Basis of my life's work

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Abstract

The following case will enable students to comprehend and apply Federal Income Tax laws pertaining to asset basis, adjusted basis, increases and decreases to basis. In addition, students will learn to distinguish between ordinary or capital income regarding a sale, gains and losses, fair market value of assets regarding a donation, differences between IRC sections 1245 and 1250 property, and depreciation recapture.

Keywords: IRC section 1245 and 1250 property, asset basis, gains and losses, and ordinary versus capital income.

Note: This is a fictitious case developed for educational use only. All names, numbers, percentages, dates, etc. used herein were created for the purposes of this case and should be interpreted as factual.

Case Information

Rudolph Messi aka "Rudy" learned the craft of machinist from his father in Michigan shortly after World War II. Every day after school Rudy would come to his father's shop and work in tandem with his father learning the art and mastering the craft of being a machinist. After graduating from high school Rudy went to work for his father specializing in tool and die making. Rudy was a natural with every tool found within the shop especially his father's variable speed metal lathe.

In 1952 Rudy joined the US Navy where is abilities were put to good use. Rudy not only received up to date training on new machinery, he also got to see a large part of the world. After an honorable discharge Rudy settled in the Pacific Northwest working for Boeing as an aircraft machinist honing his craft further in his quest to open up his own business just like his father.

By 1969 Rudy was married and had 4 children. They wanted to move to San Diego, his wife's home town. He left Boeing and opened his San Diego shop with machinery he acquired from US Navy auctions. Although these tools are used Rudy knew from his extensive experience that when machinery was placed up for auction by the government it represented a good investment. The practice of purchasing used machinery either from the United States Government or from larger established manufacturing companies continued until 1992 when Rudy made is last major purchase from a government auction. Rudy always feeling the pressure to keep up to date started to resist the urge to purchase computerized automated machinery and limited his purchases of equipment to those that still required a sage hand in order to operate.

Always being a technological generation behind in purchasing machinery Rudy kept abreast of changes within his industry through continuing education courses which eventually earned him an associate's degree in machine technology from a technical school in the area. Rudy stated that he was becoming a dinosaur and that the industry was losing out on human expertise while giving into computer generated machining.

Regarding Rudy's machine shop, Rudy was a stickler for keeping a clean shop and properly working machinery. There was never a time within Rudy's tenure that you could not eat off of his floor or find a damaged piece of machinery. At the business's zenith, Rudy employed 19 other machinists each of his employees would attest to his unwavering stance on shop safety, cleanliness, and properly working machinery.

Through the years leading up to Rudy's decision to retire, Rudy witnessed firsthand the decline in American manufacturing and his business's transition into becoming just a shop that can duplicate and fix parts for smaller manufacturing companies and automotive repair businesses. By May 2012 Rudy just employed his daughter Lucy who was the office manager and his grandson Mathew who was his apprentice, but Mathew was only working for his grandfather until he would graduate from the local university.

In August of 2012 Rudy met with is Accountant Lucas Kaufman and formulated an exit strategy that would be executed by December 20th of the current year. Discussing certain possible outcomes Rudy decided that he did not want to sell his business to anyone, but rather sell off his shop machinery to individual buyers, and or to the scrap yard.

Rudy's business formation and financial setup was simple and straight forward. His business was set up as a Subchapter S corporation. Rudy personally owned the property where his business was located. This property was purchased by Rudy in 1971 and was retained as personal investment property. Rudy the individual (landlord) rented the property to Rudy's corporation. Although not uncommon in the normal course of business Mr. Kaufman filed and received a favorable letter ruling from the IRS regarding this matter business.

With respect to the investment property Rudy had seen how urban sprawl changed the look and landscape of the general area. Where once you saw barns and warehouses now you have subdivisions, schools, and strip malls. Being a machinist Rudy paid close attention to details when constructing his building and he did so mimicking typical Spanish architectural found within the surrounding San Diego area. It was a 25,000 square foot 2 story building which over time blended well with the open space, but now looked outdated amidst the new clean urban look of the community. Upon closing his business Rudy has decided to commit to restoring and retro-fitting his investment property for a professional office space building.

There were various people meeting with Rudy regarding the sale of his machinery. Rudy settled on two companies for the sale of his business assets. International Machine Sales, Inc. offered to purchase all of Rudy's machinery commenting on the fact that the only thing that they had to do was to remove the assets from the premises and ship them off to their final destination. The other company/individual who was interested in purchasing some, but not all of the assets was one of Rudy's former employees Jennifer Owens who opened up her own business in Coos Bay, Oregon. Jennifer previously purchased most of her machinery from Rudy in 1992 when Rudy rotated his machinery out in order to make way for his new purchases. Jennifer only needed two pieces of equipment and Rudy agreed to sell those two pieces for $7,000. International Machine Sales quickly agreed to purchase the rest of the machinery for $57,700.

Mr. Kaufman informed Rudy that since he was closing the business, it did not classify as a sale, but rather as "a disposition other than a sale". Mr. Kaufman explained to Rudy that he would still have to file a final return for the business and would have to show the sale of the assets of the business in a separate form that will not affect the corporate return. Rudy told Mr. Kaufman to do what must be done and that he would need to meet with him on a separate issue regarding the restoration of his investment property. The meeting was set for the following week.

Meeting day, Rudy and Mr. Kaufman sat down and discussed the topic of his investment property. Rudy explained that after he cleared out his building he will begin the restoration and transformation of his building into a professional rental space. This renovation would cost $485,000 when finished and would increase monthly rentals from $2,000 to $38,000. The construction would take 8 months to finish. Mr. Kaufman informed Rudy to have Lucy account and categorized on how the money was spent. Rudy stated that it will be done and that Lucy will become the property manager overseeing operations.

A listing of all business along with sales, disposals, and capital/revenue expenditures are indicated in Appendix 1.

A listing of Rudy's investment property including final amounts for the property's renovation is indicated in Appendix 2.

Appendix 1:

The following is a list of business assets that were sold.
Business Assets (All business and personal assets are depreciated using the straight line method.
Asset: Variable Speed Metal Lathe

Service Date	Service Life	Cost	Acc. Dep.	Date of Disposition	Sales Amount
10-Feb-92	7	25,000	25,000	7-Dec-12	$17,500

Asset: Mandrel Tubing Roller

Service Date	Service Life	Cost	Acc. Dep.	Date of Disposition	Sales Amount
10-Feb-92	7	40,000	40,000	7-Dec-12	$25,200

Asset: Milling Machine

Service Date:	Service Life	Cost	Acc. Dep.	Date of Disposition	Sales Amount
10-Feb-92	7	20,000	20,000	7-Dec-12	$10,500

Extraordinary Repair on Milling Machine

Service Date:	Service Life	Cost	Acc. Dep.
05-Jan-2011	4	10,000	5,000

Asset: Band Saw

Service Date:	Service Life	Cost	Acc. Dep.	Date of Disposition	Sales Amount
10-Feb-92	7	5,000	5,000	7-Dec-12	$2,500

Asset: Sand Blaster

Service Date:	Service Life	Cost	Acc. Dep.	Date of Disposition	Sales Amount
10-Jan-2012	7	5,000	714	7-Dec-12	$4,500

Asset: Boring Machine

Service Date:	Service Life	Cost	Acc. Dep.	Date of Disposition	Sales Amount
10-Mar-2002	7	8,000	8,000	7-Dec-12	$4,500

Extraordinary Repair

Service Date:	Service Life	Cost	Acc. Dep.
05-Jan-2012	7	7,000	1,000

Appendix 2

Asset: Commercial Rental Property (Building)

Service Date:	Service Life	Cost	Acc. Dep.
10-June-1971	40	125,000	125,000

Asset: Land

Service Date	Cost
10-June-1971	10,000

Construction/Renovation of investment Property:

Expense:	Amount
Design Fees	$20,000
Building Renovation	$380,000
Retention Pond	$20,000
Parking Lot Expansion and resurfacing	$53,000
Interest Incurred during construction	$12,000

Questions:

1. How is basis and adjusted basis calculated for A) business used in the normal course of business regarding manufacturing? And repeat these calculations for B) Investment property used in the course of business for commercial rental?
2. Regarding Rudy's business assets determine the individual assets gain or loss on sale, its net affect , and whether the gain or losses will be capital or ordinary income/(loss) on Rudy's business or personal return?
3. Instead of selling the business assets Rudy decides to donate each asset to a local high schools technical program. What would be the basis of his donations? Assume that the fair market value (FMV) equals Rudy's selling price for each of his business assets.
4. Determine the basis of Rudy's investment property for both land and structure after the property's renovation.
5. Compare and contrast IRC section 1245 and 1250 property regarding Rudy's business and investment property.
6. What if Rudy's accountant decided to use the Modified Cost Recovery System (MACRS) instead the current SLD method for Rudy's boring machine and its extraordinary repair.

TEACHING NOTES FOR INSTRUCTOR:

Case Overview

This case helps the student to analyze and determine the basis of assets from a tax accounting perspective. The primary stakeholders of this case are owners of any business who owns and depreciates assets. The determination of basis in the hands of the owner will determine any gain or loss of an asset in disposing, selling, donating, and exchanging said asset.

The individual components regarding the increases and decreases to basis compared with the interpretation of the tax code will enhance the students understanding of how to guide future clients through their own business dealings and tax planning for future endeavors.

The owner/operator of this tool & die business finds himself coming to a close of an era and wants to provide a future earnings stream for himself and those of his family. He relies on expert advice from his professional accountant in helping him achieve his final goals.

Learning objectives and suggested use of the case are as follows:

1. Understanding and implementation of the principle of asset basis.
2. Understanding the differences between IRC sections 1245 and 1250.
3. Understand the role that a CPA can play in the loan application process by preparing forecasts and projections.
4. Expose students to operating issues regarding asset basis in a variety of situations including renovations, sales, and donations.

Suggested Audience

This case is intended for a variety of classes including entrepreneurship, finance, financial accounting, and individual/corporate tax.

Solutions Manual:

1. How is basis and adjusted basis calculated with respect to A) business used in the normal course of business regarding manufacturing? And B) Investment property used in the course of business for commercial rental?

A) Business Assets (Basis)	B) Investment Rea Property (Basis)
According to IRS publication 551, pages 3 & 4: “Cost Basis: The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items: (Sales tax, Freight, Installation and testing, Excise taxes, debt obligations, recording fees, revenue stamps, and property taxes (if assumed for the seller.)”	According to IRS publication 551, pages 3 & 4: “Cost Basis: Purchased price of the property plus: Real estate taxes (i.e. paid by buyer that was owed by seller), Settlement charges (i.e. title insurance, abstract fees, legal fees), Points on mortgage, and Assumption of mortgage.”

A) Business assets (Adjusted Basis:	B) Investment Real Property (Adjusted Basis)
According to IRS publication 551, pages 4 & 5: "Cost Basis + Extraordinary repairs – Depreciation (regular, any special depreciation, and section 179)"	According to IRS publication 551, pages 4 & 5: "Cost Basis + (Capital Improvements, Casualty Losses, Zoning Costs, Legal Fees) – (Depreciation, Insurance reimbursement on casualty losses, easements, and any investment credits.)"

2. Regarding Rudy's business assets determine the individual assets gain or loss on sale, its net affect , and whether the gain or losses will be capital or ordinary income/(loss) on Rudy's business or personal return?

Asset:	Sales Amount	Basis	Amount	Gain or (Loss)
Metal Lathe	17,500	0	17,500	Gain
Tubing Roller	25,200	0	25,200	Gain
Milling Machine	10,500	5,000	5,500	Gain
Band Saw	2,500	0	2,500	Gain
Sand Blaster	4,500	4,286	214	Gain
Boring Machine	4,500	6,000	(1,500)	(Loss)
Total (net)			49,414	Gain

The $49,414 gain would be considered ordinary income and would be filed on form 4797 and would be listed on Rudy's personal return as ordinary income.

3. Instead of selling the business assets Rudy decides to donate each asset to a local high schools technical program. What would be the basis of his donations? Assume that the fair market value (FMV) equals Rudy's selling price for each of his business assets.

There are two possible scenarios and it hinges on the FMV of the assets.

If FMV is greater than basis.	If FMV is less than basis
IRS Publication 551, pages 8 & 9: "If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift. Also, for figuring gain or loss from a sale or other disposition of the property, or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your	IRS Publication 551, pages 8 & 9: "If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustment to basis while you held the property (see

basis by any required adjustments to basis while you held the property. See Adjusted Basis earlier."	Adjusted Basis earlier). If you use the donor's adjusted basis for figuring a gain and get a loss, and then use the FMV for figuring a loss and have a gain, you have neither gain nor loss on the sale or disposition of the property."

4. Determine the basis of Rudy's investment property for both land and structure after the property's renovation.

Land	Land Improvements	Building
Basis: $10,000	Retention Pond $20,000 Parking lot Expansion <u>53,000</u> Total $73,000	Adjusted Basis: $ 0.00 Building Design Fees: 20,000 Renovation 380,000 Interest <u>12,000</u> Total $412,000

5. Compare and contrast IRC section 1245 and 1250 property regarding Rudy's business and investment property.

   Answer: According to IRS Section 1245 and IRS publication 544: "Property includes any property that is or has been subject to an allowance for depreciation or amortization. Section 1245 property does not include buildings and structural components. The term building includes a house, barn, warehouse, or garage. The term structural component includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc."
   According to IRS Section 1250 and IRS Publication 544: "All real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property. It includes leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable."

   Rudy's business assets should be classified as section 1245 property. Rudy's investment real property should be classified as section 1250 property.

6. Regarding Rudy's boring machine and its extraordinary repair, what if Rudy's accountant decided to use the Modified Cost Recovery System (MACRS) instead the current SLD method?
   Answer: If Lucas Kaufman use the MACRS method instead of SLD the first years deprecation would equal $1,000 rounded ($7,000 * 14.29%). Under the current SLD the

same amount of depreciation was calculated. Therefore, there was no difference and no depreciation recapture would be recognized.
The basic premise behind depreciation recapture (on section 1245 property) is the difference between the straight line depreciation rate and the MACRS rate used within the example. Depreciation recapture usually occurs if the asset is sold or traded in within the first couple of years of its life. No depreciation recapture would occur if the asset is sold and no extraordinary repairs were made after the estimated useful life has been achieved.

References:

Internal Revenue Service, *Publication 551 – Basis of Assets*, July, 2011.
Internal Revenue Service, *Publication 544 – Sales and Other Dispositions of Assets,* August 14, 2012
Internal Revenue Service, *Publication 946 – How to Depreciate Property,* (2011)
IRC § 1245
IRC § 1250