Property Transactions: § 1231 and Recapture Provisions

After completing Chapter 17, you should be able to:

LO.1
Understand the rationale for and the nature and treatment of gains and losses from the disposition of business assets.

LO.2
Distinguish § 1231 assets from ordinary assets and capital assets and calculate the § 1231 gain or loss.

LO.3
Determine when § 1245 recapture applies and how it is computed.

LO.4
Determine when § 1250 recapture applies and how it is computed.

LO.5
Understand considerations common to §§ 1245 and 1250.

LO.6
Apply the special recapture provisions for related parties and IDC and be aware of the special recapture provision for corporations.

LO.7
Describe and apply the reporting procedures for §§ 1231, 1245, and 1250.

LO.8
Identify tax planning opportunities associated with §§ 1231, 1245, and 1250.
Generic Motors Corporation sold machinery, office furniture, and unneeded production plants for $100 million last year. The corporation’s disposition of these assets resulted in $60 million of gains and $13 million of losses. How are these gains and losses treated for tax purposes? Do any special tax rules apply? Could any of the gains and losses receive capital gain or loss treatment? This chapter answers these questions by explaining how to classify gains and losses from the disposition of assets that are used in the business rather than held for resale.

Chapter 8 discussed how to depreciate such assets. Chapters 14 and 15 discussed how to determine the adjusted basis and the amount of gain or loss from their disposition.

A long-term capital gain was defined in Chapter 16 as the recognized gain from the sale or exchange of a capital asset held for the required long-term holding period.¹ Long-term capital assets are capital assets held more than one year.

This chapter is concerned with classification under § 1231, which applies to the sale or exchange of business properties and to certain involuntary conversions. The business properties are not capital assets because they are depreciable and/or real property used in business or for the production of income. Section 1221(2) provides that such assets are not capital assets. Nonetheless, these business properties may be held for long periods of time and may be sold at a gain. Congress decided many years ago that such assets deserved limited capital gain–type treatment. Unfortunately, this limited capital gain–type treatment is very complex and difficult to understand.

Because the limited capital gain–type treatment sometimes gives too much tax advantage if assets are eligible for depreciation (or cost recovery), certain recapture

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¹§ 1222(3). To be eligible for any beneficial tax treatment, the holding period must be more than one year.
CHAPTER 17 Property Transactions: § 1231 and Recapture Provisions

rules may prevent the capital gain treatment when depreciation is taken. Thus, this chapter also covers the recapture provisions that tax as ordinary income certain gains that might otherwise qualify for long-term capital gain treatment.

Section 1231 Assets

RELATIONSHIP TO CAPITAL ASSETS

Depreciable property and real property used in business are not capital assets. Thus, the recognized gains from the disposition of such property (principally machinery, equipment, buildings, and land) would appear to be ordinary income rather than capital gain. Due to § 1231, however, net gain from the disposition of such property is sometimes treated as long-term capital gain. A long-term holding period requirement must be met; the disposition must generally be from a sale, exchange, or involuntary conversion; and certain recapture provisions must be satisfied for this result to occur. Section 1231 may also apply to involuntary conversions of capital assets. Since an involuntary conversion is not a sale or exchange, such a disposition normally would not result in a capital gain.

If the disposition of depreciable property and real property used in business results in a net loss, § 1231 treats the loss as an ordinary loss rather than as a capital loss. Ordinary losses are fully deductible for adjusted gross income (AGI). Capital losses are offset by capital gains, and, if any loss remains, the loss is deductible to the extent of $3,000 per year for individuals and currently is not deductible at all by regular corporations. It seems, therefore, that § 1231 provides the best of both potential results: net gain may be treated as long-term capital gain, and net loss is treated as ordinary loss.

TAX IN THE NEWS

A DEFINITION FOR UNRECAPTURED § 1250 GAIN

The Jobs and Growth Tax Relief Reconciliation Act of 2003 significantly changed the taxation of long-term capital gains for individuals. Long-term capital gains may now be taxed at 5, 15, 25, or 28 percent depending on the circumstances of the taxpayer. Only a very careful reading of the legislation reveals that § 1231 assets are also involved in the change because gains on these assets may be taxed as capital gains. On July 28, 1997, the congressional committee shaping what became the Taxpayer Relief Act of 1997 unexpectedly and with little forethought created the capital gain category that is taxed at 25 percent. This gain is called the “unrecaptured § 1250 gain.” Congress failed to specifically define this gain and left it to the IRS to define it in the tax forms and the instructions to those forms. The unrecaptured § 1250 gain is initially a § 1231 gain. Determining which of the § 1231 gain is this 25% gain is quite complex, but also very important. Many real estate sales involve § 1231 gain that is ultimately reported as capital gain. From 1998 through 2003, Congress did not enact any legislation to clarify or eliminate the confusion over the unrecaptured § 1250 gain. Consequently, it is still difficult to identify this gain, but whether § 1231 gain includes any 25% gain can sometimes make a difference of millions of dollars in tax.
Part V Property Transactions

Example 1

Roberto sells business land and a building at a $5,000 gain and business equipment at a $3,000 loss. Both properties were held for the long-term holding period. Roberto’s net gain is $2,000, and that net gain may (depending on various recapture rules discussed later in this chapter) be treated as a long-term capital gain under § 1231.

Example 2

Samantha sells business equipment at a $10,000 loss and business land at a $2,000 gain. Both properties were held for the long-term holding period. Samantha’s net loss is $8,000, and that net loss is an ordinary loss.

The rules regarding § 1231 treatment do not apply to all business property. Important in this regard are the holding period requirements and the fact that the property must be either depreciable property or real estate used in business. Nor is § 1231 necessarily limited to business property. Transactions involving certain capital assets may fall into the § 1231 category. Thus, § 1231 singles out only some types of business property.

As discussed in Chapter 16, long-term capital gains receive beneficial tax treatment. Section 1231 requires netting of § 1231 gains and losses. If the result is a gain, it may be treated as a long-term capital gain. The net gain is added to the “real” long-term capital gains (if any) and netted with capital losses (if any). Thus, the net § 1231 gain may eventually be eligible for beneficial capital gain treatment or help avoid the unfavorable net capital loss result. The § 1231 gain and loss netting may result in a loss. In this case, the loss is an ordinary loss and is deductible for AGI. Finally, § 1231 assets are treated the same as capital assets for purposes of the appreciated property charitable contribution provisions (refer to Chapter 10).

Justification for Favorable Tax Treatment

The favorable capital gain/ordinary loss treatment sanctioned by § 1231 can be explained by examining several historical developments. Before 1938, business property had been included in the definition of capital assets. Thus, if such property was sold for a loss (not an unlikely possibility during the depression years of the 1930s), a capital loss resulted. If, however, the property was depreciable and could be retained for its estimated useful life, much (if not all) of its costs could be recovered in the form of depreciation. Because the allowance for depreciation was fully deductible whereas capital losses were not, the tax law favored those who did not dispose of an asset. Congress recognized this inequity when it removed business property from the capital asset classification. During the period 1938–1942, therefore, all such gains and losses were ordinary gains and losses.

With the advent of World War II, two developments in particular forced Congress to reexamine the situation regarding business assets. First, the sale of business assets at a gain was discouraged because the gain would be ordinary income. Gains were common because the war effort had inflated prices. Second, taxpayers who did not want to sell their assets often were required to because the government acquired them through condemnation. Often, as a result of the condemnation awards, taxpayers who were forced to part with their property experienced large gains and were deprived of the benefits of future depreciation deductions. Of course, the condemnations constituted involuntary conversions, so taxpayers could defer the gain by timely reinvestment in property that was “similar or related in service or use.” But where was such property to be found in view of wartime restrictions and other governmental condemnations? The end result did not seem equitable: a large ordinary gain due to government action and no possibility of deferral due to government restrictions.

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In recognition of these conditions, in 1942, Congress eased the tax bite on the disposition of some business property by allowing preferential capital gain treatment. Thus, the present scheme of § 1231 and the dichotomy of capital gain/ordinary loss treatment evolved from a combination of economic considerations existing in 1938 and 1942.

**PROPERTY INCLUDED**

Section 1231 property generally includes the following assets if they are held for more than one year:

- Depreciable or real property used in business or for the production of income (principally machinery and equipment, buildings, and land).
- Timber, coal, or domestic iron ore to which § 631 applies.
- Livestock held for draft, breeding, dairy, or sporting purposes.
- Unharvested crops on land used in business.
- Certain purchased intangible assets (such as patents and goodwill) that are eligible for amortization.

These assets are ordinary assets until they have been held for more than one year. Only then do they become § 1231 assets.

**PROPERTY EXCLUDED**

Section 1231 property generally does not include the following:

- Property not held for the long-term holding period. Since the benefit of § 1231 is long-term capital gain treatment, the holding period must correspond to the more-than-one-year holding period that applies to capital assets. Livestock must be held at least 12 months (24 months in some cases). Unharvested crops do not have to be held for the required long-term holding period, but the land must be held for the long-term holding period.
- Nonpersonal use property where casualty losses exceed casualty gains for the taxable year. If a taxpayer has a net casualty loss, the individual casualty gains and losses are treated as ordinary gains and losses.
- Inventory and property held primarily for sale to customers.
- Copyrights; literary, musical, or artistic compositions, etc.; and certain U.S. government publications.
- Accounts receivable and notes receivable arising in the ordinary course of the trade or business.

**SPECIAL RULES FOR CERTAIN § 1231 ASSETS**

A rather diverse group of assets is included under § 1231. The following discussion summarizes the special rules for some of those assets.

**Timber.** A taxpayer can elect to treat the cutting of timber held for sale or for use in business as a sale or exchange. If the taxpayer makes this election, the transaction qualifies under § 1231. The taxpayer must have owned the timber or a contract to cut it on the first day of the year and for the long-term holding period before the date the cutting takes place. The recognized § 1231 gain or loss is determined at the time the timber is cut and is equal to the difference between the timber’s fair market value as of the first day of the taxable year and the adjusted basis for depletion. If a taxpayer sells the timber for more or less than the fair

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3§ 631(a) and Reg. § 1.631–1.
market value as of the first day of the taxable year in which it is cut, the difference is ordinary income or loss.

This provision was enacted to provide preferential treatment relative to the natural growth value of timber, which takes a relatively long time to mature. Congress believed this favorable treatment would encourage reforestation of timber lands. If a taxpayer disposes of timber held for the long-term holding period, either by sale or under a royalty contract (where the taxpayer retains an economic interest in the property), the disposal is treated as a sale of the timber. Therefore, any gain or loss qualifies under § 1231.

Several years ago, Tom purchased a tract of land with a substantial stand of trees on it. The land cost $40,000, and the timber cost $100,000. On the first day of 2004, the timber was appraised at $250,000. In August 2004, Tom cut the timber and sold it for $265,000. Tom elects to treat the cutting as a sale or exchange under § 1231. He has a $150,000 § 1231 gain ($250,000 − $100,000) and a $15,000 ordinary gain ($265,000 − $250,000).

What if the timber had been sold for $235,000? Tom would still have a $150,000 § 1231 gain, but would also have a $15,000 ordinary loss. The price for computation of § 1231 gain is the price at the beginning of the year. Any difference between that price and the sales price is ordinary gain or loss. Here, since the price declined by $15,000, Tom has an ordinary loss in that amount.

Livestock. Cattle and horses must be held 24 months or more and other livestock must be held 12 months or more to qualify under § 1231. The primary reason for enacting this provision was the considerable amount of litigation over the character of livestock (whether livestock was held primarily for sale to customers (ordinary income) or for use in a trade or business (§ 1231 property)). Poultry is not livestock for purposes of § 1231.

Section 1231 Assets Disposed of by Casualty or Theft. When § 1231 assets are disposed of by casualty or theft, a special netting rule is applied. For simplicity, the term casualty is used to mean both casualty and theft dispositions. First, the casualty gains and losses from § 1231 assets and the casualty gains and losses

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EXAMPLE 3

Note that the holding period is “12 months or more” and not “more than 12 months.”

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from *long-term nonpersonal use capital assets* are determined. A nonpersonal use capital asset might be an investment painting or a baseball card collection held by a nondealer in baseball cards.

Next, the § 1231 asset casualty gains and losses and the nonpersonal use capital asset casualty gains and losses are netted together (see Concept Summary 17–1). If the result is a *net loss*, the § 1231 casualty gains and the nonpersonal use capital asset casualty gains are treated as ordinary gains, the § 1231 casualty losses are deductible for AGI, and the nonpersonal use capital asset casualty losses are deductible from AGI subject to the 2 percent-of-AGI limitation.

If the result of the netting is a *net gain*, the net gain is treated as a § 1231 gain. Thus, a § 1231 asset disposed of by casualty may or may not get § 1231 treatment, depending on whether the netting process results in a gain or a loss. Also, a
nonpersonal use capital asset disposed of by casualty may get § 1231 treatment or ordinary treatment, but will not get capital gain or loss treatment!

*Personal use property casualty* gains and losses are not subject to the § 1231 rules. If the result of netting these gains and losses is a gain, the net gain is a capital gain. If the netting results in a loss, the net loss is a deduction *from* AGI to the extent it exceeds 10 percent of AGI.

Casualties, thefts, and condemnations are *involuntary conversions*. Involuntary conversion gains may be deferred if conversion proceeds are reinvested; involuntary conversion losses are recognized currently (refer to Chapter 15) regardless of whether the conversion proceeds are reinvested. Thus, the special netting process discussed above for casualties and thefts would not include gains that are not currently recognizable because the insurance proceeds are reinvested.

The special netting process for casualties and thefts also does not include condemnation gains and losses. Consequently, a § 1231 asset disposed of by condemnation will receive § 1231 treatment. This variation between recognized casualty and condemnation gains and losses sheds considerable light on what § 1231 is all about. Section 1231 has no effect on whether or not realized gain or loss is recognized. Instead, § 1231 merely dictates how such recognized gain or loss is classified (ordinary, capital, or § 1231) under certain conditions.

*Personal use property condemnation* gains and losses are not subject to the § 1231 rules. The gains are capital gains (because personal use property is a capital asset), and the losses are nondeductible because they arise from the disposition of personal use property.

**GENERAL PROCEDURE FOR § 1231 COMPUTATION**

The tax treatment of § 1231 gains and losses depends on the results of a rather complex netting procedure. The steps in this netting procedure are as follows.

**Step 1: Casualty Netting.** Net all recognized long-term gains and losses from casualties of § 1231 assets and nonpersonal use capital assets. Casualty gains result when insurance proceeds exceed the adjusted basis of the property. This casualty netting is beneficial because if there is a net gain, the gain may receive long-term capital gain treatment. If there is a net loss, it receives ordinary loss treatment.

a. If the casualty gains exceed the casualty losses, add the excess to the other § 1231 gains for the taxable year.

b. If the casualty losses exceed the casualty gains, exclude all casualty losses and gains from further § 1231 computation. If this is the case, all casualty gains are ordinary income. Section 1231 asset casualty losses are deductible *for* AGI. Other casualty losses are deductible *from* AGI.

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Step 2: § 1231 Netting. After adding any net casualty gain from Step 1a to the other § 1231 gains and losses (including recognized § 1231 asset condemnation gains and losses), net all § 1231 gains and losses.

a. If the gains exceed the losses, the net gain is offset by the “lookback” nonrecaptured § 1231 losses (see below) from the five prior tax years. To the extent of this offset, the net § 1231 gain is classified as ordinary gain. Any remaining gain is long-term capital gain.

b. If the losses exceed the gains, all gains are ordinary income. Section 1231 asset losses are deductible for AGI. Other casualty losses are deductible from AGI.

Step 3: § 1231 Lookback Provision. The net § 1231 gain from Step 2a is offset by the nonrecaptured net § 1231 losses for the five preceding taxable years. For 2004, the lookback years are 1999, 2000, 2001, 2002, and 2003. To the extent of the nonrecaptured net § 1231 loss, the current-year net § 1231 gain is ordinary income. The nonrecaptured net § 1231 losses are those that have not already been used to offset net § 1231 gains. Only the net § 1231 gain exceeding this net § 1231 loss carryforward is given long-term capital gain treatment. Concept Summary 17–1 summarizes the § 1231 computational procedure. Examples 6 and 7 illustrate the § 1231 lookback provision.

Examples 4 through 7 illustrate the application of the § 1231 computation procedure.

**Example 4**

During 2004, Ross had $125,000 of AGI before considering the following recognized gains and losses:

<table>
<thead>
<tr>
<th>Capital Gains and Losses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term capital gain</td>
<td>$3,000</td>
</tr>
<tr>
<td>Long-term capital loss</td>
<td>(400)</td>
</tr>
<tr>
<td>Short-term capital gain</td>
<td>1,000</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>(200)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Casualties</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Theft of diamond ring (owned four months)</td>
<td>(800)*</td>
</tr>
<tr>
<td>Fire damage to personal residence (owned 10 years)</td>
<td>(400)*</td>
</tr>
<tr>
<td>Gain from insurance recovery on fire loss to business building (owned two years)</td>
<td>200</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>§ 1231 Gains and Losses from Depreciable Business Assets Held Long Term</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset A</td>
<td>$ 300</td>
</tr>
<tr>
<td>Asset B</td>
<td>1,100</td>
</tr>
<tr>
<td>Asset C</td>
<td>(500)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gains and Losses from Sale of Depreciable Business Assets Held Short Term</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset D</td>
<td>$ 200</td>
</tr>
<tr>
<td>Asset E</td>
<td>(300)</td>
</tr>
</tbody>
</table>

*As adjusted for the $100 floor on personal casualty losses.

Ross had no net § 1231 losses in tax years before 2004.
Disregarding the recapture of depreciation (discussed later in the chapter), Ross’s gains and losses receive the following tax treatment:

- The diamond ring and the residence are personal use assets. Therefore, these casualties are not § 1231 transactions. The $800 (ring) plus $400 (residence) losses are potentially deductible from AGI. However, the total loss of $1,200 does not exceed 10% of AGI. Thus, only the business building (a § 1231 asset) casualty gain remains. The netting of the § 1231 asset and nonpersonal use capital asset casualty gains and losses contains only one item—the $200 gain from the business building. Consequently, there is a net gain and that gain is treated as a § 1231 gain (added to the § 1231 gains).
- The gains from § 1231 transactions (Assets A, B, and C and the § 1231 asset casualty gain) exceed the losses by $1,100 ($1,600 − $500). This excess is a long-term capital gain and is added to Ross’s other long-term capital gains.
- Ross’s net long-term capital gain is $3,700 ($3,000 + $1,100 from § 1231 transactions − $400 long-term capital loss). Ross’s net short-term capital gain is $800 ($1,000 − $200). The result is capital gain net income of $4,500. The $3,700 net long-term capital gain portion is eligible for beneficial capital gain treatment [assume all the gain is 5%/15% gain (see the discussion in Chapter 16)]. The $800 net short-term capital gain is subject to tax as ordinary income.5
- Ross treats the gain and loss from Assets D and E (depreciable business assets held for less than the long-term holding period) as ordinary gain and loss.

**Results of the Gains and Losses on Ross’s Tax Computation**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NLTCG</td>
<td>3,700</td>
</tr>
<tr>
<td>NSTCG</td>
<td>800</td>
</tr>
<tr>
<td>Ordinary gain from sale of Asset D</td>
<td>200</td>
</tr>
<tr>
<td>Ordinary loss from sale of Asset E</td>
<td>(300)</td>
</tr>
<tr>
<td>AGI from other sources</td>
<td>125,000</td>
</tr>
<tr>
<td>AGI</td>
<td>129,400</td>
</tr>
</tbody>
</table>

- Ross will have personal use property casualty losses of $1,200 [$800 (diamond ring) + $400 (personal residence)]. A personal use property casualty loss is deductible only to the extent it exceeds 10% of AGI. Thus, none of the $1,200 is deductible ($129,400 × 10% = $12,940).

**EXAMPLE 5**

Assume the same facts as in Example 4, except the loss from Asset C was $1,700 instead of $500.

- The treatment of the casualty losses is the same as in Example 4.
- The losses from § 1231 transactions now exceed the gains by $100 ($1,700 − $1,600). As a result, the gains from Assets A and B and the § 1231 asset casualty gain are ordinary income, and the loss from Asset C is a deduction for AGI (a business loss). The same result can be achieved by simply treating the $100 net loss as a deduction for AGI.
- Capital gain net income is $3,400 ($2,600 long term + $800 short term). The $2,600 net long-term capital gain portion is eligible for beneficial capital gain treatment, and the $800 net short-term capital gain is subject to tax as ordinary income.

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5Ross’s taxable income (unless the itemized deductions and the personal exemption and dependency deductions are extremely large) will put him in at least the 28% bracket. Thus, the alternative tax computation will yield a lower tax. See Example 40 in Chapter 16.
Results of the Gains and Losses on Ross’s Tax Computation

<table>
<thead>
<tr>
<th>Description</th>
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</tr>
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<tbody>
<tr>
<td>NLTCG</td>
<td>$2,600</td>
</tr>
<tr>
<td>NSTCG</td>
<td>800</td>
</tr>
<tr>
<td>Net ordinary loss on Assets A, B, and C and § 1231</td>
<td></td>
</tr>
<tr>
<td>casualty gain</td>
<td>(100)</td>
</tr>
<tr>
<td>Ordinary gain from sale of Asset D</td>
<td>200</td>
</tr>
<tr>
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<tr>
<td>Ordinary gain from recapture of § 1231 losses</td>
<td>700</td>
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* None of the personal use property casualty losses will be deductible since $1,200 does not exceed 10% of $128,200.

E X A M P L E  6

Assume the same facts as in Example 4, except that Ross has a $700 nonrecaptured net § 1231 loss from 2003.

* The treatment of the casualty losses is the same as in Example 4.
* The 2004 net § 1231 gain of $1,100 is treated as ordinary income to the extent of the 2003 nonrecaptured § 1231 loss of $700. The remaining $400 net § 1231 gain is a long-term capital gain and is added to Ross’s other long-term capital gains.
* Ross’s net long-term capital gain is $3,000 ($3,000 + $400 from § 1231 transactions - $400 long-term capital loss). Ross’s net short-term capital gain is still $800 ($1,000 - $200). The result is capital gain net income of $3,800. The $3,000 net long-term capital gain portion is eligible for beneficial capital gain treatment, and the $800 net short-term capital gain is subject to tax as ordinary income.

Results of the Gains and Losses on Ross’s Tax Computation

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* None of the personal use property casualty losses will be deductible since $1,200 does not exceed 10% of $129,400.

E X A M P L E  7

Assume the same facts as in Example 4, except that Ross had a net § 1231 loss of $2,700 in 2002 and a net § 1231 gain of $300 in 2003.

* The treatment of the casualty losses is the same as in Example 4.
* The 2002 net § 1231 loss of $2,700 will have carried over to 2003 and been offset against the 2003 net § 1231 gain of $300. Thus, the $300 gain will have been classified as ordinary income, and $2,400 of nonrecaptured 2002 net § 1231 loss will carry over to 2004. The 2004 net § 1231 gain of $1,100 will be offset against this loss, resulting in $1,100 of ordinary income. The nonrecaptured net § 1231 loss of $1,300 ($2,400 - $1,100) carries over to 2005.
* Capital gain net income is $3,400 ($2,600 net long-term capital gain + $800 net short-term capital gain). The $2,600 net long-term capital gain portion is eligible for beneficial capital gain treatment, and the $800 net short-term capital gain is subject to tax as ordinary income.

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### Results of the Gains and Losses on Ross's Tax Computation

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<td>NSTCG</td>
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<tr>
<td>Ordinary gain from recapture of § 1231 losses</td>
<td>1,100</td>
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<tr>
<td>Ordinary gain from sale of Asset D</td>
<td>200</td>
</tr>
<tr>
<td>Ordinary loss from sale of Asset E</td>
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### Section 1245 Recapture

Now that the basic rules of § 1231 have been introduced, it is time to add some complications. The Code contains two major recapture provisions—§§ 1245 and 1250. These provisions cause *gain* to be treated *initially* as ordinary gain. Thus, what may appear to be a § 1231 gain is ordinary gain instead. These recapture provisions may also cause a gain in a nonpersonal use casualty to be *initially* ordinary gain rather than casualty gain. Classifying gains (and losses) properly initially is important because improper initial classification may lead to incorrect mixing and matching of gains and losses. This section discusses the § 1245 recapture rules, and the next section discusses the § 1250 recapture rules.

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### Preparing Tax Returns without Proper Preparation

A college student works at a CPA firm during an internship. As part of his duties, he prepares Federal income tax returns that include reporting on dispositions of § 1231 assets. The student has never had a tax course in college and has received no training from the CPA firm. Should he refuse to prepare the returns?

Section 1245 requires taxpayers to treat all gain as ordinary gain unless the property is disposed of for more than was paid for it. This result is accomplished by requiring that all gain be treated as ordinary gain to the extent of the depreciation taken on the property disposed of. Section 1231 gain results only when the property is disposed of for more than its original cost. The excess of the sales price over the original cost is § 1231 gain. Section 1245 applies *primarily* to non-real-estate property such as machinery, trucks, and office furniture. Section 1245 does not apply if property is disposed of at a loss. Generally, the loss will be a § 1231 loss unless the form of the disposition is a casualty.

Alice purchased a $100,000 business machine and deducted $70,000 depreciation before selling it for $80,000. If it were not for § 1245, the $50,000 gain would be § 1231 gain ($80,000 amount realized – $30,000 adjusted basis). Section 1245 prevents this potentially favorable result by treating as ordinary income (not as § 1231 gain) any gain to the extent of depreciation taken. In this example, the entire $50,000 gain would be ordinary income. If Alice had sold...
the machine for $120,000, she would have a gain of $90,000 ($120,000 amount realized – $30,000 adjusted basis). The § 1245 gain would be $70,000 (equal to the depreciation taken), and the § 1231 gain would be $20,000 (equal to the excess of the sales price over the original cost).

**Section 1245 recapture** provides, in general, that the portion of recognized gain from the sale or other disposition of § 1245 property that represents depreciation (including § 167 depreciation, § 168 cost recovery, § 179 immediate expensing, § 168(k) 30 or 50 percent additional first-year depreciation, and § 197 amortization) is recaptured as ordinary income. Thus, in Example 8, $50,000 of the $70,000 depreciation taken is recaptured as ordinary income when the business machine is sold for $80,000. Only $50,000 is recaptured rather than $70,000 because Alice is only required to recognize § 1245 recapture ordinary gain equal to the lower of the depreciation taken or the gain recognized.

The method of depreciation (e.g., accelerated or straight-line) does not matter. All depreciation taken is potentially subject to recapture. Thus, § 1245 recapture is often referred to as full recapture. Any remaining gain after subtracting the amount recaptured as ordinary income will usually be § 1231 gain. If the property is disposed of in a casualty event, however, the remaining gain will be casualty gain. If the business machine in Example 8 had been disposed of by casualty and the $80,000 received had been an insurance recovery, Alice would still have a gain of $50,000, and the gain would still be recaptured by § 1245 as ordinary gain. The § 1245 recapture rules apply before there is any casualty gain. Since all the $50,000 gain is recaptured, no casualty gain arises from the casualty.

The following examples illustrate the general application of § 1245.

**EXAMPLE 9**

On January 1, 2004, Gary sold for $13,000 a machine acquired several years ago for $12,000. He had taken $10,000 of depreciation on the machine.

- The recognized gain from the sale is $11,000. This is the amount realized of $13,000 less the adjusted basis of $2,000 ($12,000 cost – $10,000 depreciation taken).
- Depreciation taken is $10,000. Therefore, since § 1245 recapture gain is the lower of depreciation taken or gain recognized, $10,000 of the $11,000 recognized gain is ordinary income, and the remaining $1,000 gain is § 1231 gain.
- The § 1231 gain of $1,000 is also equal to the excess of the sales price over the original cost of the property ($13,000 – $12,000 = $1,000 § 1231 gain).
Assume the same facts as in the previous example, except the asset is sold for $9,000 instead of $13,000.

- The recognized gain from the sale is $7,000. This is the amount realized of $9,000 less the adjusted basis of $2,000.
- Depreciation taken is $10,000. Therefore, since the $10,000 depreciation taken exceeds the recognized gain of $7,000, the entire $7,000 recognized gain is ordinary income.
- The § 1231 gain is zero. There is no § 1231 gain because the selling price ($9,000) does not exceed the original purchase price ($12,000).

Assume the same facts as in Example 9, except the asset is sold for $1,500 instead of $13,000.

- The recognized loss from the sale is $500. This is the amount realized of $1,500 less the adjusted basis of $2,000.
- Since there is a loss, there is no depreciation recapture. All of the loss is § 1231 loss.

If § 1245 property is disposed of in a transaction other than a sale, exchange, or involuntary conversion, the maximum amount recaptured is the excess of the property’s fair market value over its adjusted basis. See the discussion under Considerations Common to §§ 1245 and 1250 later in the chapter.

**SECTION 1245 PROPERTY**

Generally, § 1245 property includes all depreciable personal property (e.g., machinery and equipment), including livestock. Buildings and their structural components generally are not § 1245 property. The following property is also subject to § 1245 treatment:

- Amortizable personal property such as goodwill, patents, copyrights, and leaseholds of § 1245 property. Professional baseball and football player contracts are § 1245 property.
- Amortization of reforestation expenditures.
- Expensing of costs to remove architectural and transportation barriers that restrict the handicapped and/or elderly.
- Section 179 immediate expensing of depreciable tangible personal property costs.
- Property for which the § 168(k) 30 or 50 percent additional first-year depreciation is taken.
- Certain depreciable tangible real property (other than buildings and their structural components) employed as an integral part of certain activities such as manufacturing and production. For example, a natural gas storage tank where the gas is used in the manufacturing process is § 1245 property.
- Pollution control facilities, railroad grading and tunnel bores, on-the-job training, and child care facilities on which amortization is taken.
- Single-purpose agricultural and horticultural structures and petroleum storage facilities (e.g., a greenhouse or silo).
- Fifteen-year, 18-year, and 19-year nonresidential real estate for which accelerated cost recovery is used is subject to the § 1245 recapture rules, although it is technically not § 1245 property. Such property would have been placed in service after 1980 and before 1987.

James acquired nonresidential real property on January 1, 1986, for $100,000. He used the statutory percentage method to compute the ACRS cost recovery. He sells the asset on January 15, 2004, for $120,000. The amount and nature of James’s gain are computed as follows:

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CHAPTER 17  Property Transactions: § 1231 and Recapture Provisions

Amount realized $120,000
Adjusted basis
Cost $100,000
Less cost recovery: 1986–2003 (95,600)
2004 (175)
January 15, 2004, adjusted basis (4,225)
Gain realized and recognized $115,775

The gain of $115,775 is treated as ordinary income to the extent of all depreciation taken because the property is 19-year nonresidential real estate for which accelerated depreciation was used. Thus, James reports ordinary income of $95,775 ($95,600 + $175) and § 1231 gain of $20,000 ($115,775 – $95,775).

OBSERVATIONS ON § 1245

• In most instances, the total depreciation taken will exceed the recognized gain. Therefore, the disposition of § 1245 property usually results in ordinary income rather than § 1231 gain. Thus, generally, no § 1231 gain will occur unless the § 1245 property is disposed of for more than its original cost. Refer to Examples 9 and 10.
• Recapture applies to the total amount of depreciation allowed or allowable regardless of the depreciation method used.
• Recapture applies regardless of the holding period of the property. Of course, the entire recognized gain would be ordinary income if the property were held for less than the long-term holding period because § 1231 would not apply.
• Section 1245 does not apply to losses, which receive § 1231 treatment.
• Gains from the disposition of § 1245 assets may also be treated as passive activity gains (see Chapter 11).

Section 1250 Recapture

Generally, § 1250 property is depreciable real property (principally buildings and their structural components) that is not subject to § 1245. Intangible real property, such as leaseholds of § 1250 property, is also included.

Section 1250 recapture rarely applies since only the amount of additional depreciation is subject to recapture. To have additional depreciation, accelerated depreciation must have been taken on the asset. Straight-line depreciation is not recaptured (except for property held one year or less). Since depreciable real property placed in service after 1986 can only be depreciated using the straight-line method, there will be no § 1250 depreciation recapture on such property. Nor does § 1250 apply if the real property is sold at a loss.

If depreciable real property has been held for many years before it is sold, however, the § 1250 recapture rules may apply and are therefore discussed here. Additional depreciation is the excess of the accelerated depreciation actually deducted over depreciation that would have been deductible if the straight-line method had been used. Section 1250 recapture may apply when either (1) residential rental real property was acquired after 1975 and before 1987 and accelerated
depreciation was taken or (2) nonresidential real property was acquired before 1981 and accelerated depreciation was taken after December 31, 1969.

If § 1250 property with additional depreciation is disposed of in a transaction other than a sale, exchange, or involuntary conversion, the depreciation recapture is limited to the excess of the property’s fair market value over the adjusted basis. For instance, if a corporation distributes real property to its shareholders as a dividend and the fair market value of the real property is greater than its adjusted basis, the corporation will recognize a gain. If accelerated depreciation was taken on the property, § 1250 recapture will apply.

It is important to know what assets are defined as § 1250 property because even when there is no additional depreciation, the gain from such property may be subject to a special 25 percent tax rate. See the discussion of Unrecaptured § 1250 Gain later in this chapter.

The discussion below describes the computational steps when § 1250 recapture applies and indicates how that recapture is reflected on Form 4797 (Sales of Business Property).

COMPUTING RECAPTURE ON NONRESIDENTIAL REAL PROPERTY

For § 1250 property other than residential rental property, the potential recapture is equal to the amount of additional depreciation taken since December 31, 1969. This nonresidential real property includes buildings such as offices, warehouses, factories, and stores. (The definition of and rules for residential rental housing are discussed later in the chapter.) The lower of the potential § 1250 recapture amount or the recognized gain is ordinary income. The following general rules apply:

- Additional depreciation is depreciation taken in excess of straight-line after December 31, 1969, on property that was acquired before 1981.
- If the property is held for one year or less (usually not the case), all depreciation taken, even under the straight-line method, is additional depreciation.

The following procedure is used to compute recapture on nonresidential real property that was acquired before 1981 and for which accelerated depreciation was taken after December 31, 1969, under § 1250:

- Determine the recognized gain from the sale or other disposition of the property.
- Determine the additional depreciation (if any).
- The lower of the recognized gain or the additional depreciation is ordinary income.
- If any recognized gain remains (total recognized gain less recapture), it is § 1231 gain. However, it would be casualty gain if the disposition was by casualty.

The following example shows the application of the § 1250 computational procedure.

**EXAMPLE 13**

On January 3, 1980, Larry acquired a new building at a cost of $200,000 for use in his business. The building had an estimated useful life of 50 years and no estimated salvage value. Depreciation has been taken under the 150% declining-balance method through December 31, 2003. Pertinent information with respect to depreciation taken follows:
On January 2, 2004, Larry sold the building for $180,000. Compute the amount of his § 1250 ordinary income and § 1231 gain.

- Larry’s recognized gain from the sale is $83,810. This is the difference between the $180,000 amount realized and the $96,190 adjusted basis ($200,000 cost – $103,810 depreciation taken).
- Additional depreciation is $7,810.
- The amount of ordinary income is $7,810. Since the additional depreciation of $7,810 is less than the recognized gain of $83,810, the entire gain is not recaptured.
- The remaining $76,000 ($83,810 – $7,810) gain is § 1231 gain.

**COMPUTING RECAPTURE ON RESIDENTIAL RENTAL HOUSING**

Section 1250 recapture sometimes applies to the sale or other disposition of residential rental housing. Property qualifies as *residential rental housing* only if at least 80 percent of gross rent income is rent income from dwelling units. The rules are the same as for other § 1250 property, except that only the post-1975 additional depreciation may be recaptured on property acquired before 1987. If any of the recognized gain is not absorbed by the recapture rules pertaining to the post-1975 period, the remaining gain is § 1231 gain.

Assume the same facts as in the previous example, except the building is residential rental housing.

- Post-1975 ordinary income is $7,810 (post-1975 additional depreciation of $7,810).
- The remaining $76,000 ($83,810 – $7,810) gain is § 1231 gain.

Under § 1250, when straight-line depreciation is used, there is no § 1250 recapture potential unless the property is disposed of in the first year of use. Generally, however, the § 1250 recapture rules do not apply to depreciable real property unless the property is disposed of in the first year of use.

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7§ 168(e)(2)(A). Note that there may be residential, nonrental housing (e.g., a bunkhouse on a cattle ranch). Such property is commonly regarded as “nonresidential real estate.” The rules for such property were discussed in the previous section.
**SECTION 1250 RECAPTURE SITUATIONS**

The § 1250 recapture rules apply to the following property for which accelerated depreciation was used:

- Nonresidential real estate acquired before 1981.
- Real property used predominantly outside the United States.
- Certain government-financed or low-income housing.

Concept Summary 17–2 compares and contrasts the § 1245 and § 1250 depreciation recapture rules.

**UNRECAPTURED § 1250 GAIN (REAL ESTATE 25% GAIN)**

This section will explain what gain is eligible for the 25 percent tax rate on unrecovered § 1250 gain. This gain is used in the alternative tax computation for net capital gain discussed in Chapter 16. Unrecovered § 1250 gain (25% gain) is some or all of the § 1231 gain that is treated as long-term capital gain and relates to a sale of depreciable real estate.

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8Described in § 1250(a)(1)(B).
The maximum amount of this 25% gain is the depreciation taken on real property sold at a recognized gain. That maximum amount is reduced in one or more of the following ways:

- The recognized gain from disposition is less than the depreciation taken. The 25% gain is reduced to the recognized gain amount. Refer to Example 13. The depreciation taken was $103,810, but the recognized gain was only $83,810. Consequently, all of the recognized gain is potential 25% § 1231 gain.
- There is § 1250 depreciation recapture because the property is residential real estate acquired before 1987 on which accelerated depreciation was taken. The § 1250 recapture reduces the 25% gain. Refer to Example 14. Of the $83,810 recognized gain, $7,810 was recaptured by § 1250 as ordinary income, leaving $76,000 of the potential 25% § 1231 gain.
- There is § 1245 depreciation recapture because the property is nonresidential real estate acquired in 1981–1986 on which accelerated depreciation was taken. No 25% § 1231 gain will be left because § 1245 will recapture all of the depreciation or the recognized gain, whichever is less. Refer to Example 12. Depreciation of $95,775 was taken, but all of it was recaptured as ordinary income by § 1245. Thus, there is no remaining potential 25% § 1231 gain. The entire $20,000 § 1231 gain in Example 12 is potential 5%/15% gain.
- § 1231 loss from disposition of other § 1231 assets held long term reduces the gain from real estate.
- § 1231 lookback losses convert some or all of the potential 25% § 1231 gain to ordinary income.

Special 25% Gain Netting Rules. Where there is a § 1231 gain from real estate and that gain includes both potential 25% gain and potential 5%/15% gain, any § 1231 loss from disposition of other § 1231 assets first offsets the 5%/15% portion of the § 1231 gain and then offsets the 25% portion of the § 1231 gain. Also, any § 1231 lookback loss first recharacterizes the 25% portion of the § 1231 gain and then recharacterizes the 5%/15% portion of the § 1231 gain as ordinary income.

Net § 1231 Gain Limitation. The amount of unrecaptured § 1250 gain may not exceed the net § 1231 gain that is eligible to be treated as long-term capital gain. The unrecaptured § 1250 gain is the lesser of the unrecaptured § 1250 gain or the net § 1231 gain that is treated as capital gain. Thus, if there is a net § 1231 gain, but it is all recaptured by the five-year § 1231 lookback loss provision, there is no surviving § 1231 gain or unrecaptured § 1250 gain.

Refer to Example 6. There was $200 of § 1231 gain from the building fire that would also be potential 25% gain if at least $200 of depreciation was taken. The net § 1231 gain was $1,100 including the $200 building gain. (The $500 loss from Asset C would offset the potential 5%/15% § 1231 gain and not the potential 25% gain, so all of the potential 25% gain of $200 is in the $1,100 net § 1231 gain.) However, the $700 of § 1231 lookback losses would first absorb the $200 building gain, so the $400 of § 1231 gain that is treated as long-term capital gain includes no 25% gain.

Section 1250 Property for Purposes of the Unrecaptured § 1250 Gain. Section 1250 property includes any real property (other than § 1245 property) that is or has been depreciable. Land is not § 1250 property because it is not depreciable.
Bill is a single taxpayer with 2004 taxable income of $84,000 composed of:

- $64,000 ordinary taxable income,
- $3,000 short-term capital loss,
- $15,000 long-term capital gain from sale of stock, and
- $8,000 § 1231 gain that is all unrecaptured § 1250 gain (the actual unrecaptured gain was $11,000, but net § 1231 gain is only $8,000).

Bill’s net capital gain is $20,000 ($15,000 long-term capital gain + $8,000 unrecaptured § 1250 gain/net § 1231 gain – $3,000 short-term capital loss). The $3,000 short-term capital loss is offset against the $8,000 unrecaptured § 1250 gain, reducing that gain to $5,000 (see the discussion in Chapter 16 concerning netting of capital losses). Bill’s adjusted net capital gain is $15,000 ($20,000 net capital gain – $5,000 unrecaptured § 1250 gain). Bill’s total tax (using the alternative tax calculation discussed in Chapter 16) is $16,238 [$12,738 (tax on ordinary taxable income) + $1,250 ($5,000 unrecaptured § 1250 gain × 25%) + $2,250 ($15,000 adjusted net capital gain × 15%)].

Considerations Common to §§ 1245 and 1250

**EXCEPTIONS**

Recapture under §§ 1245 and 1250 does not apply to the following transactions.

**Gifts.** The recapture potential carries over to the donee.9

Wade gives his daughter, Helen, § 1245 property with an adjusted basis of $1,000. The amount of recapture potential is $700. Helen uses the property in her business and claims further depreciation of $100 before selling it for $1,900. Helen’s recognized gain is $1,000 ($1,900 amount realized – $900 adjusted basis), of which $800 is recaptured as ordinary income ($100 depreciation taken by Helen + $700 recapture potential carried over from Wade). The remaining gain of $200 is § 1231 gain. Even if Helen used the property for personal purposes, the $700 recapture potential would still be carried over.

**Death.** Although not a very attractive tax planning approach, death eliminates all recapture potential.10 In other words, any recapture potential does not carry over from a decedent to an estate or heir.

Assume the same facts as in Example 17, except Helen receives the property as a result of Wade’s death. The $700 recapture potential from Wade is extinguished. Helen has a basis for the property equal to the property’s fair market value (assume $1,700) at Wade’s death. She will have a $300 gain when the property is sold because the selling price ($1,900) exceeds the property’s adjusted basis of $1,600 ($1,700 original basis to Helen – $100 depreciation) by $300. Because of § 1245, $100 is ordinary income. The remaining gain of $200 is § 1231 gain.

**Charitable Transfers.** The recapture potential reduces the amount of the charitable contribution deduction under § 170.11

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9§§ 1245(b)(1) and 1250(d)(1) and Reg. §§ 1.1245–4(a)(1) and 1.1250–3(a)(1).

10§ 170(e)(1)(A) and Reg. § 1.170A–4(b)(1). In certain circumstances, § 1231 gain also reduces the amount of the charitable contribution. See § 170(e)(1)(B).
EXCHANGE FOR FOREIGN PROPERTY YIELDS RECOUPTURE GAIN

Tangible personal property used in a trade or business may be the subject of a § 1031 like-kind exchange, and the postponed gain is most likely postponed § 1245 gain. However, tangible personal property used predominantly within the United States cannot be exchanged for tangible personal property used predominantly outside the United States. Thus, such an exchange would cause recognized gain, and, as long as the fair market value of the property given up does not exceed its original cost, all of the gain is § 1245 depreciation recapture gain.

EXAMPLE 19

Kanisha donates to her church § 1245 property with a fair market value of $10,000 and an adjusted basis of $7,000. Assume that the amount of recapture potential is $2,000 (the amount of recapture that would occur if the property were sold). Her charitable contribution deduction (subject to the limitations discussed in Chapter 10) is $8,000 ($10,000 fair market value − $2,000 recapture potential).

Certain Nontaxable Transactions. In certain transactions, the transferor’s adjusted basis of property carries over to the transferee. The recapture potential also carries over to the transferee. Included in this category are transfers of property pursuant to the following:

- Nontaxable incorporations under § 351.
- Certain liquidations of subsidiary companies under § 332.
- Nontaxable contributions to a partnership under § 721.
- Nontaxable reorganizations.

Gain may be recognized in these transactions if boot is received. If gain is recognized, it is treated as ordinary income to the extent of the recapture potential or recognized gain, whichever is lower.

Like-Kind Exchanges (§ 1031) and Involuntary Conversions (§ 1033).

Realized gain will be recognized to the extent of boot received under § 1031. Realized gain also will be recognized to the extent the proceeds from an involuntary conversion are not reinvested in similar property under § 1033. Such recognized gain is subject to recapture as ordinary income under §§ 1245 and 1250. The remaining recapture potential, if any, carries over to the property received in the exchange. Realized losses are not recognized in like-kind exchanges, but are recognized in involuntary conversions (see Chapter 15).

EXAMPLE 20

Anita exchanges § 1245 property with an adjusted basis of $300 for § 1245 property with a fair market value of $6,000. The exchange qualifies as a like-kind exchange under § 1031. Anita also receives $1,000 cash (boot). Her realized gain is $6,700 ($7,000 amount realized − $300 adjusted basis of property). Assuming the recapture potential is $7,500, Anita recognizes $1,000 of § 1245 gain of $1,000 because she received boot of $1,000. The remaining recapture potential of $6,500 carries over to the like-kind property received.

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12§§ 1245(b)(3) and 1250(d)(3) and Reg. §§ 1.1245–4(c) and 1.1250–3(c).
13Reg. §§ 1.1245–2(a)(4) and –2(c)(2) and 1.1250–2(d)(1) and (3) and –3(c)(3).
14§§ 1245(b)(3) and 1250(d)(3) and Reg. §§ 1.1245–4(c) and 1.1250–3(c). Some of these special corporate problems are discussed in Chapter 20. Partnership contributions are also discussed in Chapter 20.
OTHER APPLICATIONS
Sections 1245 and 1250 apply notwithstanding any other provisions in the Code. That is, the recapture rules under these Sections override all other Sections. Special applications include installment sales and property dividends.

Installment Sales. Recapture gain is recognized in the year of the sale regardless of whether gain is otherwise recognized under the installment method. All gain is ordinary income until the recapture potential is fully absorbed. Nonrecapture (§ 1231) gain is recognized under the installment method as cash is received.

Example 21
Seth sells § 1245 property for $20,000, to be paid in 10 annual installments of $2,000 each plus interest at 10%. Seth realizes a $6,000 gain from the sale, of which $4,000 is attributable to depreciation taken. If Seth uses the installment method, he recognizes the entire $4,000 of recapture gain as ordinary income in the year of the sale. The $2,000 of nonrecapture (§ 1231) gain will be recognized at the rate of $200 per year for 10 years.

Gain is also recognized on installment sales in the year of the sale in an amount equal to the § 179 (immediate expensing) and § 168(k) 30 or 50 percent additional first-year depreciation deductions taken with respect to the property sold.

Property Dividends. A corporation generally recognizes gain if it distributes appreciated property as a dividend. Recapture under §§ 1245 and 1250 applies to the extent of the lower of the recapture potential or the excess of the property’s fair market value over the adjusted basis.

Example 22
Emerald Corporation distributes § 1245 property as a dividend to its shareholders. The amount of the recapture potential is $300, and the excess of the property’s fair market value over the adjusted basis is $800. Emerald recognizes $300 of ordinary income and $500 of §1231 gain.

Concept Summary 17–3 integrates the depreciation recapture rules with the § 1231 netting process. It is an expanded version of Concept Summary 17–1.

Special Recapture Provisions

SPECIAL RECAPTURE FOR CORPORATIONS
Corporations selling depreciable real estate may have ordinary income in addition to that required by § 1250. See the discussion of this topic in Chapter 20.

GAIN FROM SALE OF DEPRECIABLE PROPERTY BETWEEN CERTAIN RELATED PARTIES
When the sale or exchange of property, which in the hands of the transferee is depreciable property (principally machinery, equipment, and buildings, but not

LO.6 Apply the special recapture provisions for related parties and IDC and be aware of the special recapture provision for corporations.

1²§ 1245(d) and 1250(i).
²§ 453(i). The installment method of reporting gains on the sale of property is discussed in Chapter 18.
³§ 311(b) and Reg. §§ 1.1245–1(c) and –6(b) and 1.1250–1(a)(4), –1(b)(4), and –1(c)(2).
⁴§ 291(a)(1).

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Concealed in the paragraph is the following text:

This provision applies to both direct and indirect sales or exchanges. A related party is defined as an individual and his or her controlled corporation or partnership or a taxpayer and any trust in which the taxpayer (or the taxpayer’s spouse) is a beneficiary.

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*Includes casualties and thefts.

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§ 1239.
Isabella sells a personal use automobile (therefore nondepreciable) to her controlled corporation. The automobile, which was purchased two years ago, originally cost $5,000 and is sold for $7,000. The automobile is to be used in the corporation’s business. If the related-party provision did not exist, Isabella would realize a $2,000 long-term capital gain. The income tax consequences would be favorable because Isabella’s controlled corporation is entitled to depreciate the automobile based upon the purchase price of $7,000. Under the related-party provision, Isabella’s $2,000 gain is ordinary income.

EXAMPLE 23

Isabella sells a personal use automobile (therefore nondepreciable) to her controlled corporation. The automobile, which was purchased two years ago, originally cost $5,000 and is sold for $7,000. The automobile is to be used in the corporation’s business. If the related-party provision did not exist, Isabella would realize a $2,000 long-term capital gain. The income tax consequences would be favorable because Isabella’s controlled corporation is entitled to depreciate the automobile based upon the purchase price of $7,000. Under the related-party provision, Isabella’s $2,000 gain is ordinary income.

INTANGIBLE DRILLING COSTS

Taxpayers may elect to either expense or capitalize intangible drilling and development costs for oil, gas, or geothermal properties.\(^2\) Intangible drilling and development costs (IDC) include operator (one who holds a working or operating interest in any tract or parcel of land) expenditures for wages, fuel, repairs, hauling, and supplies. These expenditures must be incident to and necessary for the drilling of wells and preparation of wells for production. In most instances, taxpayers elect to expense IDC to maximize tax deductions during drilling.

Intangible drilling and development costs are subject to § 1254 recapture when the property is disposed of. The gain on the disposition of the property is subject to recapture as ordinary income.

Reporting Procedures

Noncapital gains and losses are reported on Form 4797, Sales of Business Property. Before filling out Form 4797, however, Form 4684, Casualties and Thefts, Part B, must be completed to determine whether any casualties will enter into the § 1231 computation procedure. Recall that gains from § 1231 asset casualties may be recaptured by § 1245 or § 1250. These gains will not appear on Form 4684. The § 1231 gains and nonpersonal use long-term capital gains are netted against § 1231 losses and nonpersonal use long-term capital losses on Form 4684 to determine if there is a net gain to transfer to Form 4797, Part I.

Because the 2004 tax forms were unavailable at this writing, 2003 tax forms are used in the remainder of the discussion.

\(^2\)§ 263(c).
Form 4797 is divided into four parts, summarized as follows:

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<td>IV</td>
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</tbody>
</table>

Generally, the best approach to completing Form 4797 is to start with Part III. Once the recapture amount has been determined, it is transferred to Part II. The balance of any gain remaining after the recapture has been accounted for is transferred from Part III to Part I. Also transferred to Part I is any net gain from certain casualties and thefts as reported on Form 4684, Part B (refer to above and Chapter 15). If the netting process in Form 4797, Part I, results in a gain, it is reduced by the nonrecaptured net § 1231 losses from prior years (line 8 of Part I). Any remaining gain is shifted to Schedule D, Capital Gains and Losses, of Form 1040. If the netting process in Part I of Form 4797 results in a loss, it goes to Part II to be treated as an ordinary loss.

The complex rules for the alternative tax on net capital gain for individuals, estates, and trusts affect the reporting of gains and losses from the disposition of business and rental assets. S corporations, partnerships, individuals, estates, and trusts that use Form 4797 must provide information sufficient to determine what portion of the gain surviving Form 4797, Part I (the gain that goes to Schedule D) is 28% gain, 25% gain, or 5%/15% gain.

The process explained below is based upon an analysis of Form 1040, Schedule D, and Form 4797 and their instructions. One key point to remember is that all the gains and losses that end up being treated as ordinary gains and losses (and, therefore, end up in Part II of Form 4797) are not eligible for any of the special tax rates for net capital gain. Another key point is that the gain that goes from Part I of Form 4797 to Schedule D will go to line 11 of Schedule D (long-term capital gains and losses). The entire gain from Form 4797 goes in column 11(f), but only the 5%/15% gain portion of the gain from Form 4797 goes in column 11(g).

The 25% gain (if any) from Form 4797 is part of the Schedule D, line 11(f) gain. *Nothing on the face of Form 4797 or Schedule D identifies this gain.* Only when the alternative tax on net capital gain is computed in Part IV of Schedule D is the 25% gain portion of the Form 4797 net gain specifically mentioned on line 19.

Also remember that § 1231 assets are assets held more than one year. Therefore, no gain or loss is reportable on Form 4797, Part I, unless that holding period requirement is satisfied.

**Example 24**

For 2003, Troy Williams, a single taxpayer (Social Security number 467–85–3036), has taxable income of $133,000 including the following recognized gains and losses (a 2003 example has been used since 2004 forms were unavailable):
## Part V  Property Transactions

### Sale of Depreciable Business Assets Held Long Term

<table>
<thead>
<tr>
<th>Asset A (Note 1)</th>
<th>$36,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset B (Note 2)</td>
<td>29,976</td>
</tr>
<tr>
<td>Asset C (Note 3)</td>
<td>(880)</td>
</tr>
</tbody>
</table>

### Sale of Depreciable Business Assets Held Short Term

| Asset D (Note 4) | ($ 600) |

### Capital Assets

<table>
<thead>
<tr>
<th>Long-term gain (Note 5)</th>
<th>$ 3,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term loss (Note 6)</td>
<td>(200)</td>
</tr>
</tbody>
</table>

**Note 1.** Asset A was acquired on June 23, 2000, for $50,000. It was five-year MACRS property, and four years’ cost recovery allowances totaled $38,480. The property was sold for $48,020 on August 31, 2003.

**Note 2.** Asset B was purchased on May 10, 1993, for $37,000. It was 27.5-year residential rental real estate, and straight-line depreciation totaled $14,126. Asset B was sold for $43,000 on November 10, 2003.

**Note 3.** Asset C was purchased on December 9, 2000, for $16,000. It was five-year MACRS property, and four years’ cost recovery totaled $12,314. The property was sold for $2,806 on December 30, 2003.

**Note 4.** Asset D was purchased for $7,000 on July 27, 2003. It was five-year MACRS property but proved unsuitable to Troy’s business. Troy sold it for $6,400 on November 3, 2003.

**Note 5.** The LTCG resulted from the sale of 100 shares of Orange Corporation stock purchased for $10,000 on April 5, 2001. The shares were sold on October 21, 2003, for $13,223. Expenses of sale were $223.

**Note 6.** The STCL resulted from the sale of 50 shares of Blue Corporation stock purchased for $350 on March 14, 2003. The shares were sold for $170 on August 20, 2003. Expenses of sale were $20.

The sale of asset A at a gain results in the recapture of cost recovery deductions. That recapture is shown in Part III of Form 4797. The gain from the sale of asset B is carried from line 32 to Part I, line 6, of Form 4797. On line 2, the loss from asset C appears. Part I is where the § 1231 netting process takes place. Assume Troy Williams has no nonrecaptured net § 1231 losses from prior years. The net gain on line 7 is transferred to Schedule D, line 11. In Part II of Form 4797, the ordinary gains are accumulated. On line 13, the recapture from line 31 (Part III) is shown. On line 10, the loss from asset D is shown. The net gain on line 18 is ordinary income and is transferred to Form 1040, line 14.

Schedule D, Part I, line 1, reports the short-term capital loss from the Blue Corporation stock. Part II of Schedule D has the net § 1231 gain transferred from Form 4797 on line 11 and the Orange Corporation gain on line 8. The net capital gain is determined on line 17a, Part III. The capital gain is then carried to line 13(a) of Form 1040.

On Form 4797, Part III, the $20,126 § 1231 gain from Asset B is made up of $14,126 (equals depreciation taken) of potential 25% gain and $6,000 of potential 5%/15% gain. The $880 § 1231 loss from Form 4797, Part I, line 2, offsets the potential 5%/15% portion of the $20,126 § 1231 gain on Form 4797, Part I, line 6. Consequently, of the $19,246 § 1231 gain that goes from Form 4797, Part I, line 7, to Schedule D, line 11, $14,126 is 25% gain and $5,120 is 5%/15% gain. Schedule D, Part IV, line 19, shows an unrecaptured § 1250 gain of $13,926. This gain results from the $14,126 25% gain being reduced by the $200 short-term capital loss from Schedule D, line 7. Troy’s 2003 tax liability is $30,523 using the alternative tax on net capital gain method. ■

The 2003 tax form solution for Example 24 appears on the following pages.
## Part II

### Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (See instructions.)

<table>
<thead>
<tr>
<th>(a) Description of property</th>
<th>(b) Date acquired (mo., day, yr.)</th>
<th>(c) Date sold (mo., day, yr.)</th>
<th>(d) Gross sales price</th>
<th>(e) Depreciation allowed or allowable since acquisition</th>
<th>(f) Cost or other basis, plus improvements and expense of sale</th>
<th>(g) Gain or (loss) for entire year Subtract (f) from the sum of (d) and (e)</th>
<th>(h) Post-May 5, 2003, gain or loss* (see below)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Asset C</td>
<td>12/9/00</td>
<td>12/30/03</td>
<td>2,806</td>
<td>12,314</td>
<td>16,000</td>
<td>(880)</td>
<td>(880)</td>
</tr>
<tr>
<td>3 Gain, if any, from Form 4684, line 39</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Section 1231 gain from installment sales from Form 6252, line 26 or 37</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Gain, if any, from line 32, from other than casualty or theft</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Combine lines 2 through 6 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Partnerships (except electing large partnerships) and S corporations.</strong> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>All others.</strong> If line 7, column (g) is zero or a loss, enter that amount on line 11 below and skip lines 8 and 9. If line 7, column (g) is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>8 Nonrecaptured net section 1231 losses from prior years (see instructions)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>9 Subtract line 8 from line 7. If line 9, column (g) is zero or less, enter -0- in column (g). If line 9, column (g) is zero, enter the gain from line 7, column (g) on line 12 below. If line 9, column (g) is more than zero, enter the amount from line 8, column (g) on line 12 below and include the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D (see instructions)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain and the amount, if any, on line 8, column (g), does not equal or exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) after May 5, 2003. However, do not include gain attributable to unrecovered section 1250 gain.

### Part II

#### Ordinary Gains and Losses

<table>
<thead>
<tr>
<th>Asset D</th>
<th>7/27/03</th>
<th>11/3/03</th>
<th>6,400</th>
<th>0</th>
<th>7,000</th>
<th>(600)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Line 11</th>
<th>Loss, if any, from line 7, column (g)</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Gain, if any, from line 7, column (g) or amount from line 8, column (g), if applicable</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Gain, if any, from line 31</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Net gain or (loss) from Form 4684, lines 31 and 38a</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Ordinary gain from installment sales from Form 6252, line 25 or 36</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Ordinary gain or (loss) from like-kind exchanges from Form 8824</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Recapture of section 179 expense deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18a</td>
<td>For all except individual returns, Enter the gain or (loss) from line 18 on the return being filed.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18b</td>
<td>For individual returns:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18b(1)</td>
<td>(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(d), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from “Form 4797, line 18b(1).” See instructions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18b(2)</td>
<td>(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

For Paperwork Reduction Act Notice, see page 7 of the instructions.
### Part III  Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

<table>
<thead>
<tr>
<th></th>
<th>Description of section 1245, 1250, 1252, 1254, or 1255 property:</th>
<th>(b) Date acquired</th>
<th>(c) Date sold</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Asset A</td>
<td>6/24/00</td>
<td>8/31/03</td>
</tr>
<tr>
<td>B</td>
<td>Asset B</td>
<td>5/10/93</td>
<td>11/1/03</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Property A</th>
<th>Property B</th>
<th>Property C</th>
<th>Property D</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>Gross sales price (Note: See line 1 before completing.)</td>
<td>48,020</td>
<td>43,000</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Cost or other basis plus expense of sale</td>
<td>50,000</td>
<td>37,000</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Depreciation (or depletion) allowed or allowable</td>
<td>38,480</td>
<td>14,126</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Adjusted basis. Subtract line 22 from line 21</td>
<td>11,520</td>
<td>22,874</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Total gain. Subtract line 23 from line 20</td>
<td>36,500</td>
<td>20,126</td>
<td></td>
</tr>
</tbody>
</table>

#### Part IV  Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less

<table>
<thead>
<tr>
<th></th>
<th>(a) Section 179</th>
<th>(b) Section 280F(b)(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>33</td>
<td>Section 179 expense deduction or depreciation allowable in prior years</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>Recomp. depreciation. See instructions</td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>Recapture amount. Subtract line 34 from line 33. See the instructions for where to report</td>
<td></td>
</tr>
</tbody>
</table>
**CHAPTER 17**  Property Transactions: § 1231 and Recapture Provisions

---

**SCHEDULE D** *(Form 1040)*  

**Capital Gains and Losses**

*Include in column (g) all gains and losses from column (f) from sales, exchanges, or conversions (including installment payments received) after May 5, 2003. However, do not include gain attributable to unrecaptured section 1250 gain, “collectibles gains and losses” (as defined on page D-8 of the instructions) or eligible gain on qualified small business stock (see page D-4 of the instructions).*

---

**Part I**  Short-Term Capital Gains and Losses—Assets Held One Year or Less

<table>
<thead>
<tr>
<th>(a) Description of property (Example: 100 sh. XYZ Co.)</th>
<th>(b) Date acquired (Mo., day, yr.)</th>
<th>(c) Date sold (Mo., day, yr.)</th>
<th>(d) Sales price (see page D-6 of the instructions)</th>
<th>(e) Cost or other basis (see page D-6 of the instructions)</th>
<th>(f) Gain or (loss) for the entire year Subtract (e) from (d)</th>
<th>(g) Post-May 5 gain or (loss)* (see below)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blue Corp. (50 shares)</td>
<td>3/14/03</td>
<td>8/20/03</td>
<td>170</td>
<td>370</td>
<td>(200)</td>
<td>(200)</td>
</tr>
<tr>
<td>Orange Corp. (100 shares)</td>
<td>4/5/01</td>
<td>10/21/03</td>
<td>13,223</td>
<td>10,223</td>
<td>3,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>

**Part II**  Long-Term Capital Gains and Losses—Assets Held More Than One Year

<table>
<thead>
<tr>
<th>(a) Description of property (Example: 100 sh. XYZ Co.)</th>
<th>(b) Date acquired (Mo., day, yr.)</th>
<th>(c) Date sold (Mo., day, yr.)</th>
<th>(d) Sales price (see page D-6 of the instructions)</th>
<th>(e) Cost or other basis (see page D-6 of the instructions)</th>
<th>(f) Gain or (loss) for the entire year Subtract (e) from (d)</th>
<th>(g) Post-May 5 gain or (loss)* (see below)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Orange Corp. (100 shares)</td>
<td>4/5/01</td>
<td>10/21/03</td>
<td>13,223</td>
<td>10,223</td>
<td>3,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>

---

*Include in column (g) all gains and losses from column (f) from sales, exchanges, or conversions (including installment payments received) after May 5, 2003. However, do not include gain attributable to unrecaptured section 1250 gain, “collectibles gains and losses” (as defined on page D-8 of the instructions) or eligible gain on qualified small business stock (see page D-4 of the instructions).*
**Part III**

<table>
<thead>
<tr>
<th><strong>Taxable Gain or Deductible Loss</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>17a Combine lines 7b and 16 and enter the result. If a loss, enter -0- on line 17b and go to line 18. If a gain, enter the gain on Form 1040, line 13a, and go to line 17b below.</td>
</tr>
<tr>
<td>17b Combine lines 7a and 15. If zero or less, enter -0-. Then complete Form 1040 through line 40. Next: • If line 16 of Schedule D is a gain or you have qualified dividends on Form 1040, line 9b, complete Part IV below. Otherwise, skip the rest of Schedule D and complete the rest of Form 1040.</td>
</tr>
<tr>
<td>18 If line 17a is a loss, enter here and on Form 1040, line 13a, the smaller of (a) that loss or (b) ($3,000) (or, if married filing separately, ($1,500)) (see page D-7 of the instructions)</td>
</tr>
</tbody>
</table>

**Part IV**

<table>
<thead>
<tr>
<th><strong>Tax Computation Using Maximum Capital Gains Rates</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>If line 16 or line 17a is zero or less, skip lines 19 and 20 and go to line 21. Otherwise, go to line 19 Enter your unrecaptured section 1250 gain, if any, from line 18 of the worksheet on page D-7.</td>
</tr>
<tr>
<td>20 Enter your 28% rate gain, if any, from line 7 of the worksheet on page D-8 of the instructions.</td>
</tr>
<tr>
<td>If lines 19 and 20 are zero, go to line 21. Otherwise, complete the worksheet on page D-11 of the instructions to figure the amount to enter on lines 35 and 33 below, and skip all other lines below.</td>
</tr>
<tr>
<td>21 Enter your taxable income from Form 1040, line 40.</td>
</tr>
<tr>
<td>22 Enter the smaller of line 16 or line 17a, but not less than zero.</td>
</tr>
<tr>
<td>23 Enter your qualified dividends from Form 1040, line 9b.</td>
</tr>
<tr>
<td>24 Add lines 22 and 23.</td>
</tr>
<tr>
<td>25 Amount from line 4g of Form 4952 (investment interest expense).</td>
</tr>
<tr>
<td>26 Subtract line 25 from line 24. If zero or less, enter -0-. Add lines 26 and 30.</td>
</tr>
<tr>
<td>27 Subtract line 26 from line 21. If zero or less, enter -0-.</td>
</tr>
<tr>
<td>28 Enter the smaller of line 21 or: • $56,800 if married filing jointly or qualifying widow(er); • $28,400 if single or married filing separately; or • $38,050 if head of household</td>
</tr>
<tr>
<td>If line 27 is more than line 28, skip lines 29–39 and go to line 40.</td>
</tr>
<tr>
<td>29 Subtract line 29 from line 28. If zero or less, enter -0- and go to line 40. Add lines 29 and 31.</td>
</tr>
<tr>
<td>30 Subtract line 29 from line 21. If zero or less, enter -0-.</td>
</tr>
<tr>
<td>31 Enter the smaller of line 30 or line 31.</td>
</tr>
<tr>
<td>32 Enter the smaller of line 32 by 5% (.05).</td>
</tr>
<tr>
<td>If lines 30 and 32 are the same, skip lines 34–39 and go to line 40.</td>
</tr>
<tr>
<td>33 Multiply line 32 by 5% (.05).</td>
</tr>
<tr>
<td>34 Subtract line 32 from line 30.</td>
</tr>
<tr>
<td>35 Enter your qualified 5-year gain, if any, from line 8 of the worksheet on page D-10.</td>
</tr>
<tr>
<td>36 Enter the smaller of line 34 or line 35.</td>
</tr>
<tr>
<td>37 Multiply line 36 by 8% (.08).</td>
</tr>
<tr>
<td>38 Subtract line 36 from line 34.</td>
</tr>
<tr>
<td>39 Multiply line 38 by 10% (.10).</td>
</tr>
<tr>
<td>If lines 30 and 32 are the same, skip lines 34–39 and go to line 40.</td>
</tr>
<tr>
<td>40 Enter the smaller of line 21 or line 26.</td>
</tr>
<tr>
<td>41 Enter the amount from line 30.</td>
</tr>
<tr>
<td>42 Subtract line 41 from line 40.</td>
</tr>
<tr>
<td>43 Add lines 17b and 23*.</td>
</tr>
<tr>
<td>44 Enter the amount from line 32 if line 32 is blank, enter -0-. Subtract line 44 from line 43.</td>
</tr>
<tr>
<td>45 Enter the smaller of line 42 or line 45.</td>
</tr>
<tr>
<td>46 Multiply line 46 by 15% (15).</td>
</tr>
<tr>
<td>47 Subtract line 46 from line 42.</td>
</tr>
<tr>
<td>48 Multiply line 48 by 20% (20).</td>
</tr>
<tr>
<td>49 Figure the tax on the amount on line 49. Use the Tax Table or Tax Rate Schedules, whichever applies.</td>
</tr>
<tr>
<td>50 Add lines 33, 37, 47, 49, and 50.</td>
</tr>
<tr>
<td>51 Figure the tax on the amount on line 21. Use the Tax Table or Tax Rate Schedules, whichever applies.</td>
</tr>
<tr>
<td>52 Tax on all taxable income. Enter the smaller of line 51 or line 52 here and on Form 1040, line 41.</td>
</tr>
</tbody>
</table>

*If lines 23 and 25 are more than zero, see Lines 31 and 43 on page D-9 for the amount to enter. **Schedule D (Form 1040) 2003**
Prepare an individual Form 1040, the tax return pre-
parer examines a Schedule K–1 from a partnership in which
the taxpayer has an ownership interest. The first page of the
Schedule K–1 indicates a $23,000 § 1231 gain. On the sec-
second page of the K–1, the tax return preparer finds the following
statement: “$12,300 of the $23,000 § 1231 gain reported on
page 1 of this Schedule K–1 is unrecaptured § 1250 gain
(25% gain).” The tax return preparer has no idea what this
phrase means and does nothing with it in preparing the indi-
vidual return. Could this affect the tax computation on the
individual return? What is the tax return preparer’s responsi-
bility for resolving his uncertainty?

**Example 25**

Mark has a $2,000 net STCL for 2004. He could sell business land held 27 months for a $3,000
§ 1231 gain. He will have no other capital gains and losses or § 1231 gains and losses in 2004
or 2005. He has no nonrecaptured § 1231 losses from prior years. Mark is in the 28% tax
bracket in 2004 and will be in the 25% bracket in 2005. If he sells the land in 2004, he will
have a $1,000 net LTCG ($3,000 § 1231 gain – $2,000 STCL) and will pay a tax of $150 ($1,000
× 15%). If Mark sells the land in 2005, he will have a 2004 tax savings of $560 ($2,000 capital
tax deduction × 28% tax rate on ordinary income). In 2005, he will pay tax of $450 ($3,000
× 15%). By postponing the sale for a year, Mark will have the use of $710 ($560 + $150).

**Example 26**

Beth has a $15,000 § 1231 loss in 2004. She could sell business equipment held 30 months for a
$20,000 § 1231 gain and a $12,000 § 1245 gain. Beth is in the 28% tax bracket in 2004 and
will be in the 25% bracket in 2005. She has no nonrecaptured § 1231 losses from prior years.
If she sells the equipment in 2004, she will have a $5,000 net § 1231 gain and $12,000 of ordinary
gain. Her tax would be $4,110 [(5,000 § 1231 gain × 15%) + ($12,000 ordinary gain × 28%)].

If Beth postpones the equipment sale until 2005, she would have a 2004 ordinary loss of
$15,000 and tax savings of $4,200 ($15,000 × 28%). In 2005, she would have $5,000 of
§ 1231 gain (the 2004 § 1231 loss carries over and recaptures $15,000 of the 2005 § 1231 gain
as ordinary income) and $27,000 of ordinary gain. Her tax would be $7,500 [(5,000 § 1231
gain × 15%) + ($27,000 ordinary gain × 25%)]. By postponing the equipment sale, Beth has
the use of $8,310 ($4,200 + $4,110).

**Timing of Recapture**

Since recapture is usually not triggered until the property is sold or disposed of,
may be possible to plan for recapture in low-bracket or loss years. If a taxpayer
has net operating loss carryovers that are about to expire, the recognition of ordinary
income from recapture may be advisable to absorb the loss carryovers.
Ahmad has a $15,000 net operating loss carryover that will expire this year. He owns a machine that he plans to sell in the early part of next year. The expected gain of $17,000 from the sale of the machine will be recaptured as ordinary income under § 1245. Ahmad sells the machine before the end of this year and offsets $15,000 of the ordinary income against the net operating loss carryover.

**POSTPONING AND SHIFTING RECAPTURE**

It is also possible to postpone recapture or to shift the burden of recapture to others. For example, recapture is avoided upon the disposition of a § 1231 asset if the taxpayer replaces the property by entering into a like-kind exchange. In this instance, recapture potential is merely carried over to the newly acquired property (refer to Example 20).

Recapture can be shifted to others through the gratuitous transfer of § 1245 or § 1250 property to family members. A subsequent sale of such property by the donee will trigger recapture to the donee rather than the donor (refer to Example 17). This procedure would be advisable only if the donee is in a lower income tax bracket than the donor.

**AVOIDING RECAPTURE**

The immediate expensing election (§ 179) is subject to § 1245 recapture. If the election is not made, the § 1245 recapture potential will accumulate more slowly (refer to Chapter 8). Since using the immediate expense deduction complicates depreciation and book accounting for the affected asset, not taking the deduction may make sense even though the time value of money might indicate it should be taken.

**KEY TERMS**

- Additional depreciation, 17–15
- Intangible drilling and development costs (IDC), 17–24
- Long-term nonpersonal use capital assets, 17–7
- Related party, 17–23
- Section 1231 gains and losses, 17–4
- Section 1231 lookback, 17–9
- Section 1231 property, 17–5
- Section 1245 property, 17–14
- Section 1245 recapture, 17–13
- Section 1250 property, 17–15
- Section 1250 recapture, 17–15
- Unrecaptured § 1250 gain, 17–18

**PROBLEM MATERIALS**

**Discussion Questions**

1. Why is it necessary to classify certain transactions as § 1231 asset transactions?
2. Is it possible that stock owned by a securities dealer could be a § 1231 asset?
3. If an asset becomes a § 1231 asset once it has been held for more than one year, what is it during that first year?
4. The taxpayer owns a Thoroughbred racehorse and is in the business of horse racing. The horse was purchased when it was one year old and has been owned by the taxpayer for over two years. What is the tax status of the racehorse?
5. Personal use property casualty gains exceed personal use property casualty losses. What is the nature of the net gain?

6. Examine Concept Summary 17–1. Assume that there is a net § 1231 gain of $45,000 for the year. Could some or all of the gain be treated as ordinary income?

7. Sally lives in an area that was hit hard by a hurricane. She has correctly determined that she has a $15,000 business property long-term casualty loss and an $11,000 business property long-term casualty gain. What tax issues must Sally deal with?

8. Does § 1231 have any effect on whether realized gain or loss is recognized?

9. Tangible personal property held more than one year and used in a trade or business is disposed of at a loss as a result of a condemnation. Is the loss subject to § 1231 treatment?

10. An individual taxpayer had a net § 1231 loss in 2001 and a net § 1231 gain in 2002, 2003, and 2004. What factors will influence whether any of the 2004 net § 1231 gain will be treated as long-term capital gain?

11. Review Examples 4 and 6 in the text. In both examples, the taxpayer’s AGI is $129,400 even though in Example 6 there is $700 of nonrecaptured § 1231 loss from 2003. Explain why the two AGI amounts are the same.

12. A taxpayer owns depreciable business equipment held for the long-term holding period. What would have to be true for the equipment to generate a § 1231 loss when it is sold?

13. A depreciable business machine has been owned for four years and is no longer useful to the taxpayer. What would have to be true for the disposition of the machine to generate at least some § 1231 gain?

14. Sylvia owns two items of business equipment. They were both purchased in 2000 for $100,000, both have a seven-year recovery period, and both have an adjusted basis of $37,490. Sylvia is considering selling these assets in 2004. One of them is worth $40,000, and the other is worth $23,000. Since both items were used in her business, Sylvia simply assumes that the loss on one will be offset against the gain from the other and the net gain or loss will increase or reduce her business income. Is she correct?

15. If depreciable equipment used in a business is sold at a recognized gain on July 10, 2004, and it was purchased on August 21, 2003, does § 1245 depreciation recapture apply to the asset?

16. Depreciable nonresidential real estate was acquired in 1986, was depreciated using accelerated depreciation, and can be sold in 2004 for a recognized gain. Is any of the recognized gain subject to § 1245 depreciation recapture?

17. Depreciable nonresidential real estate was acquired in 1995, was depreciated using straight-line depreciation, and can be sold in 2004 for a recognized gain. How could the taxpayer minimize the amount of unrecaptured § 1250 gain from disposition of the real estate?

18. How would § 1250 depreciation recapture apply if residential rental real estate was acquired in 2000?

19. Examine Example 13 in this chapter. Why is the amount in the “Additional Depreciation” column negative for 2003?

20. Residential rental real estate is acquired and disposed of in 2004. There is a small gain on the disposition of the property. The gain is less than the depreciation taken on the property. What is the nature of that gain?

21. What is the definition of residential rental housing?

22. Abigail sells one § 1231 asset during the year at a gain of $45,000. The asset was depreciable real estate she had held for seven years. She wants to know what her maximum unrecaptured § 1250 gain might be.
23. An individual taxpayer has a net § 1231 gain from disposition of depreciable real estate. The net § 1231 gain is treated as a long-term capital gain. The net § 1231 gain is less than the depreciation taken on the real estate. The taxpayer also has a net short-term capital loss that is less than the net § 1231 gain. Does the taxpayer have any unrecaptured § 1250 gain subject to tax at 25% in the alternative tax on net capital gain calculation?

24. An individual taxpayer receives tangible personal property by gift. The property had been depreciated by the donor and had a fair market value greater than the donor’s adjusted basis at the date of the gift. Does the § 1245 depreciation recapture potential carry over from the donor to the donee?

25. An individual taxpayer receives tangible personal property by inheritance. The property had been depreciated by the decedent and had a fair market value greater than the decedent’s adjusted basis at the date of the decedent’s death. Does the § 1245 depreciation recapture potential carry over from the decedent to the beneficiary?

26. A corporation distributes a truck it has owned for three years to its sole shareholder. The shareholder will use the truck for personal use activity. The truck’s fair market value at the time of the distribution is greater than its adjusted basis, but less than its original cost. Does the corporation recognize a gain? If so, what is the character of the gain?

27. A corporation distributes a truck it has owned for three years to its sole shareholder. The shareholder will use the truck for business activity. The truck’s fair market value at the time of the distribution is greater than its adjusted basis, but less than its original cost. Does the corporation recognize a gain? If so, what is the character of the gain?

28. Refer to Form 4797 at the end of this chapter. Where would a § 1231 loss be entered on the form?

29. Refer to Form 4797 at the end of this chapter. Where would a § 1231 gain on the disposition of business land be entered on the form?

30. Refer to Form 4797 at the end of this chapter. Where would a § 1231 lookback loss be entered on the form?

31. Sue-Jen purchased a contract to cut timber on a 100-acre tract of land in South Dakota in March 2002 for $100,000. On January 1, 2003, the timber had a fair market value of $110,000. Because of careless cutting in November 2003, when the fair market value was $115,000, the wood was sold on January 30, 2004, for $78,000.
   a. What gain (loss) was recognized in 2002, 2003, and 2004 if Sue-Jen elects to treat the cutting as a sale?
   b. What was the nature of the gains (losses) in (a)?
   c. Does the answer change if the timber was sold in December 2003? Why?
   d. If the timber was worth only $48,000 on January 1, 2003, was cut in November when worth $21,000, and was sold in December for $49,000, how would the answers to (a) and (b) change?

32. Bob owns a farming sole proprietorship. During the year, Bob sold a milk cow that he had owned for 15 months and a workhorse that he had owned for 66 months. The cow had an adjusted basis of $18,000 and was sold for $25,000. The horse had an adjusted basis of $350 and was sold for $1,000. Bob also has a $200 long-term capital loss from the sale of corporate stock. He has $55,000 of other AGI (not associated with the items above) for the year. He has $2,000 nonrecaptured § 1231 losses from the previous five years. What is the nature of the gains or losses from the disposition of the farm animals, and what is Bob’s AGI for the year?

33. A painting that Kwan Lee held for investment was destroyed in a flood. The painting was insured, and Kwan had a $20,000 gain from this casualty. He also had a $7,000 loss from an uninsured antique vase that was destroyed by the flood. The vase was
also held for investment. Kwan had no other property transactions during the year and has no nonrecaptured § 1231 losses from prior years. Both the painting and the vase had been held more than one year when the flood occurred. Compute Kwan’s net gain or loss and identify how it would be treated. Also, write a letter to Kwan explaining the nature of the gain or loss. Kwan’s address is 2367 Meridian Road, Hannibal Point, MO 34901.

34. Vicki has the following net § 1231 results for each of the years shown. What would be the nature of the net gains in 2003 and 2004?

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Net § 1231 Loss</th>
<th>Net § 1231 Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>$26,000</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>43,000</td>
<td>$41,000</td>
</tr>
<tr>
<td>2001</td>
<td>32,000</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>$41,000</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>39,000</td>
<td></td>
</tr>
</tbody>
</table>

35. Yoshida owns two parcels of business land (§ 1231 assets). One parcel can be sold at a loss of $30,000, and the other parcel can be sold at a gain of $40,000. Yoshida has no nonrecaptured § 1231 losses from prior years. The parcels could be sold at any time because potential purchasers are abundant. Yoshida has a $25,000 short-term capital loss carryover from a prior tax year and no capital assets that could be sold to generate long-term capital gains. Both the land parcels have been held more than one year. What should Yoshida do based upon these facts? (Assume tax rates are constant and ignore the present value of future cash flow.)

36. Gray Industries (a sole proprietorship) sold three § 1231 assets during 2004. Data on these property dispositions are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Acquired</th>
<th>Depreciation</th>
<th>Sold for</th>
<th>Sold on</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rack</td>
<td>$100,000</td>
<td>10/10/00</td>
<td>$60,000</td>
<td>$135,000</td>
<td>10/10/04</td>
</tr>
<tr>
<td>Forklift</td>
<td>35,000</td>
<td>10/16/01</td>
<td>23,000</td>
<td>5,000</td>
<td>10/10/04</td>
</tr>
<tr>
<td>Bin</td>
<td>87,000</td>
<td>03/12/03</td>
<td>34,000</td>
<td>60,000</td>
<td>10/10/04</td>
</tr>
</tbody>
</table>

a. Determine the amount and the character of the recognized gain or loss from the disposition of each asset.
b. Assuming Gray has no nonrecaptured net § 1231 losses from prior years, how much of the 2004 recognized gains is treated as capital gains?

37. Green Industries (a sole proprietorship) sold three § 1231 assets during 2004. Data on these property dispositions are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Acquired</th>
<th>Depreciation</th>
<th>Sold for</th>
<th>Sold on</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rack</td>
<td>$100,000</td>
<td>10/10/00</td>
<td>$60,000</td>
<td>$75,000</td>
<td>10/10/04</td>
</tr>
<tr>
<td>Forklift</td>
<td>35,000</td>
<td>10/16/01</td>
<td>23,000</td>
<td>5,000</td>
<td>10/10/04</td>
</tr>
<tr>
<td>Bin</td>
<td>87,000</td>
<td>03/12/03</td>
<td>34,000</td>
<td>60,000</td>
<td>10/10/04</td>
</tr>
</tbody>
</table>

a. Determine the amount and the character of the recognized gain or loss from the disposition of each asset.
b. Assuming Green has $5,000 nonrecaptured net § 1231 losses from the five prior years, how much of the 2004 recognized gains is treated as capital gains?
38. Magenta Industries (a sole proprietorship) sold three § 1231 assets during 2004. Data on these property dispositions are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Acquired</th>
<th>Depreciation</th>
<th>Sold for</th>
<th>Sold on</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rack</td>
<td>$110,000</td>
<td>10/10/01</td>
<td>$60,000</td>
<td>$55,000</td>
<td>10/10/04</td>
</tr>
<tr>
<td>Forklift</td>
<td>45,000</td>
<td>10/16/00</td>
<td>23,000</td>
<td>15,000</td>
<td>10/10/04</td>
</tr>
<tr>
<td>Bin</td>
<td>97,000</td>
<td>03/12/03</td>
<td>34,000</td>
<td>60,000</td>
<td>10/10/04</td>
</tr>
</tbody>
</table>

a. Determine the amount and the character of the recognized gain or loss from the disposition of each asset.
b. Assuming Magenta has $2,000 nonrecaptured net § 1231 losses from prior years, how much of the 2004 recognized gains is treated as capital gains?

39. On December 1, 2002, Gray Manufacturing Company (a corporation) purchased another company’s assets, including a patent. The patent was used in Gray’s manufacturing operations; $40,500 was allocated to the patent, and it was amortized at the rate of $225 per month. On July 30, 2004, Gray sold the patent for $70,000. Twenty months of amortization had been taken on the patent. What are the amount and nature of the gain Gray recognizes on the disposition of the patent? Write a letter to Gray discussing the treatment of the gain. Gray’s address is 6734 Grover Street, Back Bay Harbor, ME 23890. The letter should be addressed to Siddim Sadatha, Controller.

40. On June 1, 2000, Sparrow Enterprises (not a corporation) acquired a retail store for $500,000 (with $100,000 being allocated to the land). The store was 39-year real property, and the straight-line cost recovery method was used. The property was sold on June 21, 2004, for $470,000.

   a. Compute the cost recovery and adjusted basis for the store using Table 8–8 from Chapter 8.
   b. What are the amount and nature of Sparrow’s gain or loss from disposition of the store? What amount, if any, of the gain is unrecaptured § 1250 gain?

41. On January 2, 1986, Moad acquired residential rental real estate for $450,000. Of the cost, $100,000 was allocated to the land and $350,000 to the building. On May 20, 2004, the building was sold for $345,000 and the land for $500,000.

   a. Using Table 8–6 in Chapter 8, compute cost recovery on the building through the date of sale and then determine the amount and character of the recognized gain from its sale.
   b. Determine the amount and character of the recognized gain from the sale of the land.

42. Dave is the sole proprietor of a trampoline shop. During 2004, the following transactions occurred:

   * Unimproved land adjacent to the store was condemned by the city on February 1. The condemnation proceeds were $25,000. The land, acquired in 1982, had an allocable basis of $40,000. Dave has additional parking across the street and plans to use the condemnation proceeds to build his inventory.
   * A truck used to deliver trampolines was sold on January 2 for $3,500. The truck was purchased on January 2, 2000, for $6,000. On the date of sale, the adjusted basis was $2,509.
   * Dave sold an antique rowing machine at an auction. Net proceeds were $3,900. The rowing machine was purchased as used equipment 17 years ago for $5,200 and is fully depreciated.
   * Dave sold an apartment building for $200,000 on September 1. The rental property was purchased on September 1, 2001, for $150,000 and was being depreciated over a 27.5-year life using the straight-line method. At the date of sale, the adjusted basis was $124,783.

http://wft.swlearning.com
* Dave’s personal yacht was stolen September 5. The yacht had been purchased in August at a cost of $25,000. The fair market value immediately preceding the theft was $20,000. Dave was insured for 50% of the original cost, and he received $12,500 on December 1.

* Dave sold a Buick on May 1 for $9,600. The vehicle had been used exclusively for personal purposes. It was purchased on September 1, 2000, for $20,800.

* Dave’s trampoline stretching machine (owned two years) was stolen on May 5, but the business’s insurance company will not pay any of the machine’s value because Dave failed to pay the insurance premium. The machine had a fair market value of $8,000 and an adjusted basis of $6,000 at the time of theft.

* Dave had AGI of $402,000 from sources other than those described above.

* Dave has no nonrecaptured § 1231 lookback losses.

  a. For each transaction, what are the amount and nature of recognized gain or loss?
  b. What is Dave’s 2004 AGI?

43. On January 1, 1986, Cora Hassant acquired depreciable real property for $100,000. She used accelerated depreciation to compute the asset’s cost recovery. The asset was sold for $89,000 on January 3, 2004, when its adjusted basis was $18,000. Straight-line cost recovery for the period of time the asset was held would have been $72,700.

  a. What are the amount and nature of the gain if the real property was residential?
  b. What are the amount and nature of the gain if the real property was nonresidential?
  c. Cora is curious about how the recapture rules differ for residential rental real estate acquired in 1986 and for residential rental real estate acquired in 1987 and thereafter. Write a letter to Cora explaining the differences. Her address is 2345 Westridge Street #23, Homer, MT 67342.

44. Joanne is in the 35% tax bracket and owns depreciable business equipment that she purchased several years ago for $135,000. She has taken $100,000 of depreciation on the equipment, and it is worth $85,000. Joanne’s niece, Susan, is starting a new business and is short of cash. Susan has asked Joanne to gift the equipment to her so that Susan can use it in her business. Joanne no longer needs the equipment. Identify the alternatives available to Joanne if she wishes to help Susan and the tax effects of those alternatives. (Assume all alternatives involve the business equipment in one way or another, and ignore the gift tax.)

45. In 2002, Terry received equipment from his father as a gift. The father had a basis of $45,000 for the equipment, he had purchased it for $100,000, and it was worth $63,000 at the time of the gift. Terry used the equipment in his business, took $12,000 of depreciation on it, and sold it in 2004 for $52,000. What are the amount and nature of Terry’s gain or loss from disposition of the equipment?

46. In 2002, Terry received equipment from his father as a bequest after the father died. The father had a basis of $45,000 for the equipment, he had purchased it for $100,000, and it was worth $63,000 at the time of his death. Terry used the equipment in his business, took $12,000 of depreciation on it, and sold it in 2004 for $52,000. What are the amount and nature of Terry’s gain or loss from disposition of the equipment?

47. In 2002, Terry purchased equipment for $100,000. Terry used the equipment in his business, took $62,000 of depreciation on it, and contributed it in 2004 to a charity. The equipment was worth $52,000 at the time of the contribution. What are the amount and nature of Terry’s gain or loss from disposition of the equipment? What is the amount of his charitable contribution deduction?

48. Vermilion Corporation sold a machine used in its business for $453,000 on the installment basis. It received a $53,000 down payment in 2004 and will receive payments of $100,000 (plus fair market value interest) for each of the next four years. The machine was originally purchased for $1 million in 1993 and had a zero adjusted basis at the time of its sale. How much gain must be recognized, when must it be recognized, and what is the nature of the gain from this sale?
49. Emily is the sole shareholder of Brown Corporation. Brown has a zero basis for a printing machine that Emily would like to use in a personal activity. The machine’s fair market value is $4,500. Brown distributes the machine as a property dividend to Emily. Brown has accumulated earnings and profits of $3 million. What are the amount and nature of the gain recognized by Brown? What are the amount and nature of the distribution received by Emily?

50. Eli is the sole shareholder of Blue Corporation. Blue has a zero basis for a printing machine that Eli would like to use in another business he owns. The machine’s fair market value is $45,000. Blue sells the machine to Eli for $45,000. What are the amount and nature of the gain recognized by Blue? What is the tax basis of the machine for Eli?

51. On a 2003 Form 4797, Part I, the amounts on line 7(g) and line 8(g) are $45,000 and $49,000, respectively. The form was prepared for an individual taxpayer. What number should appear on Form 4797, line 12?

52. Jay sold three items of business equipment for a total of $300,000. None of the equipment was appraised to determine its value. Jay’s cost and adjusted basis for the assets are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
<th>Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Skidder</td>
<td>$230,000</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Driller</td>
<td>120,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Platform</td>
<td>620,000</td>
<td>—0—</td>
</tr>
<tr>
<td>Total</td>
<td>$970,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Jay has been unable to establish the fair market values of the three assets. All he can determine is that combined they were worth $300,000 to the buyer in this arm’s length transaction. How should Jay allocate the sales price and figure the gain or loss on the sale of the three assets?

Cumulative Problems

53. Glen and Diane Okumura are married, file a joint return, and live at 39 Kaloa Street, Honolulu, HI 56790. Glen’s Social Security number is 777–88–2000 and Diane’s is 888–77–1000. The Okumuras have two dependent children, Amy (age 15) and John (age 9). Glen works for the Hawaii Public Works Department, and Diane works in a retail dress shop. The Okumuras had the following transactions during 2004:

a. Glen earned $97,000 in wages and had Federal income tax withholding of $9,000.

b. Diane earned $18,000 in wages from the dress shop and had Federal income tax withholding of $1,000.

c. The Okumuras sold a small apartment building for $199,980 on November 15, 2004. The building was acquired in October 1998 for $300,000; cost recovery was $86,820.

d. The Okumuras received $3,000 in qualified dividends on various domestic corporation stocks that they own.

e. The Okumuras sold stock on November 5 for a $5,000 long-term capital gain and other stock on December 10 at a $2,000 short-term capital loss.

f. The Okumuras had the following itemized deductions: $11,000 unreimbursed medical expenses; $10,500 personal use real property taxes; $7,000 qualified residence interest; $1,500 of Glen’s unreimbursed employee business expenses; $535 of investment-related expenses; and $2,700 of state income taxes paid.

g. The Okumuras spent $3,000 on qualifying child care expenses during the year.

Compute the Okumuras’ 2004 net tax payable or refund due. Suggested software: Any commercially available tax preparation software. Also write a letter to the Okumuras describing how the sale of the apartment building affects their return.
54. Justin Stone is an employee of DataCare Services, Inc. His annual salary is $87,000. The appropriate amount is withheld from his salary for Social Security and Medicare. Justin lives at 112 Green Road, Sandusky, ID 45623. His Social Security number is 567–89–1234. Justin owned three apartment buildings at the beginning of 2003. All of the apartment buildings have generated a profit each year that Justin has owned them. On November 22, 2003, Justin sold building 3 for $450,000. Information on the buildings is summarized below.

<table>
<thead>
<tr>
<th>Building</th>
<th>Cost</th>
<th>Date Acquired</th>
<th>Prior Years' Depreciation</th>
<th>Current-Year Revenues</th>
<th>Current-Year Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$125,000</td>
<td>1/2/97</td>
<td>$27,081</td>
<td>$30,000</td>
<td>$4,000 repairs; 12,000 interest; 1,000 miscell.</td>
</tr>
<tr>
<td>2</td>
<td>$246,000</td>
<td>1/3/98</td>
<td>44,351</td>
<td>47,000</td>
<td>5,000 repairs; 17,000 interest; 2,300 miscell.</td>
</tr>
<tr>
<td>3</td>
<td>$400,000</td>
<td>1/3/99</td>
<td>57,572</td>
<td>88,000</td>
<td>8,000 repairs; 37,000 interest; 7,800 miscell.</td>
</tr>
</tbody>
</table>

Other information follows:
- On November 22, 2003, Justin sold for $14,000 equipment that had been used for repairing various items in the apartments. The equipment was purchased for $25,000 on July 10, 1996, and was fully depreciated prior to 2003.
- Justin has no recaptured § 1231 losses from prior years.
- Justin is age 38, single, divorced, and has custody of his nine-year-old son, Flint. Justin provides more than 50% of Flint’s support. Flint’s Social Security number is 098–77–6543.
- Justin had $5,000 interest income from Blue Corporation bonds.
- Justin had $3,000 interest income from a State Bank certificate of deposit.
- Justin had a $2,000 5%/15% long-term capital gain distribution from the Brown Stock Investment Fund.
- Justin made a $3,000 deductible contribution to a traditional IRA.
- Justin had the following itemized deductions: $5,600 real estate taxes on his home; $8,900 mortgage interest on his home; $760 charitable contributions (all in cash, properly documented, and no single contribution exceeded $25); $2,300 state income tax withholding during 2003; $2,000 state estimated income tax payments during 2003.
- Justin does not wish to donate to the Presidential Election Campaign Fund.
- He had $15,000 of Federal income tax withholding during 2003 and made total Federal estimated income tax payments of $45,000 during 2003.

Compute Justin’s 2003 net tax payable or refund due. If you use tax forms for your computations, you will need Form 1040 and Schedules A, B, D, and E. You will also need Forms 4562 and 4797, but ignore Form 6251. Suggested software: Any commercially available tax preparation software.

Research Problems

Note: Solutions to Research Problems can be prepared by using the RIA Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Online quizzing @ WFT Interactive Study Center
Research Problem 1. Sidney owns a professional football franchise. He has received an offer of $80 million for the franchise, all the football equipment, the rights to concession receipts, the rights to a stadium lease, and the rights to all the player contracts he owns. Most of the players have been with the team for quite a long time and have contracts that were signed several years ago. The contracts have been substantially depreciated. Sidney is concerned about potential § 1245 recapture when the contracts are sold. He has heard about “previously unrecaptured depreciation with respect to initial contracts” and would like to know more about it. Find a definition for that phrase and write an explanation of it.

Research Problem 2. Walter is both a real estate developer and the owner and manager of residential rental real estate. Walter is retiring and is going to sell both the land he is holding for future development and the rental properties he owns. Straight-line depreciation was used to depreciate the rental real estate. The rental properties will be sold at a substantial loss, and the development property will be sold at a substantial gain. What is the nature of these gains and losses?

Partial list of research aids:
§§ 1221 and 1231.

Research Problem 3. An individual cash basis taxpayer sells rental real estate on the installment basis. The gain from the disposition is $45,000. Of this amount, $30,000 is potential 25% gain, and $15,000 is potential 5%/15% gain. In what sequence are these gains recognized as gain is recognized on the installment sale?

Research Problem 4. A 30% or 50% special depreciation allowance is available for purchases of new tangible depreciable personal property. In some situations, this 30% or 50% special depreciation allowance can also be taken on leasehold improvements even though they are 39-year real property. Does this special depreciation make these leasehold improvements subject to § 1245 depreciation recapture when the taxpayer disposes of them?

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the World Wide Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 5. Summarize tax planning strategies related to each of the following topics that are presented on the Internet by tax advisers looking for clients:

a. A strategy for maximizing gains that are eligible for the 5%/15% alternative tax rate rather than the 25% rate.
b. A strategy for maximizing gains that are eligible for the 5%/15% alternative tax rate rather than the 28% rate.

Research Problem 6. Determine whether Canada has an equivalent to § 1231 treatment for gains from disposition of business depreciable assets.

Research Problem 7. Find a state Web site that has tax forms and instructions for that state. Let’s call that state “X.” Find a discussion in those sources that reveals whether state X taxes gains from the sale of real estate that is located in state Y when the taxpayer is an individual and is a full-time resident of state X.