

Chapter 7 Property Dispositions

Key Concepts

- The character of assets, classified first as business, investment, or personal-use assets, and then as Section 1231, capital, or ordinary income assets, determines the taxation of gains and losses.
- Section 1231 assets are depreciable assets and nondepreciable realty used in a trade or business. Net Section 1231 gains are taxed as long-term capital gains, while net Section 1231 losses are fully deductible as ordinary losses.
- Section 1245 full recapture (applicable primarily to personalty), Section 1250 partial recapture (applicable to realty), and Section 1231 look-back rules convert all or part of Section 1231 gain into ordinary income.
- Corporate capital gains are included in ordinary income, but capital losses only offset capital gains. Individuals include short-term capital gains in ordinary income; long-term capital gains are usually taxed at reduced tax rates; and their deductions for capital losses are limited to \$3,000 annually. Both corporations and individuals have carryover provisions for unused losses.
- Section 1244 allows taxpayers to deduct capital losses on small business corporation stock as ordinary losses, and Section 1202 allows taxpayers to exclude up to one-half of gains on qualified small business corporation stock.
- Section 121 allows qualifying taxpayers to avoid gain recognition of up to \$250,000 (\$500,000 if married filing jointly) on the sale of their personal residences.

1. Determining gain or loss on dispositions

Amount realized on the disposition

Adjusted basis of the property

Owner's holding period

Taxes on a recognized gain reduce the taxpayer's cash flow.

A recognized loss increases cash flow due to the tax savings generated by the loss.

Gains cost you tax dollars.

Losses save you tax dollars.

Type of taxpayer

Taxpayer's marginal tax bracket

Type of asset disposed of all affect cash flow.

a. Types of dispositions

Sale

Exchange

Involuntary conversion

Abandonment

To determine the tax impact of a disposition you must

Determine the amount realized and the adjusted basis

Calculate the gain or loss realized and recognized and

Determine the character of the gain or loss

b. Amount realized equals the sum of the following

The amount of money received

The fair market value of property received

Seller's liabilities that are assumed by the buyer (like giving cash)

Minus the sum of the following:

The selling or exchange expenses

Buyer's liabilities assumed by the seller

c. Realized versus recognized gain or loss

Amount realized-adjusted basis = Realized G/L

Recognized gain/loss is amount included or deducted by TP

d. Holding period

Holding period begins on date of purchase/acquired

Carryover basis from another asset (gift)

Substituted basis by reference to another asset (like-kind exchange)

Holding period normally carries over (is added to) the holding period of the acquired asset.

Gift

Inherited assets get long-term treatment regardless of the amount of time the decedent held the asset.

e. Character of gains and losses

Section 1231 assets

Capital assets

Ordinary income assets

Section 1231

Must be held for more than one year

Depreciable realty and personalty used in a trade or business

Nondepreciable trade or business realty

Long term capital gain property held for the production of income that is converted by theft, casualty, seizure, or condemnation

Capital assets (investment properties are personal use assets)

Section 1221 states that all assets are capital except

Inventory

Real and depreciable property used in a trade or business

Accounts and notes receivable from services or inventory

Copyrights, literary and artistic compositions in the hands of the creator or acquired by gift or nontaxable exchange from the creator.

Ordinary income assets

f. Mixed-use assets

2. Disposition of Section 1231 assets

a. Depreciation recapture

Depreciation reduces basis. At time of sale some of the gain may be a result of this reduced basis. There is no recapture on property sold at a loss.

Section 1245 full recapture applies to

Machinery, equipment, furniture and fixtures

Not buildings or their structural components

TP recognizes ordinary income in the amount equal to the lesser of the gain realized or prior depreciation deductions.

Any realized gain in excess of prior depreciation deductions is Section 1231 gain.

Section 179 expense election is also recaptured.

Section 1250 partial recapture

Only to realty

Applies to the excess depreciation on certain real property

Excess is accelerated minus straight line

After 1986, realty has been depreciated using straight line, so no excess

Additional Section 291 corporate recapture on buildings

Corporate recapture increment is 20% of Section 1245 recapture

Applies only to **corporate taxpayers**

Unrecaptured section 1250 gains for **individuals** taxed at a maximum rate of 25%

Cost \$1,200,000

Basis 900,000

Selling price \$1,400,000

Basis 900,000

Gain 500,000

Unrecaptured depreciation is the lesser of depreciation taken (\$300,000) or gain realized (\$500,000)

So, $\$300,000 \times .25 = \$75,000$ tax on unrecaptured gain

b. Section 1231 netting

Let's study Figure 7.1 on page 244

Section 1231 look-back rules

To prevent bunching 1231 gains in one year and 1231 losses in another

TPs must recapture any of the current year's net 1231 gains as ordinary income to the extent of any net 1231 losses deducted during the previous 5 tax years

Let's study Figure 7.2 on page 245

3. Disposition of capital assets

Capital assets include stocks, bonds, land, and collectibles such as coins, art, antiques

Held more than one year get Long Term treatment

One year or less, short term

a. The capital gain and loss netting process

Figure 7.3 on page 247

b. Tax treatment of net capital gains and loss depends on whether the TP is a C corporation or an individual.

Corporate capital gains and losses

Net short and long term capital gains are taxed as ordinary income

Corporations can carry capital losses back 3 and forward 5 years

The carryback must begin with the third year prior to the current year.

All losses carried to another year are treated as short term.

Let's study Figure 7.4 on page 248.

Individual's capital gains and losses

Can use \$3000 of excess loss against ordinary income. Must use short term first.

No carryback, all carry forward indefinitely.

Losses carried forward maintain their character.

Taxing individual's capital gains

Net short term capital gain is treated as ordinary income

15% rate applies to most capital gains

25% rate applies to unrecaptured Section 1250 gains

28% rate applies to collectibles and Section 1202 gains (qualifying small business corporation stock)

Let's look at the Schedule D

4. Disposition of ordinary income property

Trade or business assets that do not meet the more than one year holding period

Inventory

Accounts and notes receivable arising sale of goods or services

1245/1250 recapture

5. Mixed-use property

SUMMARY OF PROPERTY TRANSACTION TAXATION FOR INDIVIDUALS-
page 255 Table 7.1

6. Special rules for small business stock

Section 1244 is FANTASTIC

Up \$50,000 (\$100,000 MFJ) of the loss on this stock can be ordinary loss.

Loss in excess of this amount is capital.

Applies to individuals and partnerships that are the original purchasers of this stock.

Stock in a domestic small business corporation (total capitalization does not exceed \$1,000,000) issued in exchange for money or property.

Must be an operating company at the time the shareholder disposes of the stock. 50% or more of the corp's gross revenue must be from the sales of goods or services for the five years preceding the year in which the Section 1244 stock is sold.

Section 1202 gains on qualified small business stock

Must be a domestic C Corp

Gross value of corp's assets cannot exceed \$50,000,000

Seller of stock must be the original owner who acquired the stock in exchange for money, property or services.

Corporation is an active T/B engaged in mfg, retailing or wholesaling

Must be held more than 5 years to get 1202 treatment

50% of the capital gain is excluded

The excluded gain cannot exceed the greater of (1) 10 times the adjusted basis of the qualifying stock sold in the tax year or (2) \$10,000,000 less any gain excluded on qualifying stock in the preceding tax years by the TP.

Remaining gain is included in the capital gain netting process.

Included gain is taxed at 28%.

Comparison of 1244 and 1202 in Table 7.3

7. Sale of principal residence Section 121

TP or spouse must have owned the residence for at least two out of the five previous years (ownership by a divorced or deceased spouse is included)

Both spouses must meet the use test. Must have occupied the residence for two of the last five years prior to the date of sale.

Neither may have sold or exchanged a personal residence within two years of the sale (some exceptions apply). Must be a two year gap between sales.

Any gain related to the portion of the home that was a home office cannot be excluded.

8. Losses on related party sales Section 267

Disallows losses on related party sales or exchanges

Only applies to losses

Buyer's basis is price paid

If buyer later sells the property at a gain, the gain can be reduced by the disallowed loss.