CHAPTER 9
ACQUISITION OF PROPERTY

I. Importance of Capital Investments

A. A capital investment results in the creation of an asset that provides economic and/or personal benefits over several years.

B. The amount invested (basis) in business assets affects taxable income throughout the life of the asset.

C. A realization of income (i.e. disposition) related to a capital investment may result in a taxable event.

II. Classes of Property - Factors - Type and Use

A. Types of Property - Tangible and Intangible

1. Tangible Property - Real (Realty) v. Personal (Personalty)

2. Intangible Property - Lacks physical existence.

B. Uses of Property

1. Trade or Business Use

2. Production of Income Use (Investment Use)

3. Personal Use

III. Property Investment Cycle - Figure 9-1

IV. Adjusted Basis - Exhibit 9-1

A. The adjusted basis (AB) of a capital investment tracks the investment in that asset. i.e. as capital investment is recovered through deductions, etc., the basis in the asset must be reduced. Similarly, additions to basis must be made for additional investments (Capital Recovery Concept).

B. Conduit Entity Basis - Exhibit 9-2

Figure 9.1

Property Investment Cycle

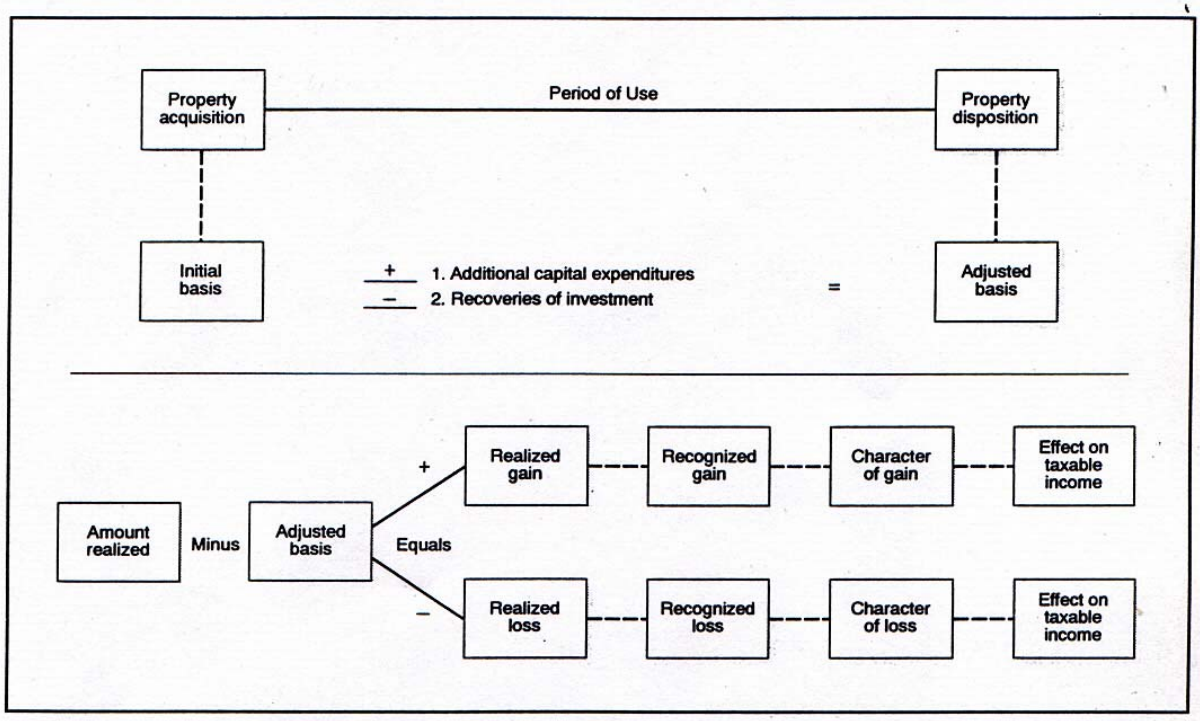

Exhibit 9.1

Computation of Adjusted Basis

Initial basis	$XXX
Increases in basis from	
■ Additional investments	
• Capital invested	
• Costs of protecting ownership	
• Special property tax assessments for local benefits	XXX
■ Reinvestment of income	
• Income taxed to owners of conduit entities	XXX
Decreases in basis from	
■ Annual tax deductions resulting in a reduction of tax liability	
• Depreciation, depletion, and amortization	
• Losses from conduit entities	(XXX)
■ Dispositions of all or part of interest in an asset	
• Casualty loss	
• Sale or gift of part of an asset	(XXX)
■ Capital recovery resulting from excluded income	
• Nontaxable dividends	
• Easements	(XXX)
Equals: Adjusted basis	$XXX*

* Adjusted basis cannot be less than zero.

Exhibit 9.2

Conduit Entity Basis Computation

Initial basis in stock (cost) or basis of investment at the beginning of the current year	$X,XXX
Increases in basis:	
• Additional capital invested during the year	
• Taxable and nontaxable income allocated to the owner for the current year	
• Liability adjustment	
— A partner's share of any increase in liabilities related to the partnership	XXX
Decreases in basis:	
• Cash received from the entity	
• Property received from the entity:	
— If a partnership, subtract the partnership's basis for the property	
— If an S corporation, subtract the fair market value of the property	
• Deductions, losses, and nondeductible expenses allocated to the owner for the current year	
• Liability adjustment	
— A partner's share of any decrease in liabilities related to the partnership	(XXX)
Equals: Adjusted basis in the conduit entity	$X,XXX

V. Determining Initial Basis

A. Initial Basis is determined by the method of acquisition.

1. **Carryover Basis**

   a. **Transfers/Gifts**

2. **Holding Period**

   a. **General Rule - When the basis of an asset is made, in whole or in part, by reference to another asset or to the basis of another entity, the holding period of the asset includes the holding period of the other asset.**

VI. Methods of Acquisition

A. Purchase

1. **Initial basis is the cost of the asset purchased. Cost includes anything given to purchase the asset as well as any costs incurred to get the asset ready for intended use.**

   a. **Gross Selling Price + Other Acquisition Costs**

      1) **Cash, FMV of Property, or Services**
      2) **Debt incurred or assumed**
      3) **Legal fees, commissions, demolitions, improvements, etc.**

2. **Employee Bargain Purchase**

   a. **If income is recognized as a result of a bargain purchase, the basis in the asset is increased by the amount of income recognized (double taxation).**

3. **Multiple Asset Purchases - When 2 or more assets are purchased for a lump-sum price, the purchase price is allocated based on the relative market values of the assets purchased.**

   a. **Other Allocation basis**

      1) **Appraisals**
      2) **Written Agreement with Seller**

4. **Purchase of a Business - basis depends on whether assets are purchased directly or stock of the company owning the assets is purchased.**

      1) **If assets are purchased directly, purchaser's basis is in the assets. Amounts paid in excess of fair market of individual assets are goodwill (amortizable over 15 years).**

      2) **If the stock of the company owning the assets is purchased, purchaser's basis is in the stock. Assets of the business remain at their previous basis.**

B. **Assets Acquired by Gift**

   1. **Effect of Exclusion from income of Gift/ Capital Recovery Concept**

   2. **General Rule: Donee's Basis is Equal to Donor's Basis (Carryover Basis Rule). Donee's basis is increased for gift tax paid by donor on appreciation in value (no adjustment if property has not appreciated)**

      a. **Exception - If the fair market value of the property at the date of the gift is less than the donor's basis (loss property), then the donee's basis is determined by the price at which the donee ultimately sells the property (Split Basis Rule for Gifts)**

         1) **Basis for Gain - Donor's Basis**

         2) **Basis for Loss - Fair Market Value (Also Depreciable Basis)**

NOTE: Because there is no appreciation in value, no gift tax adjustment is made on loss property!

NOTE: The donee's basis can never exceed donor's basis (adjusted for gift tax)

D. Inherited Property

1. **General Rule: The heir's basis is equal to the Fair Market Value at the date of the decedent's death (Primary Valuation Date).**

2. **Alternate Valuation Date - 6 months after the date of death. Only the executor of the estate can elect the AVD. The AVD cannot be elected if it will increase the total FMV of the estate (however, individual assets may be valued higher).**

   a. **If the AVD is elected and property is distributed before the AVD, then the basis to the heir is the FMV on the date of distribution.**

3. **Holding Period of Inherited Property is always long-term.**

NOTE: PROPERTY CAN NEVER BE VALUED LATER THAN 6 MONTHS AFTER DEATH

E. Assets Acquired from a Spouse (Divorce) [Not Covered this semester]

F. Conversion of Personal Use Property to Business Use

1. **Basis of business property is the lower of the Fair Market Value or the Adjusted Basis at the date of conversion. This value is also the depreciable basis.**

2. **When FMV is less than Adjusted Basis (loss property) at the date of conversion, the split basis rule applies. Same rule as for gifts.**

   a. **Basis for Gain - Adjusted Basis (less depreciation)**

   b. **Basis for Loss - FMV (less depreciation)**

NOTE: WHEN SPLIT BASIS RULE APPLIES, FMV IS DEPRECIABLE BASIS, BUT BOTH BASES MUST BE REDUCED BY ALLOWABLE DEPRECIATION

G. Stock Dividends/Splits

1. **Stock dividends and splits are not taxable events (unless there is a cash option). In tax-free dividends/splits, basis from the old shares is allocated to the new shares.**

   a. **If the shares of stock received in a nontaxable dividend are not of the same class as the shares on which the dividend is based, the basis must be allocated based on the relative fair market values of the shares.**

2 **If a cash option is available, a stock dividend is taxable (amount of income = FMV of stock received, see Chapter 4) even if the stock is taken. Basis of Stock = Income Recognized.**

H. Basis of Securities Sold

1. **If securities sold are not specifically identified, then the securities are assumed to be sold on a FIFO basis.**

2. **Basis of Wash Sale stock**