap on the payments, but fixed number <ol style="list-style-type: none"> a) Each year gets a basis of its share of the basis. 15A.453-1(c)(3). Basis must first be reduced by assumption of QI. b) Identify what actually is a payment in current year (cash or cash equivalent and NOT interest). (assumption of QI is not a payment either) c) Subtract AB allocated to first (and all) years from payments 3) No cap on payments, and no fixed number. Regs hesitantly say to assume 15 years, but really make sure that it is a payment. <p>Remember: Multiple any actual payments by GPR</p>
N	Discount payment back to sale. $\text{interest} = \text{payment} - \text{present value of payment at time of sale}$	<ol style="list-style-type: none"> 1) Capped payment; set period <ol style="list-style-type: none"> a) Determine what portion of the actual payment received is interest by subtracting from it the present value b) Determine unrecovered basis by subtracting from basis whatever was not treated as a gain in the first year because of GPR. (e.g. $\text{unrecovered basis} = \text{basis} - \text{earlier gain} * (1 - \text{gpr})$ a.k.a. $\text{Unrecovered basis} = \text{basis} - \text{portions of payments NOT treated as a gain in the prior years}$) c) $\text{Amount realized} = \text{payment of principal minus received basis}$ 2) No cap on the payments, but fixed number <ol style="list-style-type: none"> a) Allocate adjusted basis in proportion to the number of possible payments b) Identify payments (backing out any imputed interest) c) Subtract allocated basis from payments to find gain

Election out of installment sale regime.

	Interest	Gain
Open transaction	0 in first year later years is difference between present value and amount	Principle portions recognized only after recovering entire basis
Closed transaction	0 in first year interest income is the payment actually received discounted back.	<p>First year: Amount received at closing + fair market value of contingent payment streams</p> <p>Later years: If more than earlier valued fair market value treated as reduction of basis to the extent of the value assigned. This amount is then reduced by whatever was treated as basis. (total gain and loss should equal actual payment received minus earlier value).</p> <p>If less than earlier fair market value, a loss is recognized to the extent of the payment plus interest. However, there is also interest income recognized.</p>

Installment Sale checklist

- 1) Adjust basis downward for depreciation. (But not for recomputed 1270 basis, which re-characterizes capital gains as ordinary income to the extent of excess of straight line depreciation.)
- 2) Identify which actually constitutes a payment and multiply by GPR
- 3) Recoup QI that exceeds adjusted basis in year one.
- 4) Make sure QSI is taken into account as ordinary income.
- 5) Check for OID. If amounts due, when discounted back are less than SRPM then there is OID of the difference
- 6) If $IP < \text{Stated principal amount}$ use OID table and payment year is principal payment minus OID times GPR.
- 7) Make sure an include stated interest as OID
- 8) In a bifurcated installment sale no interest payments are QSI
- 9) To account for interest v. principal of contingent payments, subtract out the amount of the payment discounted back at the applicable federal rate.
- 10) Assumption of QI is not a payment so in allocating basis between years in a contingent payment first reduce adjusted basis.

OID Helper

Overall OID

$\sum \text{OID} = \text{Stated Redemption Price at Maturity minus issue price}$

SRPM = \sum all payment on the instrument minus QSI (in general this is the principal amount due on the note)

QSI = Unconditionally payable interest

- 1) See if special rules apply
 - a) Discount rate can be capped if the debt instrument is under 2,800,000 adjusted for inflation at 9% - 1274A
 - b) Can elect installment sale method only if under 2m
- 2) To determine whether there is OID ($\text{OID} = \text{SRPM} - \text{IP}$) where *IP is either the imputed principal or the actual principal if adequate* and *SRPM is stated interest plus stated principle minus qualifying stated interest*
 - a) See if exceptions in 1272(a) apply
 - i) tax-exempt obligations
 - ii) U.S. savings bonds
 - iii) obligations with terms of not more than one year
 - iv) and certain loans between individuals in amounts not exceeding \$10,000.
 - v) Discount rate can be capped if the debt instrument is under 2,800,000 adjusted for inflation at 9% -- 1274A
 - vi) Can elect installment sale method only if under 2m 1274C
 - b) See if holder makes election to treat all interest as OID (considered on the basis of a constant yield)
 - c) If $\text{SRPM} - \text{IP} > 0$ then there is OID
 - i) $\text{SRPM} = \sum$ all payment on the instrument minus QSI (in general this is the principal amount due on the note)
 - (1) A.k.a. $\text{SRPM} = (\text{Stated Interest plus stated principle}) - \text{qualified stated interest}$ (so, anything above qualified stated interest will not count as part of SRPM)
 - ii) QSI = interest that is 1) unconditionally (default doesn't count) payable 2) under a fixed rate (excess can be discarded) 3) at least annually and 4) properly takes into account the intervals between payments (except that the first and the last ones can be of different length)
 - iii) Defining IP
 - (1) Exceptions under § 1274(c)(3) where $\text{IP} = \text{SRPM}$, so no OID
 - (a) certain sales of farms for \$1,000,000 or less
 - (b) sales of principal residences
 - (c) sales involving total payments of \$250,000 or less
 - (2) Special circumstances
 - (a) If all interest payable on the instrument is QSI then this issue is really moot
 - (b) If the stated rate of interest is at least equal to the "test rate," then this issue is moot
 - (c) If the instrument is not issued in a "potentially abusive situation"
 - (d) no payments designated as points or interest are made to the seller at the time the instrument is issued
 - (3) Things not covered in course (publicly traded property, debt instrument issued for cash, part of an issue that is publicly traded): are covered under § 1274
 - (4) Normal circumstances: § 1273
 - (a) Step one: determine if there is adequate stated interest
 - (i) Determine the imputed principal amount of a debt instrument: \sum present values of all payments (including stated interest) due under the instrument (from the respective dates they become due), determined as of the issue date using a discount rate equal to the test rate. § 1274(b)(1) and (2); § 1.1274-2(c)(1).
 - (ii) A debt instrument as adequate stated interest if the stated principle amount is less than or equal to the imputed principal amount
 - (b) Step two: ask is there adequate stated interest?

- (i) If yes: **IP is the stated principal amount of the instrument** (the sum of all payments due under the instrument, excluding stated interest). § 1274(a)(1); § 1.1274-2(b)(1).
 - 1. if there is only one payment then $OID = SRPM - IP$
 - (ii) If no: **IP is the “imputed principal amount.”** A.k.a. the \sum present values of all payments (including stated interest) due under the instrument (from the respective dates they become due), determined as of the issue date discounted back using the test rate. § 1274(b)(1) and (2); § 1.1274-2(c)(1) a.k.a. the present value of the payments due under the instrument discounted from the dates they come due back to 1/1/99 at the test rate
 - 1. if there is only one payment $OID = SRPM - \text{Imputed Principle amount}$
- d) Amount of $OID = SRPM - IP$ (a.k.a. whatever the stated principal amounts on the instrument are, minus the actual issue price if adequate, or the imputed price if inadequate)
 - i) if interest amount, compounded annually and outstanding balance = federal rate then there is no OID
 - ii) But, if interest amount, compounded annually < federal rate
 - (1) Additional amount above what would normally be payable are considered OID
 - (2) Constant amount (e. g. 3 payments of a fixed interest amount that does not decline are not QSI, and all OID)
 - iii) check to see if *de minimis* exception applies
 - (1) OID will be deemed to be zero if it is less than .0025 (or .00167 for self-installment obligation) * SRPM * number of years to maturity from the issue date. (but if the instrument is an installment instrument, use the WEIGHTED AVERAGE MATURITY of the instrument)
 - (a) Identifying a self-amortizing installment obligation: instrument that provides for equal payments composed of principal and qualified stated interest that are unconditionally due during the entire term of the instrument with no additional required payment at maturity. Regulations Section 1.1273-1(e)(2). Although each payment under the instrument is of the same amount, the portion of each payment that is interest decreases, and the portion of each payment that is principal increases, over the term of the instrument.
 - (2) If OID is deemed to be zero, all of the stated interest is QSI
 - (3) If OID is deemed to be zero, and an amount is NOT treated as QSI because it is not labeled as interest will be includible by the holder on a ratable basis, and given capital gains treatment
 - (4) This de minimus OID can be deducted either 1) at maturity or 2) on a straight line basis or 3) in proportion to the stated interest payments
- e) Amount realized, if determined under 1274, income will be the IP of the instrument **unless it is an installment sale** (see other part of outline)
- f) Basis
 - i) Basis of buyer will be IP
 - ii) Buyers of installment instrument who have different bases than its AIP
 - (1) must allocate his basis in the instrument (i) first to the noncontingent component to the extent of its AIP (and to any deemed instruments arising from any contingent payments becoming fixed to the extent of their respective AIPs) and then (ii) thereafter to the contingent component.
 - (2) The portion of any contingent payment that is treated as principal reduces the taxpayer’s basis in the contingent component. Once the taxpayer’s basis in the contingent component has been reduced to zero, any remaining contingent principal payments are treated as gain from the sale or exchange of the instrument.
 - (3) Any remaining basis left in the contingent component after the final contingent payment has been made increases the taxpayer’s adjusted basis in the noncontingent component or, if there are no noncontingent payments remaining to be made, is treated as a loss from the sale or exchange of the instrument. Regulations Section 1.1275-4(c)(5).
 - iii) Basis of note in hands of holder is increased by amounts of OID that actually were included in income. Regulations Section 1.1272-1(g)

- (1) Holders basis is decreased by the holder's basis in the debt instrument is decreased by any payment he receives on the instrument that is not a QSI payment. § 1.1272-1(g)
- (2) A seller of a note has a basis equal to issue price of the note plus the \sum OID accruals + (fractional part of partial years) - \sum sum non-QSI payments.
 - (a) Unless the note in Lender's hands is an asset described in 1221(a)(1) (stock in trade, etc.) , recognized gain would be a long-term capital gain.
- (3) The amount received on the sale, exchange or retirement of a debt instrument subject to Regulations Section 1.1275-4(c) is allocated
 - (a) first to the noncontingent component to the extent of its AIP (and to any deemed instruments arising from any contingent payments becoming fixed to the extent of their respective AIPs)
 - (i) (The amount allocated to the noncontingent component (or any deemed instrument arising from any contingent payment becoming fixed) is treated as an amount realized from the sale, exchange or retirement of the noncontingent component (or deemed instrument). The amount allocated to the contingent component is treated as a contingent payment made on the date of the sale, exchange or retirement (and as principal or interest under Regulations Section 1.1275-4(c)(4)). Regulations Section 1.1275-4(c)(6).)
 - (b) anything left over is allocated to contingent component.
- iv) Someone who sells something in return for a note
 - (1) If a taxpayer sells non-publicly traded property entirely or in part for a debt instrument and he doesn't report it under the installment method, the portion of his amount realized attributable to the debt instrument is 1) the IP of the overall debt instrument as determined under § plus (ii) the fair market value of the contingent payments. **Can argue that this is an open transaction, but the Regulations caution that the fair market value will not be reasonably ascertainable only in rare and extraordinary cases.**
 - (2) The portion of the buyer's initial basis attributable to the debt instrument, on the other hand, is the instrument's issue price without regard to the contingent payments. The buyer's basis is then increased by the portions of the contingent payments that are treated as principal as the payments are made. § 1.1012-1(g)(1), 1.1275-4(c)(7), example 1.
- g) When a payment is received, determine its character
 - i) If it is **NOT** a payment of QSI, late charge or a "pro rata prepayment: first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and that has not been allocated to prior payments and (ii) second as a payment of principal
 - ii) Accrual and cash method tax payer take interest into account as it accrues
 - (1) The QSI, under their regular methods of accounting.
 - (2) The OID is always taken into account as it accrues.
 - iii) If it is a payment of QSI, late charge or a "pro rata prepayment:
 - (1) Pro-rata prepayments
 - (a) Pro-rata prepayments is defined as A pro rata prepayment is a payment on a debt instrument made prior to maturity that (i) is not made pursuant to the instrument's payment schedule and (ii) results in a substantially pro rata reduction of each payment remaining to be made. Regulations Section 1.1275-2(f)(2).
 - (b) Treatment of Pro Rata Prepayment. A pro rata prepayment is treated as a payment in retirement of a portion of the debt instrument. Accordingly, the **holder may recognize gain or loss on the prepayment** calculated by treating the original debt instrument as two debt instruments, one of which is retired and the other of which remains outstanding. The AIP, adjusted basis and accrued but unpaid OID as of the time immediately before the prepayment are allocated between the two instruments based on the portion of the instrument treated as being retired. § 1.1275-2(f)(1).
- 3) Pre-steps for dealing with contingent payments of OID
 - a) Bifurcate instrument into contingent and noncontingent steps
 - i) De minimis rules only apply to the instrument as a whole, not to the hypothetical separate instrument
 - b) The two instrument

- i) "non-contingent instrument"
 - (1) IP is IP of overall instrument: $IP_{\text{overall debt instrument}} = \text{MIN}(\sum \text{instrument's noncontingent principal payments or } \sum \text{present values of the noncontingent payments at the test rate})$. If the instrument is issued in a potentially abusive situation, however, the IP is the fair market value of the noncontingent payments. § 1.1274-2(g).
 - (2) **No interest payments on the noncontingent instrument are QSI Regulations Section 1.1275-4(c)(3).**
 - (a) **Remember *OID* ($OID = SRPM - IP$) where *IP* is either the imputed principal or the actual principal if adequate and *SRPM* is stated interest plus stated principle minus qualifying stated interest, so in a contingent payment $SRPM = \text{Stated Interest Plus Stated Principal of the fixed instrument}$**
 - (3) **NQSI = principal amounts + qualified stated interest since it is no longer QSI!**
 - (4) de minimis rules do not apply
- ii) contingent instruments
 - (1) normal fix and pay at the same time:
 - (a) Each contingent payment is discounted from the date it is made back to the date of the sale or exchange at the test rate applicable to the overall instrument, determined as if the term of the overall instrument began on the date of the sale or exchange and ended on the date of the payment (provided that the test rate is the stated interest rate if the payment consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate).
 - (b) The present value of the payment is treated as principal. The excess of the amount of the payment over the present value of the payment is treated as interest (includible by the holder and deductible by the issuer, subject to any applicable limitations, in the year in which the payment is made). § 1.1275-4(c)(4).
 - (i) Steps
 - 1. discount back
 - 2. subtract absolute value from amount
 - (2) **Fixing fixed and followed by payment over six months later:**
 - (a) the issuer is deemed to have issued to the holder, on the date the payment becomes fixed, a new debt instrument
 - (i) new debt instrument has stated principal of amount that becomes fixed
 - (ii) new debt instrument has IP equal to the amount that becomes fixed discounted from the date the payment comes due back to the date the payment becomes fixed at the test rate applicable to the overall instrument (substituting the date the payment comes due for the date the payment is made).
 - (iii) The IP of the deemed instrument is treated as principal or interest Section 1.1275-4(c)(4)(iii).
 - 1. It is principle: The present value of the payment is treated as principal. Regulations Section 1.1275-4(c)(4).
 - 2. It is interest: The excess of the amount of the payment over the present value of the payment is treated as interest (includible by the holder and deductible by the issuer, subject to any applicable limitations, in the year in which the payment is made). Regulations Section 1.1275-4(c)(4).
 - (b) There is no realized interest or OID until it becomes fixed
 - (3) Basis in contingent instruments
 - (a) initial basis in the office building is \$3,014,521. His basis is then increased by the portions of the contingent payments treated as principal as he makes payments
 - (4) Amount realized
 - (a) Could elect installment sale treatment – different rules
 - (i) Amount realized is BAIP plus fmv of any contingent payments
 - (b)

4) Accrual steps

- a) Determine YTM: constant amount that would produce a set of values equal to the IP of the instrument
- b) Determine accrual period. They can be any length (for this course, they will be one year)

Accrual Period	BAIP (Beginning Adjusted issue price)	YTM (constant value that would be equal to the IP of the instrument)	YTM*BAIP	Qualified Stated Interest (QSI) (stated in the note)	OID (will be ordinary income to seller) Total OID will be SRPM-IP	NQSI (interest paid above fixed rate of interest) First considered accrued but unpaid OID than principle
1	BAIP ₁ = IP of instrument: if there is adequate state interest, IP is the stated principal amount of the instrument (the sum of all payments due under the instrument, excluding stated interest). § 1274(a)(1); § 1.1274-2(b)(1). Otherwise it is the “imputed principal amount.” A.k.a. the \sum present values of all payments (including stated interest) due under the instrument (from the respective dates they become due), determined as of the issue date discounted back using the test rate. § 1274(b)(1) and (2); § 1.1274-2(c)(1) a.k.a. the present value of the payments due under the instrument discounted from the dates they come due back to 1/1/99 at the test rate	Same as above <i>http://case.tn</i>	Multiply the last two cells on the left together		OID ₁ =amount payable at maturity that is not QSI minus BAIP ₁ ¹³ (BAIP _n *YTM)-QSI	(set payments of principal can be included as NQSI)
2	BAIP _{n>1} = (Issue Price + \sum prior OID accruals) - \sum non-QSI payments made on instrument (including non-QSI payments on 1 st day) ¹⁴ a.k.a. BAIP _{n>1} = (BAIP _{n-1}	Same as above ↑	Multiply the last two cells on the left together		(BAIP _n *YTM)-QSI	(set payments of principal can be included as NQSI)

¹³ If allocation between days is necessary, it is done ratably, and without regard to de minimis rules

	– (OID _{n-1} – payments that might reduce OID as per ordering rules: first payment on OID than principal))					
9 (last)	BAIP _{n>1} = (Issue Price + ∑ prior OID accruals) - ∑ non-QSI payments made on instrument (including non-QSI payments on 1 st day) ¹⁵ a.k.a. BAIP _{n>1} = (BAIP _{n-1} – (OID _{n-1} – payments that might reduce OID as per ordering rules: first payment on OID than principal))	Same as above	Multiply the last two cells on the left together			
Check					Total OID plus last BAIP should be the IP	

QSI requirements

- payable at least annually
- Must be based on a single fixed rate of interest (so a constant payment of cash is not QSI, if the principal of the note is being paid down 1.1273-1(c)(1)(i))
- Properly take into account the interval between payments 1.1273-1(c)(1)(iii), so there needs to be a constant interest rate (taking into account) that using smaller intervals may result in a smaller payment (for example 7.77% compounded quarterly is the same as 8% compounded annually)
- Can disregard first and last payment for determining whether or not the intervals are properly accounted for 1.1273-1(f) example 2 – must be adjusted in some reasonable manner
- Must be stated in the terms of the note
- Must be constructively received by lender but can't be issuer debt instruments
- Must be unconditionally payable

¹⁴ If an interval between payments of QSI contains more than one accrual period, the amount of QSI payable at the end of the interval (or on the first day of the accrual period immediately following the interval) is allocated on a pro rata basis to the accrual periods in the interval, and the AIP at the beginning of each accrual period in the interval is increased by the amount of QSI that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. Regulations Section 1.1272-1(b)(4)(i).

¹⁵ If an interval between payments of QSI contains more than one accrual period, the amount of QSI payable at the end of the interval (or on the first day of the accrual period immediately following the interval) is allocated on a pro rata basis to the accrual periods in the interval, and the AIP at the beginning of each accrual period in the interval is increased by the amount of QSI that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. Regulations Section 1.1272-1(b)(4)(i).

- Default, insolvency don't count as conditions 1.1273-1(c)(1)(ii)
- If it is contingent, the rules say that the instrument must be bifurcate into its contingent and noncontingent components 1274-4(c)(2)

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