

Business Assets

Chapter 12

Asset Categorization

▶ ALL assets are **Capital Assets** except:

- **A**ccounts Receivable
- **C**reative works in hands of the author
- **I**nventory
- **D**epreciable Real or Personal Property held for use in a trade or business or for the production of income

Ordinary Income Assets {

Section 1231 Assets {

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Taxation of Asset Sales

- ▶ **Ordinary Income Assets**
 - Gains subject to ordinary rates
 - Losses subject to ordinary rates: unlimited
- ▶ **Capital Assets**
 - Long-term gains/losses subject to special tax rates
 - Long-term losses limited
- ▶ **Section 1231 Assets**
 - Gains are capital
 - Losses are ordinary

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Section 1231 and Corporations

- ▶ Corporations do not get favorable capital gains tax rates
- ▶ Ordinary losses may be deducted in full

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The Catch: Depreciation Recapture

IF
Section 1231 applies,
you *must* check to see if
depreciation taken will have to
be recaptured

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Depreciation Example

Randy, a highly sought after financial planner in his community, opened a new office several years ago. He purchased computers for use by his staff, and the computers were classified as 5-year class life property. Over the next 6 years, Randy and his staff used the computers, at which time they were replaced with new machines. The old machines were disposed of at no value.

Randy was able to recover his capital investment in the computers over the 5-year class life through the depreciation expense deductions, which reduced ordinary income. He received nothing upon disposition of the computers. Consequently, the disposal of the computers does not trigger any income tax consequences.

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Why Depreciation Recapture?

- ▶ Depreciation is a form of capital recovery.
- ▶ Ideally, depreciation = actual decline in value of asset.
- ▶ For tax purposes, depreciation follows a set schedule, regardless of actual decline in value.
- ▶ When an asset is sold,
 - Depreciation is recaptured FIRST,
 - Then, Section 1231 applies

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Types of Section 1231 Property

- ▶ Section 1245 Property
 - Tangible personal property
 - Example: machinery and equipment
- ▶ Section 1250 Property
 - Real property
 - Example: buildings and structures

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Steps to Determining Tax Consequences of Section 1231 Assets

1. Categorize the asset (Section 1231)
2. Calculate gain or loss
3. Consider depreciation recapture
 - If Personal Property – Section 1245
 - If Real Property – Section 1250
4. Apply best of both worlds rule

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Taxation and Section 1245

- ▶ Depreciation is recaptured (as ordinary income) to the extent of the gain
 - All depreciation must be paid back before capital gains treatment under Section 1231 applies

- ▶ 4 Possible outcomes

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Section 1245 Results

If Sale Price:	AR = AB*	AR < AB*	AR > AB* and Gain < Depreciation	AR > AB* and Gain > Depreciation
Tax Consequences	No gain or loss, no depreciation recapture. no tax consequences.	Resulting loss is always treated as an ordinary loss	Section 1245 treats the gain as ordinary gain.	Gain up to the amount of depreciation taken is treated as ordinary gain under Section 1245. Gain in excess of depreciation taken is treated as capital gain under Section 1231.
Resulting from Economics	Accounting estimate of depreciation equals economic reality.	Not enough depreciation was taken	Too much depreciation was taken	Too much depreciation was taken and the asset appreciated.
Illustrated By	Example 12.3	Example 12.4	Example 12.5	Example 12.6

*AR = Amount Realized; AB = Adjusted Basis

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Tax Consequences Section 1245 Asset

Example 12.3 – 12.6

Kasey starts a lawn mowing service. Kasey purchases equipment, including a \$1,500 lawnmower that he now has taken \$400 in depreciation. Kasey wants to sell this lawnmower to purchase more heavy-duty equipment.

Tax consequences based on various sale circumstances are to follow.

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Tax Consequences Section 1245 Asset

	Example 12.3	Example 12.4	Example 12.5	Example 12.6
Amount Realized	\$1,100	\$1,000	\$1,200	\$1,700
Adjusted Basis	\$1,100	\$1,100	\$1,100	\$1,100
Gain / (Loss)	\$0	(\$100)	\$100	\$600
Tax Impact	None	Ordinary Loss (\$100)	Ordinary Gain \$100 (Gain is less than depreciation taken)	Part ordinary gain (\$400), part capital gain (\$200) (Gain is more than depreciation taken)
Economic Reality	Depreciation estimate was perfect	Taxpayer took too little depreciation	Taxpayer took too much depreciation	Taxpayer took too much depreciation and asset appreciated

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Taxation and Section 1250

- ▶ Depreciation Taken > Straight Line Depreciation is recaptured (at ordinary rates)
- ▶ Unrecaptured Section 1250 Depreciation
 - Aka: Straight-Line Depreciation
 - Taxed at a flat 25% rate (or marginal rate, if lower)
- ▶ Excess Gain is Capital Gain under Section 1231

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Taxation Consequences Section 1250 Asset

Example

Lucas purchased an office building for \$1,000,000. He has taken depreciation deductions of \$300,000 (straight-line depreciation would have been \$200,000) at the time that he sold the building for \$1,500,000.

		Gain Taxation	
Amount Realized	\$1,500,000	Ordinary Income	\$100,000
Adjusted Basis	(\$700,000)	25% Tax Rate	\$200,000
Total Gain	\$800,000	Capital Gain	\$500,000
			\$800,000

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Recapture Rules and Tax Planning

- ▶ **Gifts**
 - Depreciation recapture potential carries over to donee
- ▶ **Non-Taxable Exchanges**
 - Depreciation recapture carries over to the replacement property
- ▶ **Testamentary Transfers**
 - Section 1014 "Step-up" extinguishes recapture potential

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Recapture Rules and Tax Planning

- ▶ **Charitable Contributions**
 - If deduction is normally valued at FMV, must reduce deduction by amount of potential depreciation recapture
- ▶ **Installment Sales**
 - Including SCINs and Private Annuities
 - Installment reporting provisions do not apply to depreciation recapture
 - Recapture occurs when gain is realized
 - Unrecaptured Section 1250 depreciation may be deferred, but all of gain in each installment year will be taxed at 25% until all straight-line depreciation is recaptured

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5-Year Look-back Rule

- ▶ **Section 1231 Netting Process**
 - Gains and losses for the year are netted
- ▶ **Tax Planning**
 - Would be better to recognize Section 1231 gains in one year, and Section 1231 losses in another year
- ▶ **5-Year Look-back Rule**
 - Net Section 1231 gain in current year is taxed at ordinary rates to extent of unrecaptured Section 1231 losses in the last 5 years

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Look-back Provision Example

- ▶ Taxpayer had the following Section 1231 gains and losses:

2010	\$ 4,000 loss
2011	10,000 loss
2012	16,000 gain

- In 2012, taxpayer's net Section 1231 gain will be:
 - \$14,000 ordinary income, and
 - \$2,000 long-term capital gain

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Section 1231 Look-back Example

Colin has a Section 1231 gain for the current year (2012) of \$15,000. In prior years, Colin had the following net Section 1231 transactions:

	Year	Net Section 1231 Transaction
5-Year Lookback Period	2012	\$4,000 Section 1231 Loss
	2011	\$2,000 Section 1231 Loss
	2010	No Section 1231 Transactions
	2009	No Section 1231 Transactions
	2008	No Section 1231 Transactions
	2007	\$8,000 Section 1231 Gain
	2006	\$2,000 Section 1231 Gain

Colin would have to recognize \$6,000 of his 2012 gain as ordinary income since in 2011 and 2010 he had Section 1231 losses. The remaining \$9,000 of Colin's Section 1231 gain (\$15,000 - \$6,000) would be treated as a Section 1231 capital gain.

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