

Form 4797: Sale of Business Property, Allocation of Sales Price, and Tax Planning

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Form 4797

Form **4797**

Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

OMB No. 1545-0184

2022

Department of the Treasury
Internal Revenue Service

Attach to your tax return.

Attachment
Sequence No. **27**

Go to www.irs.gov/Form4797 for instructions and the latest information.

Name(s) shown on return		Identifying number
1a	Enter the gross proceeds from sales or exchanges reported to you for 2022 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	
1b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets.	
1c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	

Part I 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)

2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824.	5
6	Gain, if any, from line 32, from other than casualty or theft	6
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7



Objectives

Explain rules on how to compute gain or loss, depreciation recapture, analyze sales price allocation, dive into tax planning, and decipher the mystery of Form 4797

Agenda

- IRC §1231
- IRC §1245
- IRC §1250
- IRC §167
- IRC §179

Form 1040.
INCOME TAX.

THE PENALTY
FOR FAILURE TO HAVE THIS RETURN IN
THE HANDS OF THE COLLECTOR OF
INTERNAL REVENUE ON OR BEFORE
MARCH 1 IS \$20 TO \$1,000.
(SEE INSTRUCTIONS ON PAGE 4.)

UNITED STATES INTERNAL REVENUE.

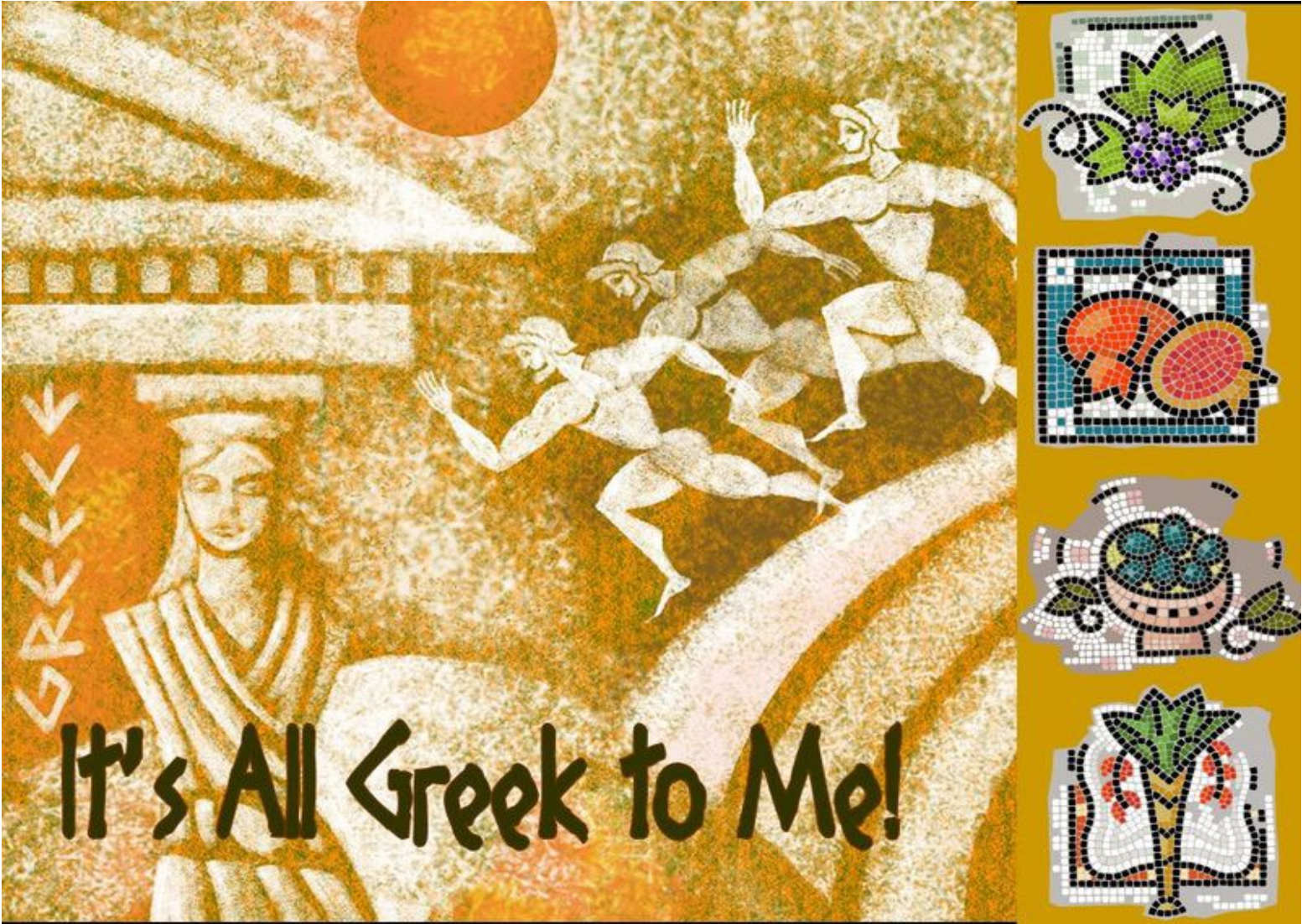
OF ANNUAL NET INCOME OF INC
(As provided by Act of Congress, approved October 3, 1913.)

Agenda

- Held more than one year
- Held more than 24 months
- Held short term
- Held long term
- Four parts of Form 4797



Form 4797



Quote of the Session

**For every complex problem
there is an answer that is
clear, simple, and wrong.**

-- H. L. Mencken --

Form 4797 Overview

- Two of the purposes for Form 4797
 - The sale or exchange of:
 - Real property used in a ***trade or business***
 - Depreciable and amortizable tangible property used in a ***trade or business***

Form 4797 Overview

- Business assets are §1231 assets
- Reports sale of business assets and creates confusion
- Capital gain or ordinary income tax consequences
- Depreciation recapture
- Unrecaptured depreciation

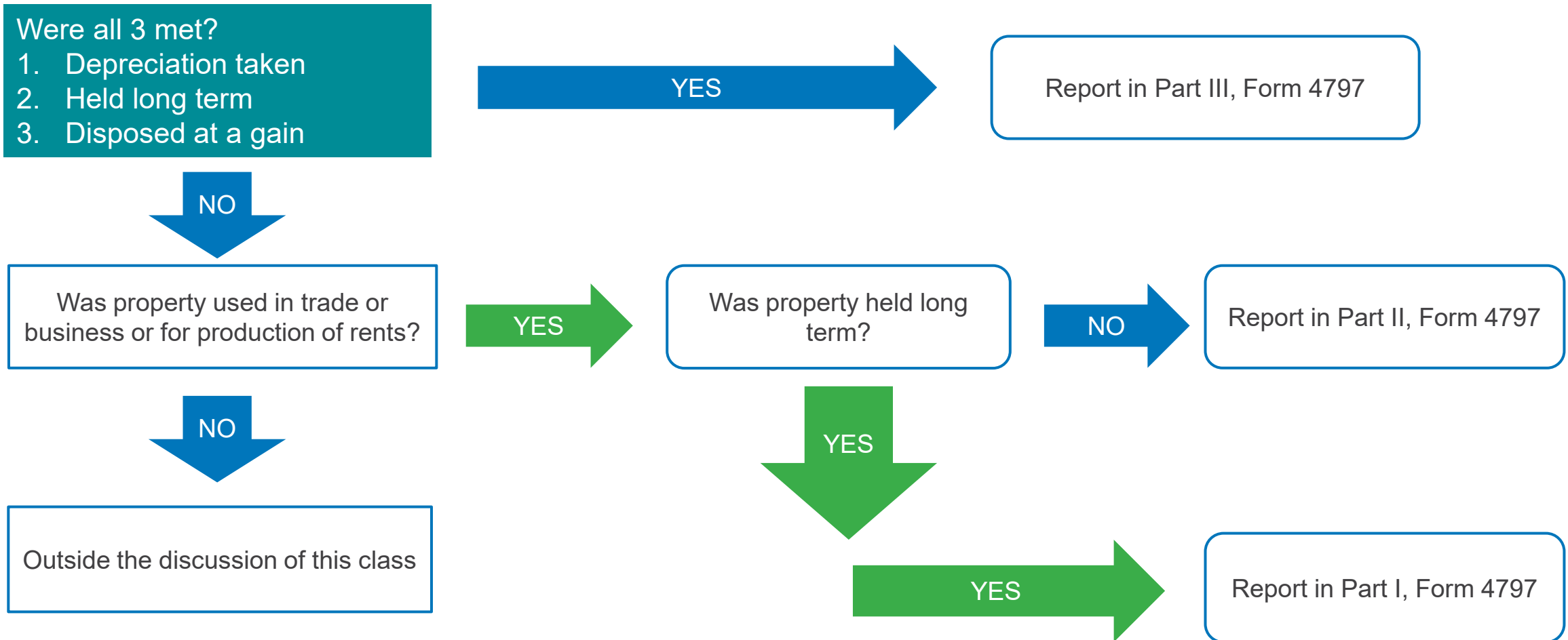
Form 4797 Overview

- §1001 dictates to simply take the difference between the **amount realized** and the **tax basis** to determine gain or loss
- However, determining the character of the resulting gain or loss – that is what is confusing – Congress has made it a complex process
- Do we have an ordinary gain or a capital gain – important, as that determines how the sale is taxed

Form 4797

- Other basis issues
 - ✓ **Gifted property**
 - ✓ **Inherited property**
 - ✓ **Change from personal use to business**

Where Does It Go?



Where Does It Go?

Type of Property	Held 1 Year or Less	Held More than 1 Year
Depreciable Tangible Trade or Business Property:		
a. Sold @ Gain	Part II	Part III (1245)
b. Sold @ Loss	Part II	Part I
Depreciable Real Trade or Business Property:		
a. Sold @ Gain	Part II	Part III (1250)
b. Sold @ Loss	Part II	Part I

Where Does It Go?

Type of Property	Held 1 Year or Less	Held More than 1 Year
Farmland held less than 10 years upon which soil, water, or land clearing expenses were deducted:		
a. Sold @ Gain	Part II	Part III (1252)
b. Sold @ Loss	Part II	Part I
Real or tangible trade or business property which was deducted under the de minimis safe harbor:		
a. Sold @ Gain	Part II	Part II
All other farmland used in a trade or business	Part II	Part I
Cost Sharing Property Section 126	Part II	Part III (1255)

Where Does It Go?

Type of Property	Held < 24 Months	Held > 24 Months
Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:		
a. Sold @ Gain	Part II	Part III (1245)
b. Sold @ Loss	Part II	Part I
c. Raised cattle & Horses sold @ Gain	Part II	Part I

Where Does It Go?

Type of Property

Held < 12 Months

Held > 12 Months

Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:

a. Sold @ Gain

Part II

Part III (1245)

b. Sold @ Loss

Part II

Part I

c. Raised livestock sold @ Gain

Part II

Part I

Where Does It Go?

■ Part I

- ✓ Held long term
- ✓ Sold at loss
- ✓ **Land** or non-depreciable asset sold at gain
- ✓ Eligible capital gain from Part III is carried to Part I

Where Does It Go?

- Part II

- ✓ Short-term transactions

- ✓ Aggregate section for all ordinary gains and losses

Where Does It Go?

- Part III (i.e. the cool section)
 - ✓ Long-term
 - ✓ Depreciable and/or amortizable asset
 - ✓ Sold at gain
- Part IV
 - ✓ Recapture under §179 and §280F(b)(2) when business use drops to less than 50%

§1231 Property

**§ 1245
property**



**§ 1250
property**

§1231 Property

- **“Cream of the Crop”** for Sale of Business Assets
 - ✓ Net losses are fully deductible as ordinary losses
 - ✓ Capital gain treatment when sold at a gain

§1231 Property

- **What is §1231 property?**
 - ✓ Used in a trade or business
 - ✓ All depreciable assets held longer than one year are §1231 assets
 - ✓ All real property, depreciable or not, held longer than one year are §1231 assets

§1231 Property

- Section 1231 property includes:
 - ✓ Buildings
 - ✓ Machinery
 - ✓ Land
 - ✓ Timber and other natural resources – coal/ore
 - ✓ Unharvested crops

§1231 Property

- Section 1231 property includes:
 - ✓ Cattle and horses held 24 months or more
 - ✓ Livestock held 12 months or more for draft, breeding, dairy or sporting. (Does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, reptiles, etc.)
 - ✓ Leaseholds that are at least a year old

§1231 Property

- Section 1231 property **does not** include:
 - ✓ Inventory or property held primarily for sale to customers
 - ✓ Patents, inventions, models or designs, secret formulas or processes, copyrights, literary, musical, or artistic compositions, letters or memoranda or similar property

Sale of Business Assets

- **What is IRC §1245 property?**
 - ✓ Code stating that depreciable property that sold at a price in excess of depreciated value may qualify for favorable capital gains tax treatment

Sale of Business Assets

- **What is IRC §1250 property?**
 - ✓ Code that states that a gain from selling real property that has been depreciated should be taxed as ordinary income, to the extent accumulated depreciation exceeds straight line depreciation

Sale of §1245 Property Example

Purchased §1245 property	\$200,000
Less A/D	<u>\$ 55,000</u>
Adjusted basis	\$145,000
Sales price	\$245,000
Less adjusted basis	<u>\$145,000</u>
Gain	\$100,000
	=====

Ordinary income up to depreciation = \$55,000

Remaining gain {\$100-\$55} of \$45,000 tax at capital gains rates

Sale of Business Assets

- **What is the difference between IRC §§1245/1250 and §1231 property?**
 - ✓ **§1231 is a Categorization Provision**
 - ✓ **Section 1231 regulates tax treatment of gains and losses of real and depreciable property held over one year in a trade or business**
 - ✓ **Net §1231 losses are fully deductible as ordinary loss**

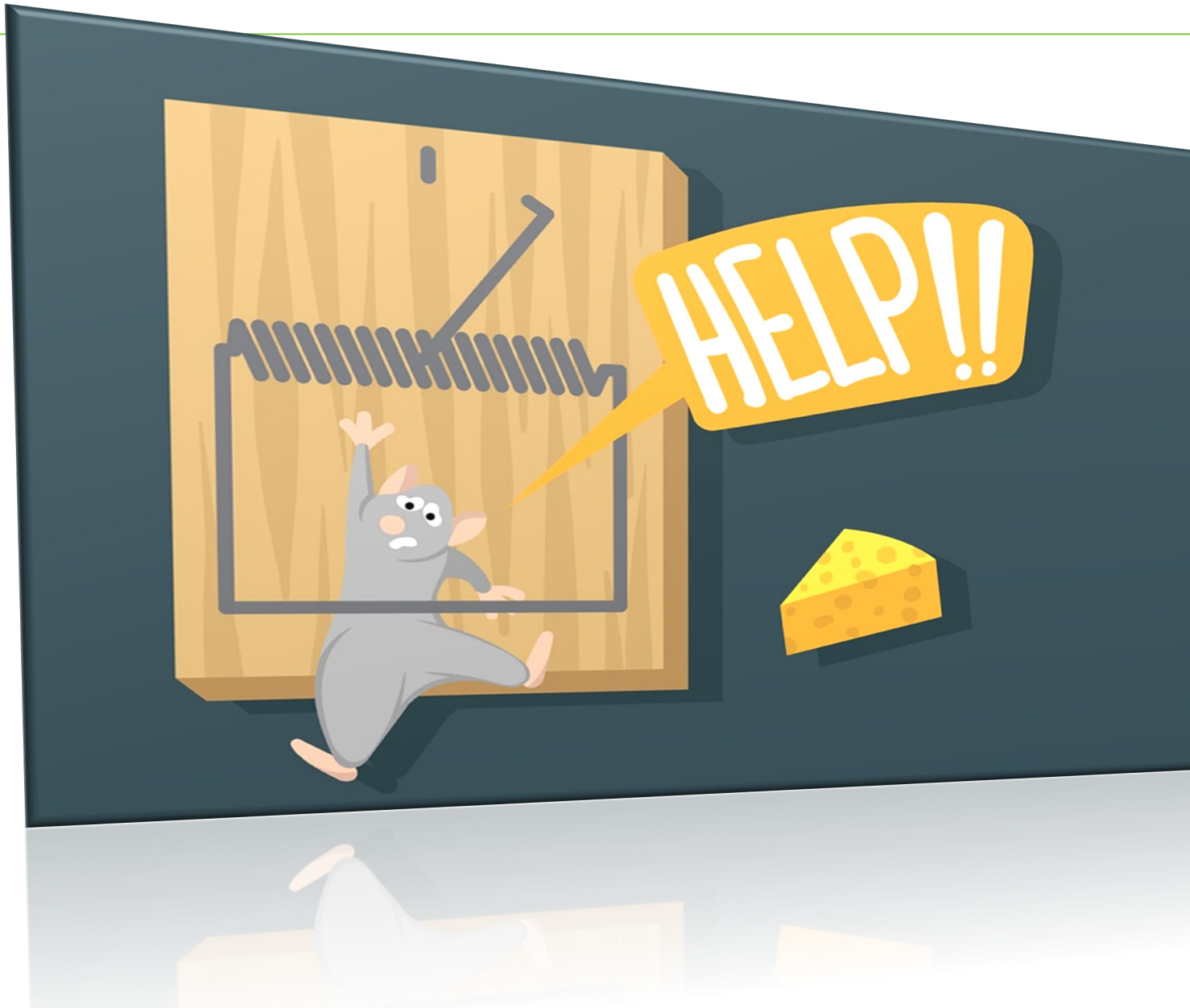
Sale of Business Assets

- **What is the difference between IRC §§1245/1250 and §1231 property?**
 - ✓ §§1245 and 1250 contains recapture rules of depreciation applying to gains from dispositions
 - ✓ Capital losses limited to \$3,000 a year

Sale of Business Assets

Beware of the §1231 Trap

Sale of Business Assets



Sale of Business Assets

- If §1231 losses have been deducted in prior years, then capital gain treatment in current year is limited and you could have ordinary income
 - Capital gain goes to Schedule D
 - Ordinary income to Part II of Form 4797
 - Need last five years of tax returns
 - **Software should track if existing client**

Sale of Business Assets

EXAMPLE : Beth sells a §1231 asset in 2021 which results in §1231 gain of \$20,000. However, Beth had §1231 (losses) and gains from preceding five years of:

2016	(\$3,000.00)
2018	(\$1,000.00)
2019	<u>(\$1,000.00)</u>
Net 1231	(\$5,000.00)

2021 capital gain to Schedule D	\$15,000.00
2021 ordinary income to Part II 4797	\$ 5,000.00

§1245 Property

- **Examples of tangible property would include furniture, fixtures, equipment, grain storage bins**

§1245 Property

- **Examples of intangible assets (§197 assets) would include goodwill, going concern, business books/records and customer-based intangibles, client lists**

§1245 Property

- **Section 1245 property is not land or land improvement, nor its buildings or inherently permanent structures, nor its structural components**

§1245 Property

- **IRC §1245 requires taxpayers to recapture the gain from a sale of the property, to the extent of depreciation claimed or the gain on the sale of property, whichever is less**

§1245 Property



§1245 Property Example – Part 1

- Sally Farmer sold a tractor used in her farming operation for \$8,000. She purchased this tractor five years ago for \$20,000 and has claimed depreciation in the amount \$13,800. Her §1245 gain is \$1,800, calculated by \$8,000 – \$6,200 (\$20,000-\$13,800). The character of this \$1,800 will be all ordinary income.

§1245 Property Example – Part 1

Purchased tractor	\$20,000
Less A/D	<u>\$13,800</u>
Adjusted basis	\$ 6,200
Sales price of tractor	\$ 8,000
Less adjusted basis	<u>\$ 6,200</u>
Gain	\$ 1,800
	=====

Ordinary income up to depreciation = \$1,800

Remaining gain of \$0 taxed at capital gains rates

§1245 Property Example – Part 2

- If Sally Farmer sold tractor for \$24,000, her gain would be \$17,800. \$13,800 of the gain (depreciation taken) would be ordinary income and the balance, \$4,000 would be §1231 and potential capital gain

§1245 Property Example – Part 2

Purchased tractor	\$20,000
Less A/D	<u>\$13,800</u>
Adjusted basis	\$ 6,200
Sales price of tractor	\$24,000
Less adjusted basis	<u>\$ 6,200</u>
Gain	\$17,800
	=====

Ordinary income up to depreciation = \$13,800

Remaining gain {\$17,800-\$13,800} of \$4,000 taxed at capital gains rates

§1250 Property

- Generally described as any depreciable “real property” held long-term and that is **not** §1245 property

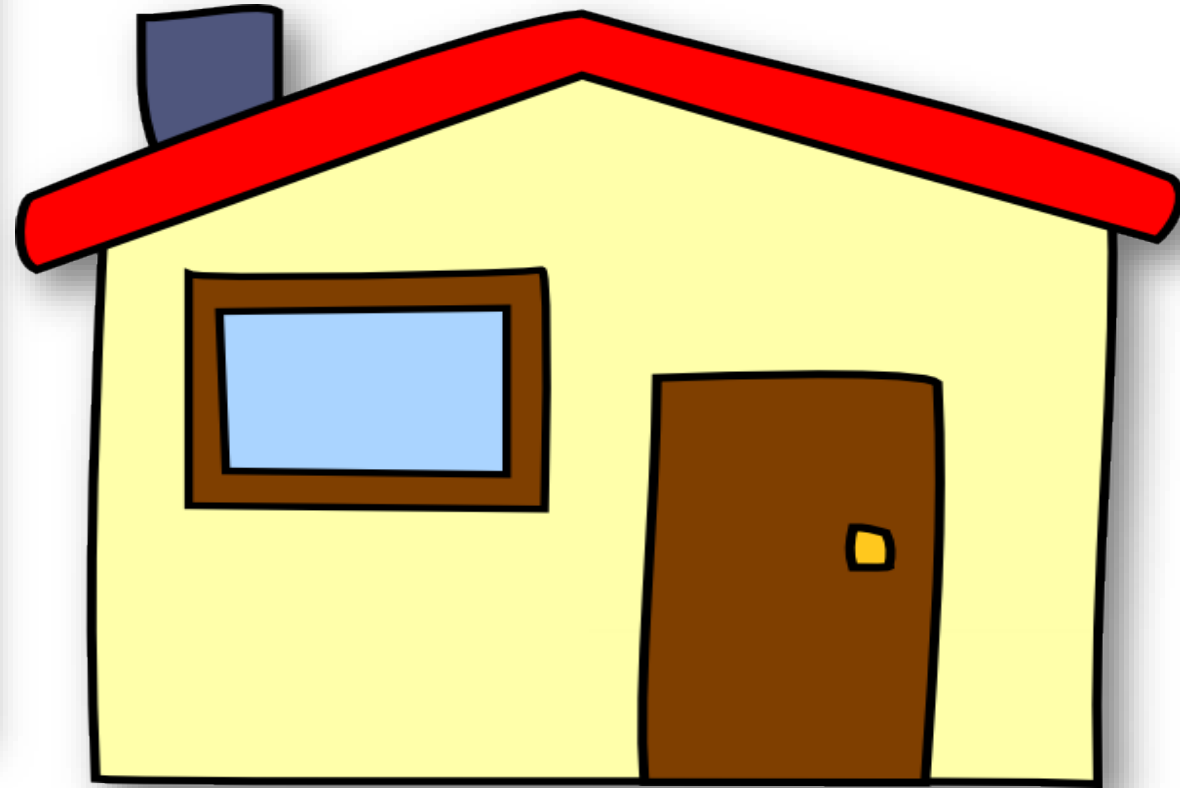
- Real property

- ✓ Buildings
- ✓ Structural components of the building
- ✓ Land.....**or is it**

§1250 Property

- **§1250 requires recharacterization of prior depreciation as ordinary income, but with a catch – it only requires recapture of prior depreciation in excess of what straight line depreciation would have been**

§1250 Property



§1250 Property

- After tax reform act of 1986 which developed MACRS we rarely see this recapture
- Since most real property is depreciated straight line under MACRS, none of the depreciation taken was/will be in excess of straight line and thus no ordinary income recapture would result

§1250 Property

- IRC §1(h)(1)(E) requires a taxpayer with §1250 property to take an additional step
- Section 1 requires taxpayer to pay a special maximum 25% tax rather than the typical preferential top capital gains rate @ 20%
- This is called unrecaptured §1250 gain

§1250 Property vs. §1245 Property



§1250 Property vs. §1245 Property

- **Real Property**

- ✓ Land, anything growing on the land, and any structures permanently attached to it.

- **Personal Property**

- ✓ All property that is not real property.

§1250 Property Example

- Sales price \$350,000
 - Cost \$250,000
 - S/L A/D \$ 50,000
 - Gain \$150,000
-
- Section 1250 unrecaptured tax of 25% is limited to A/D of \$50,000

§1231, §1250, §1250 Chart

Property Type	Sold @ Gain / Loss Long Term	Code Section That Applies
Personal Property	Loss	§1231
Personal Property	Gain > than Depreciation Taken	§1245 & §1231
Personal Property	Gain < than Depreciation Taken	§1245
Real Property	Loss	§1231
Real Property	Gain > than Depreciation Taken	§1250 (unrecaptured) & §1231
Real Property	Gain < than Depreciation Taken	§1250 (unrecaptured)
Land	Gain or Loss	§1231

§1231 Chart

Asset Descriptions	IRC Section 1231 Asset
Cash	NO
Accounts Receivables	NO
Inventory	NO
Machinery & Equipment	YES
Furniture & Fixtures	YES
Vehicles	YES
Building	YES
Land	YES
Goodwill – Acquired	YES
Goodwill – Self-created	YES

Other Issues

- Section 1245 recapture for installment sales (Form 6252) in the year of sale
- Standard Mileage Rate & Depreciation
 - ✓ 26 cents for 2022
 - ✓ 28 cents for 2023
- Sale of partnership interest
 - Hot assets {§751}

Other Issues

- Information on 1065 and 1120-S K-1's
 - ✓ Sale of §179 assets
 - ❖ Listed separately
- Sale of Lots Safe Harbor §1237
 - ✓ Five Lots
 - ✓ No substantial improvements that enhanced
 - ✓ Hold for 5 years

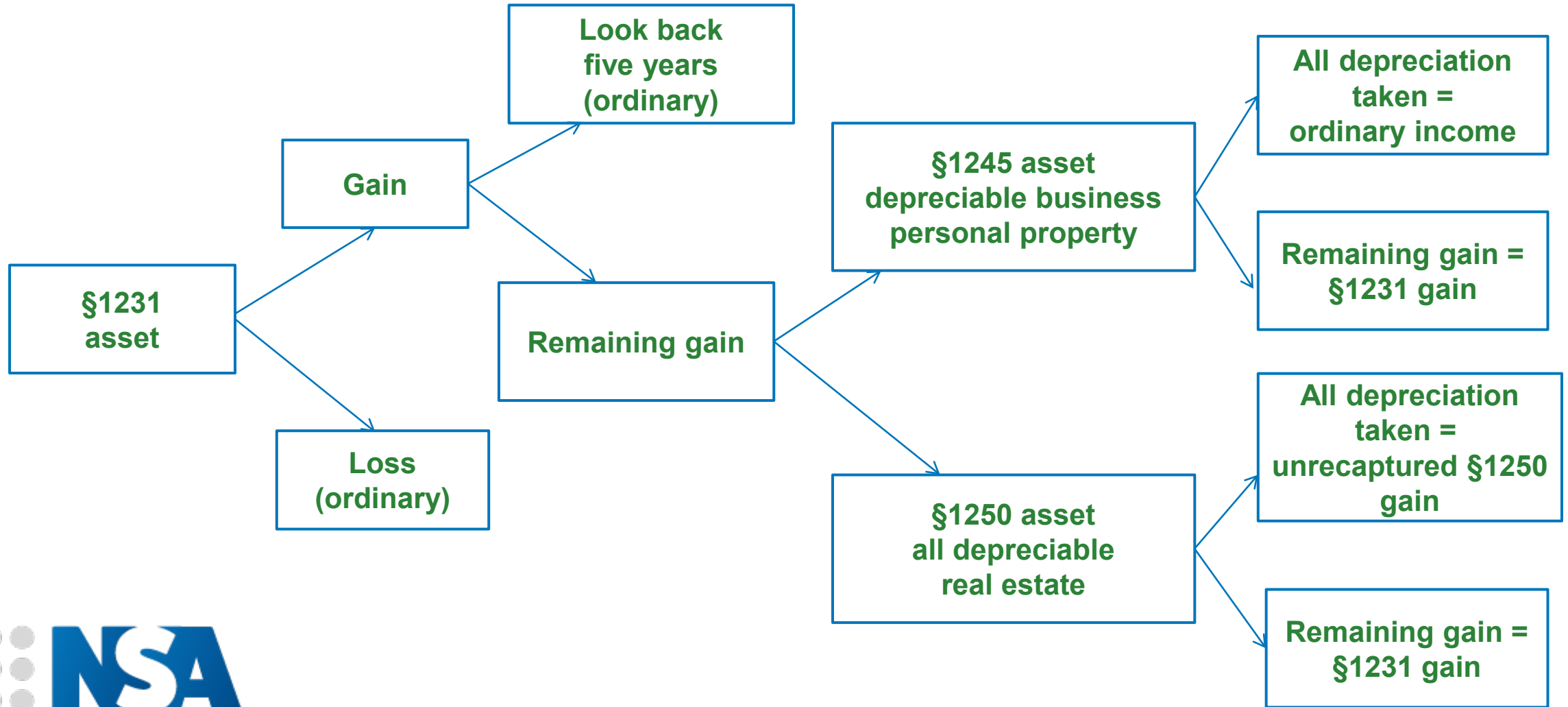
Other Issues

- Form 4797 in the new era of de minimis safe harbor
 - ✓ Asset purchases of \$500 or \$2,500 or less treated as de minimis materials and supplies
 - ✓ What happens upon disposition of these safe harbor expenses
 - ✓ Guidance and even the Form 4797 Instructions seems to suggest that we do use Form 4797, Part II, which results in ordinary income treatment for the full sales price, no capital gain treatment will be allowed for any part of the sale proceeds

Other Issues

- **IRC §1245 recapture IS QBI for §199A**
- **Unrecaptured §1250 IS NOT QBI for §199A**
- **Net IRC §1231 gain IS NOT QBI for §199A**
- **Net IRC §1231 loss REDUCES QBI for §199A**

Flowchart §§1231, 1245, 1250 Assets



Other Types of Property

- §1252 property, which is farmland held less than 10 years, on which soil, water or land-clearing expenses were deducted
- §1254 property, including intangible drilling and development costs, exploration costs and costs for developing mining operations
- §1255 property, which is cost-sharing payment property described in §126 of the Internal Revenue Code

Tax Planning

- Tax treatment of assets included in the sale of a business for individuals and pass-through entities
 - ✓ **Asset sold**
 - ✓ **Seller's tax treatment**
 - ✓ **Buyer's tax treatment**

Tax Planning

Asset Sold	Seller's Treatment	Purchaser Treatment
§ 1245	§ 1245 Recap & LT Capital Gains	Depreciate, Bonus, §179
§ 1250	§ 1250 Unrecap & LT Capital Gains	Depreciate
Land	§ 1231 Gain	Non Depreciable
Inventory	Ordinary Income	Cost of Goods Sold
Goodwill & Client Lists	§ 1245 Recap & LT Capital Gains	Amortizable 15 Years - § 197
Covenant not to compete	Ordinary Income, not subject to S/E Tax	Amortizable 15 Years - § 197

Allocations of Sales Price

■ **Basic choices**

- ✓ County assessor's valuation
- ✓ Certified independent appraisal
- ✓ Cost segregation study
- ✓ Agreement between buyer and seller
- ✓ Treasury regulations
- ✓ Court cases
- ✓ Private letter ruling

Allocations of Sales Price

Form 8594 (Rev. November 2021) Department of the Treasury Internal Revenue Service	Asset Acquisition Statement Under Section 1060 ▶ Attach to your income tax return. ▶ Go to www.irs.gov/Form8594 for instructions and the latest information.	OMB No. 1545-0074 Attachment Sequence No. 169
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Name as shown on return	Identifying number as shown on return
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Check the box that identifies you:

Purchaser Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
--	----------------------------------

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale	3 Total sales price (consideration)
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Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	\$	\$
Class II	\$	\$
Class III	\$	\$
Class IV	\$	\$
Class V	\$	\$
Class VI and VII	\$	\$
Total	\$	\$

Allocations of Sales Price

■ **Form 8594, *Asset Acquisition Statement***

- I. Savings & Checking Accounts
- II. Publicly traded securities
- III. A/R, debt instruments
- IV. Inventory
- V. Furniture, fixtures, equipment, buildings, land, vehicles
- VI. § 197 intangibles
- VII. Franchise, trademark, trade name



