Chapter 11 Notes

Property Dispositions

We are talking about selling property and the rate at which the gain is going to be taxed.

Everything in this chapter is from the perspective of a business (the owners of a business), but we have to keep in mind individual tax consequences for the owners.

**Dispositions**

*Amount realized* = cash received + FMV of other property you received + buyer’s assumption of liability – seller’s expenses

The amount realized is the total proceeds from the sale. It is everything you receive of value from the buyer less any selling costs.

*Adjusted basis* = basis (as defined in chapter 10) less accumulated depreciation (depreciation + Section 179 expensing)

*Realized gain/loss on disposition* = amount realized less adjusted basis

This is what you recognize.

**Example 1**: Eric bought land five years ago with $6,000 cash and a $30,000 loan, and paid additional expenses of $1,500 legal fees and $500 real estate commission related to the purchase. On July 1st, he sells the land to Dane. Dane pays Eric $12,000 and assumes Eric’s debt of $30,000. Eric pays $1,000 of legal fees and $2,500 real estate commissions on the sale. What is Eric’s gain or loss on the sale?

Eric’s basis in the land:

$6,000

30,000

1,500

500

$38,000 total basis in the land

Eric’s amount realized:

$12,000

30,000

(1,000)

(2,500)

$38,500 total amount realized

Realized gain = $38,500 – 38,000 = $500 gain

The bigger question here is: what is the character of the gain.

**Character of the Gain or Loss**

The character determines the rate at which the gain will be taxed and the type of income the loss will reduce.

1. Ordinary Assets (income) – assets created or used in a taxpayer’s trade or business

a. Example: inventory, accounts receivable, and machinery and equipment owned one year or les

b. Ordinary gains are taxed at ordinary rates (the brackets of ordinary tax rates)

c. Ordinary losses are deducted against ordinary income

2. Capital assets – assets held for investment, production of income, or personal-use (personal-use losses are **not** deductible)

a. **Gains** on the sale of capital assets

1. Net long-term capital gains are taxed at a special rate for individuals (generally 15%)

2. No special capital gain treatment for corporations (treated as ordinary income)

b. **Losses** on the sale of capital assets

1. Deduct net capital loss of $3,000 against ordinary income for individuals

(cannot carryback losses to years with capital gains but can carryforward losses indefinitely – no expiration on capital losses)

2. Corporations cannot deduct net capital losses against ordinary income (corporations can only deduct capital losses against capital gains) (carryback three years and forward five years)

3. Section 1231 – applies to assets used in a trade or business with a holding period of more than one year (e.g., a parking lot used in a trade or business).

a. Specific assets covered by Section 1231

1. Land

2. Depreciable real property (e.g., buildings)

3. Tangible personal property (e.g., machines, computers)

4. Intangible property (e.g., patents)

b. Tax treatment of Section 1231 assets (we covered this in chapter 7)

1. Taxpayers combine (or net) Section 1231 gains and losses

2. Net Section 1231 losses are treated as ordinary losses (no limitations on the deduction)

3. Net Section 1231 gains are treated as long-term capital gains (generally taxed at 15% for individuals)

**Example 2**: Theodore sells the following assets from his business during the year.

Land: Gain of $40,000

Machine: Gain of $15,000

Computer: Gain of $1,000

Building: Loss of $20,000

Office Furniture: Gain of $3,000

Assuming all of these assets have been held for more than one year, what is the net Section 1231 gain or loss? What is the tax liability, if any?

1231 Netting Process:

$40,000

15,000

1,000

(20,000)

3,000

$39,000 net Section 1231 gain (you need to say what the character of the gain is)

x 0.15

$5,850 tax owed

Say you have two assets: 1231 loss of $30,000 and a 1231 gain of $30,000. Ideally, the individual would want to split these two up to save on taxes (because the 1231 loss can be deducted against ordinary income and the 1231 gain is taxed at a lower rate, and disposing them in the same year will offset one another and have zero tax effect). However, Congress saw through this, and enacted the following rule:

c. Section 1231 **Look-Back Rule** (applies only to Section 1231 gains)

1. If any net Section 1231 loss in the previous five years, then treat **net** Section 1231 gain as ordinary income to the extent of those losses (look at earliest loss first (i.e., go back five years first)).

2. Remaining amount is net Section 1231 gain and is treated as a long-term capital gain (generally taxed at 15%).

**Example 3**: E-Walk, Inc. has the following **net** Section 1231 gains and losses:

2013: $12,000 gain 2016: $16,000 gain

2014: $6,000 loss 2017: $8,000 loss

2015: $25,000 loss 2018: $30,000 gain

For each year, what is the character and amount of the Section 1231 gain (loss) for tax purposes?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Unrecap. Section 1231 loss | Year | Ordinary | Section 1231 | Notes |
|  | 2013 |  | 12,000 |  |
| ~~(6,000)~~ | 2014 |  | (6,000) |  |
| ~~(25,000)~~ | 2015 |  | (25,000) |  |
| ~~(15,000)~~ | 2016 | 16,000 |  | Due to recap |
| ~~(8,000)~~ | 2017 |  | (8,000) |  |
|  | 2018 | 23,000 | 7,000 | Due to recap |
|  |  |  |  |  |

Review questions: What is a 1231 asset? Why is a 1231 designation a good thing?

**Depreciation Recapture**

The purpose of recapture is that Congress wants to prevent the taxpayer from benefiting from preferential tax treatment on a gain derived from depreciation expense taken on the asset which reduced ordinary income

1. Applies to depreciable Section 1231 assets that generate a gain (this does not apply to Section 1231 losses)

2. Depreciation recapture changes the tax treatment of all or a portion of the Section 1231 gain on depreciable assets

*Section 1245 Depreciation Recapture* (know this code section #)

1. Section 1245 property is tangible personal property and amortizable intangible property.

2. Under Section 1245, taxpayers must recapture all depreciation taken on an asset to the extent of the Section 1231 gain.

3. Section 1231 gain that is recaptured under Section 1245 is treated as ordinary income.

These gains are no longer treated as a Section 1231 gain.

Section 1231 gains that are recaptured under Section 1245 do not enter the Section 1231 netting process; they are classified as ordinary income.

Under Section 1245, taxpayers must recapture the lesser of:

1. Recognized gain, OR

2. All depreciation/amortization taken on the asset (characterized as ordinary income under §1245)

1) If the accumulated depreciation is greater than or equal to the gain, then the entire gain is ordinary income under Section 1245. This gain is only due to depreciation, not to an increase in the asset’s value.

2) If the accumulated depreciation is less than the gain, then (a) ordinary income under Section 1245 equal to the amount of accumulated depreciation and (b) Section 1231 gain equal to the gain less the accumulated depreciation. This gain is partly due to depreciation and partly to an increase in the asset’s value.

**Example 4**: Hercules Engineering purchased a machine (7-year property) three years ago for $26,000 and depreciated it using the half-year convention. The accumulated depreciation on the machine is $14,630. What is the amount and character of the gain/loss if the machine is sold for $10,000, $15,000, or $30,000?

Adj. Basis:

26,000

(14,630)

11,370

(1) 10,000 (2) 15,000 (3) 30,000

(11,370) (11,370) (11,370)

(1,370) 3,630 18,630

(1) ($1,370) Section 1231 loss

(2) Because the accumulated depreciation is greater than the gain, the $3,630 gain is treated as ordinary income under Section 1245.

(3) Because the accumulated depreciation is less than the gain, all the A/D, i.e., $14,630, is treated as ordinary income under Section 1245 and the remaining $4,000 is a Section 1231 gain.

**Example 5**: Jean is a single taxpayer and sells the following business-related assets during the year (all held for more than one year):

Machine A: Sales price = $150,000; Cost basis = $175,000; Accumulated depreciation = $75,000

Machine B: Sales price = $100,000; Cost basis = $75,000; Accumulated depreciation = $25,000

Machine C: Sales price = $50,000; Cost basis = $100,000; Accumulated depreciation = $35,000

Machine D: Sales price = $75,000; Cost basis = $90,000; Accumulated depreciation = $25,000

Assume Jean pays taxes on ordinary income at a flat rate of 30%. What is the amount and character of each gain (loss) and what is the amount of tax that Jean will have to pay as a result of the transactions?

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Machine** | **Adj. Basis** | | **Gain (Loss)** | **Character** | |
| A | 175 – 75 = 100 | | 150 – 100 = 50 | Ordinary income under Section 1245 | |
| B | 75 – 25 = 50 | | 100 – 50 = 50 | $25,000 of ordinary income under Section 1245; $25,000 of Section 1231 gain | |
| C | 100 – 35 = 65 | | 50 – 65 = (15) | Section 1231 loss | |
| D | 90 – 25 = 65 | | 75 – 65 = 10 | Ordinary income under Section 1245 | |
| Machine | | Ordinary Income | | | Section 1231 |
| A | | 50,000 | | |  |
| B | | 25,000 | | | 25,000 |
| C | |  | | | (15,000) |
| D | | 10,000 | | |  |
| Total | | 85,000 | | | 10,000 |

Tax:

85,000\*.3 = $25,500

10,000\*.15 = 1,500

$27,000 total tax due

*Section 1250 Depreciation Recapture*

1. Section 1250 property is depreciable real property.

2. Under Section 1250, the gain due to accelerated depreciation **in excess of** straight-line depreciation is recaptured and considered ordinary income.

3. Does Section 1250 recapture apply under MACRS?

No, because you use straight-line depreciation for real property under MACRS.

*Section 291 Depreciation Recapture* (modified version of Section 1250 depreciation recapture)

1. Applies only to corporations (applies to real property only)

2. Amount of gain recaptured as ordinary income is 20% of the lesser of:

1. recognized gain; OR

2. accumulated depreciation

Example 6: Nina, Inc. originally purchased a trade/business building several years ago for $750,000. The accumulated depreciation (straight-line) on the building is $450,000. Nina, Inc. sells the building for $1,000,000. What is the gain on the sale and what type of gain is it?

Adjusted basis: 750,000 – 450,000 = $300,000

Gain:

$1,000,000

(300,000)

$700,000

Section 291 recapture: $450,000\*.2 = $90,000 (450,000 b/c the A/D is lower than the gain)

The $700,000 gain is made up of two pieces: $90,000 of it is classified as ordinary income under Section 291 and the remaining $610,000 of gain is a Section 1231 capital gain.

**Other Provisions Related to Section 1231**

*Unrecaptured Section 1250 Gain for Individuals*

1. Applies to individuals only

2. Applies to real property only

3. Entire gain is treated as a Section 1231 gain

4. Requires that the Section 1231 gain is taxed at 25% on the lesser of:

1. recognized gain; OR

2. accumulated depreciation on the asset

5. The remainder of the gain is treated as a regular Section 1231 gain taxed at preferential tax rates

**Example 7**: Using the example above, assume Nina, Inc. is a sole proprietorship. What is the character of the recognized gain that Nina, Inc. reports on the sale of the trade/business building? What amount of tax will Nina, a single taxpayer, pay on the gain, assuming that her marginal tax rate is 32%?

Adjusted basis: $300,000; Gain: $700,000 (Section 1231 gain); A/D: $450,000

Section 1231 gain

U/R 1250 Reg. 1231

450,000 250,000

x .25 x .15\_\_\_

$112,500 $37,500

Total tax = $150,000

**Summary of Depreciation Recapture Rules (Section 1231 Gains Only)**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Section 1231 Assets** | | |
|  | **Land** | **Depreciable Real Property** | **Tangible Personal Property and Intangible Property** |
| **Applicable Code Section** | None | Corporations: §291  Individuals: §1250 (unrecaptured) | §1245 |
| **Tax Treatment of Recaptured Gain** | N/A – no recapture for land | §291: Ordinary income  Unrecaptured §1250: Treated as a §1231 gain that is taxed at 25% | Ordinary income |
| **Overall Tax Treatment of the Gain** | Entire gain is a Section 1231 gain | §291: Portion is ordinary income and the remainder is §1231  Unrecaptured §1250: lesser of gain or A/D taxed at 25%; remainder of gain taxed preferential rates [0/15/20] | A/D >= Gain: Entire gain is ordinary income  A/D < Gain: Ordinary income = A/D  §1231 Gain = gain – A/D (or proceeds – cost basis) – only get §1231 gain on appreciated §1245 property |