Chapter 9: Small Business Issues

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

ISSUE 1: NET OPERATING LOSS

The term **net operating loss (NOL)** gives insight as to its meaning. **Operating** indicates that a loss originates from the operating portion of a business. **Net loss** indicates that an overall loss is incurred when the taxpayer's nonbusiness income and expenses are netted against business income and expenses. Consequently, a taxpayer must have a net loss from business operations in order to have an NOL.

Special rules come into play when calculating an NOL. For example, rental activities are considered business activities and casualty losses, although usually considered personal in nature, are considered business losses. This means a taxpayer can have an NOL if net business operations (including rental activities) less the deductible portion of any casualty loss results in an overall net loss.

IRS worksheets can assist with calculating an NOL, but the worksheets are difficult to complete without a thorough understanding of the concepts underlying an NOL. Although many tax software programs are able to calculate NOLs, the results may not be accurate if the software user cannot determine whether an income or expense item is business related. Since an NOL can be carried from the loss year to as many as 22 other years (carried back two years and forward 20), it is essential that tax professionals understand the theory behind NOLs and how to compute them.

Caution. An NOL must be carried back unless an election is made to forgo the carryback period. Tax professionals should verify that this election was properly made on the original return.

COMPUTATION OF AN NOL

The IRS developed several worksheets for computing NOLs to use with Form 1045, *Application for Tentative Refund.* Unfortunately, completing these worksheets is not intuitive. A practitioner can perform a quick check to rule out an NOL: If the taxpayer's Form 1040 income immediately before the deduction for exemptions is positive, the taxpayer cannot have an NOL. However, if this amount is negative, it does not necessarily mean the taxpayer has an NOL.

Step 1: Determining an NOL

The first step in computing an NOL is segregating business income and expenses from nonbusiness income and expenses. These items are found on the taxpayer's Form 1040 and Schedule A (if applicable). Items are segregated as follows:

Income		Expenses	
Business	**Nonbusiness**	**Business**	**Nonbusiness**
• Wages • State tax refunds (unless due to excess withholding on nonbusiness income) • Schedule C and F income • Gains from the sale of business real estate or depreciable property • Form 4797 gains and losses • Rental gains • Jury duty pay • Business gains from a partnership or S corporation (taxpayer's share) • Net trust or estate income • Hobby income	• Interest earned • Dividends • Alimony received • Gain on sale of nonbusiness assets • IRA/pension distributions • Social security income • Gambling winnings • Prizes	• Educator expenses • Reservist expenses • Moving expenses • One-half of SE tax • Rental losses • Self-employed health insurance • State income tax withholding • Casualty losses • State income tax on business profits • State estimated tax payments (if due to business income) • Form 2106 expenses • Loss on sale or exchange of business real estate or depreciable property • Business losses from a partnership or S corporation (taxpayer's share) • Ordinary losses on the sale or exchange of §1244 stock • Schedule C losses • Schedule F losses • Unrecovered investment in a pension or annuity claimed on a decedent's final return	• IRA deductions • Student loan interest • HSA • SEP/Simple deduction • Investment expenses • Alimony paid • Standard deduction • Medical expenses • Sales tax table deduction • Real estate taxes • Safety deposit box fees • Personal property taxes • Mortgage interest • Contributions • Tax preparation fees • Gambling losses • Losses on the sale of nonbusiness assets

> **Note.** Personal exemptions are never included in the calculation of an NOL. Some items of expense can be either business or nonbusiness depending on the nature of the deduction (e.g., tax preparation fees).

Reasonableness Test. Tax professionals are held responsible for the reasonableness of items carried from prior years. For example, if a prior year's return has an NOL statement showing a $75,000 NOL, the tax professional preparing the current year's return should review the previous year's return to confirm that the $75,000 calculation is reasonable. If the only income and loss items reported on the previous return are a $20,000 Schedule C loss and a $5,000 standard deduction, then the $75,000 loss is clearly unreasonable and the NOL carryover should be recalculated.

The following guide can be used to determine the amount of a **reasonable** NOL:

1. Business income – business expenses = ______________

Is the result a positive number?

- If **Yes,** stop. An NOL does not exist and **calculation is complete.**
- If **No,** proceed to **2.**

2. Nonbusiness income – nonbusiness expenses = ______________

Is the result a positive number?

- If **Yes,** add the results of **1** and **2**. A negative net result indicates the reasonable NOL amount. **A positive net result indicates that an NOL does not exist.**
- If **No,** the result originally obtained in **1** is the reasonable NOL.

Example 1. The taxpayer's Form 1040 from the NOL year reports the following:

	Reported	Business	Nonbusiness
Wages	$15,000	$15,000	
Interest income	500		$ 500
Schedule C	(35,000)	(35,000)	
Standard deduction	(5,000)		(5,000)
Total	($24,500)	($20,000)	($4,500)

Since the $500 of nonbusiness interest income does not exceed the nonbusiness expenses, this $20,000 loss should represent the taxpayer's NOL.

Example 2. Use the same facts as **Example 1,** except the interest income is increased to $7,000.

	Reported	Business	Nonbusiness
Wages	$15,000	$15,000	
Interest income	7,000		7,000
Schedule C	(35,000)	(35,000)	
Standard deduction	(5,000)		(5,000)
Total	($18,000)	($20,000)	$2,000

The business income items still combine for a $20,000 loss. However, since the nonbusiness income now results in a $2,000 gain, the tentative NOL is reduced by $2,000. When these amounts are entered on Form 1045, Schedule A, they result in an NOL of $18,000.

Example 3. Glenn Johnson reported the following items of income and expense on his 2004 Form 1040 and Schedule A:

	Reported	Business	Nonbusiness
Wages	$10,000	$10,000	
Interest income	800		800
Schedule C	(60,000)	(60,000)	
Itemized deduction	(19,050)	(300)	(18,750)
Total	($68,250)	($50,300)	($17,950)

On his itemized deductions, $300 was due to state income tax assessed on business income for the prior year. Glenn's 2004 income tax return and his current year NOL calculation follow:

For Example 3

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2004** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2004, or other tax year beginning , 2004, ending , 20 OMB No. 1545-0074

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: **Glenn**	Last name: **Johnson**	**Your social security number**: **123 45 6789**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 16.: **Main Street**	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.: **Chicago IL 60606**		

Presidential Election Campaign (See page 16.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☐ Yes ☒ No Spouse ☐ Yes ☐ No

Filing Status
Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 18)
			☐
			☐
			☐
			☐

If more than four dependents, see page 18.

d Total number of exemptions claimed

Boxes checked on 6a and 6b: 1
No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see page 18)
Dependents on 6c not entered above
Add numbers on lines above ▶ 1

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	10,000
8a	**Taxable** interest. Attach Schedule B if required		8a	800
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends (see page 20)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	(60,000)
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions	15a	b Taxable amount (see page 22) 15b	
16a	Pensions and annuities	16a	b Taxable amount (see page 22) 16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits	20a	b Taxable amount (see page 24) 20b	
21	Other income. List type and amount (see page 24)		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	(49,200)

Adjusted Gross Income

23	Educator expenses (see page 26)	23		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24		
25	IRA deduction (see page 26)	25		
26	Student loan interest deduction (see page 28)	26		
27	Tuition and fees deduction (see page 29)	27		
28	Health savings account deduction. Attach Form 8889	28		
29	Moving expenses. Attach Form 3903	29		
30	One-half of self-employment tax. Attach Schedule SE	30		
31	Self-employed health insurance deduction (see page 30)	31		
32	Self-employed SEP, SIMPLE, and qualified plans	32		
33	Penalty on early withdrawal of savings	33		
34a	Alimony paid b Recipient's SSN ▶	34a		
35	Add lines 23 through 34a		35	
36	Subtract line 35 from line 22. This is your **adjusted gross income** ▶		36	(49,200)

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 75. Cat. No. 11320B Form **1040** (2004)

9

For Example 3

Form 1040 (2004) Glenn Johnson 123-45-6789 Page **2**

Tax and Credits

37	Amount from line 36 (adjusted gross income)			37	(49,200)
38a	Check if: ☐ **You** were born before January 2, 1940, ☐ Blind. ☐ **Spouse** was born before January 2, 1940, ☐ Blind. **Total boxes checked ▶ 38a**				
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 38b ☐				
39	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			39	19,050
40	Subtract line 39 from line 37			40	(68,250)
41	If line 37 is $107,025 or less, multiply $3,100 by the total number of exemptions claimed on line 6d. If line 37 is over $107,025, see the worksheet on page 33			41	3,100
42	**Taxable income.** Subtract line 41 from line 40. If line 41 is more than line 40, enter -0-			42	(71,350)
43	**Tax** (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972			43	0
44	**Alternative minimum tax** (see page 35). Attach Form 6251			44	0
45	Add lines 43 and 44 ▶			45	0
46	Foreign tax credit. Attach Form 1116 if required	46			
47	Credit for child and dependent care expenses. Attach Form 2441	47			
48	Credit for the elderly or the disabled. Attach Schedule R	48			
49	Education credits. Attach Form 8863	49			
50	Retirement savings contributions credit. Attach Form 8880	50			
51	Child tax credit (see page 37)	51			
52	Adoption credit. Attach Form 8839	52			
53	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	53			
54	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify ______	54			
55	Add lines 46 through 54. These are your **total credits**			55	
56	Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- ▶			56	0

Standard Deduction for—
- People who checked any box on line 38a or 38b **or** who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, $4,850

Married filing jointly or Qualifying widow(er), $9,700

Head of household, $7,150

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	
58	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60	Advance earned income credit payments from Form(s) W-2	60	
61	Household employment taxes. Attach Schedule H	61	
62	Add lines 56 through 61. This is your **total tax** ▶	62	0

Payments

If you have a qualifying child, attach Schedule EIC.

63	Federal income tax withheld from Forms W-2 and 1099	63	1,000		
64	2004 estimated tax payments and amount applied from 2003 return	64			
65a	**Earned income credit (EIC)**	65a			NO
b	Nontaxable combat pay election ▶ 65b				
66	Excess social security and tier 1 RRTA tax withheld (see page 54)	66			
67	Additional child tax credit. Attach Form 8812	67			
68	Amount paid with request for extension to file (see page 54)	68			
69	Other payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	69			
70	Add lines 63, 64, 65a, and 66 through 69. These are your **total payments** ▶			70	1,000

Refund

Direct deposit? See page 54 and fill in 72b, 72c, and 72d.

71	If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you **overpaid**			71	1,000
72a	Amount of line 71 you want **refunded to you** ▶			72a	1,000
▶ b	Routing number X X X X X X X X X ▶ **c** Type: ☐ Checking ☐ Savings				
▶ d	Account number X X X X X X X X X X X X X X X X X				
73	Amount of line 71 you want **applied to your 2005 estimated tax** ▶	73			

Amount You Owe

74	**Amount you owe.** Subtract line 70 from line 62. For details on how to pay, see page 55 ▶			74	
75	Estimated tax penalty (see page 55)	75			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 56)? ☒ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ TAX PROFESSIONAL Phone no. ▶ (111) 111-1111 Personal identification number (PIN) ▶ 1 1 1 1 1

Sign Here

Joint return? See page 17. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN 111-11-1111
Firm's name (or yours if self-employed), address, and ZIP code ▶ TAX SERVICES CHICAGO IL 60601		EIN 11 1111111	Phone no. (111) 111-1111

Form **1040** (2004)

For Example 3

SCHEDULES A&B (Form 1040) — Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074 — 2004 — Attachment Sequence No. 07

Name(s) shown on Form 1040: **Glenn Johnson** — Your social security number: **123 45 6789**

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1	3,000		
	2	Enter amount from Form 1040, line 37 [2] (49,200)				
	3	Multiply line 2 by 7.5% (.075)	3			
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	3,000
Taxes You Paid (See page A-2.)	5	State and local (**check only one box**): a ☒ Income taxes, **or** b ☐ General sales taxes (see page A-2)	5	300		
	6	Real estate taxes (see page A-3)	6	3,500		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	3,800
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	12,000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-4 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-4 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-4.)	13			
	14	Add lines 10 through 13			14	12,000
Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	15			
	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500	16			
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19	
Job Expenses and Most Other Miscellaneous Deductions (See page A-5.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-6.) ▶	20			
	21	Tax preparation fees	21	250		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23	250		
	24	Enter amount from Form 1040, line 37 [24] (49,200)				
	25	Multiply line 24 by 2% (.02)	25			
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26	250
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			27	
Total Itemized Deductions	28	Is Form 1040, line 37, over $142,700 (over $71,350 if married filing separately)? ☒ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 39. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶			28	19,050

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2004**

9

For Example 3

Form 1045 (2004) **Glenn Johnson** **123-45-6789** Page **2**

Schedule A—NOL (see page 5 of the instructions)

1	Enter the amount from your 2004 Form 1040, line 40. Estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount			1	**(68,250)**
2	Nonbusiness capital losses before limitation. Enter as a positive number		2		
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)		3		
4	If line 2 is more than line 3, enter the difference; otherwise, enter -0-		4		
5	If line 3 is more than line 2, enter the difference; otherwise, enter -0-	5			
6	Nonbusiness deductions (see page 5 of the instructions)		6 **18,750**		
7	Nonbusiness income other than capital gains (see page 5 of the instructions)	7 **800**			
8	Add lines 5 and 7		8 **800**		
9	If line 6 is more than line 8, enter the difference; otherwise, enter -0-			9	**17,950**
10	If line 8 is more than line 6, enter the difference; otherwise, enter -0-. **But do not enter more than line 5**	10			
11	Business capital losses before limitation. Enter as a positive number		11		
12	Business capital gains (without regard to any section 1202 exclusion)	12			
13	Add lines 10 and 12		13		
14	Subtract line 13 from line 11. If zero or less, enter -0-		14		
15	Add lines 4 and 14		15		
16	Enter the loss, if any, from line 16 of Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 15, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you do not have a loss on that line (and do not have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15		16		
17	Section 1202 exclusion. Enter as a positive number			17	
18	Subtract line 17 from line 16. If zero or less, enter -0-		18		
19	Enter the loss, if any, from line 21 of Schedule D (Form 1040). (Estates and trusts, enter the loss, if any, from line 16 of Schedule D (Form 1041).) Enter as a positive number		19		
20	If line 18 is more than line 19, enter the difference; otherwise, enter -0-		20		
21	If line 19 is more than line 18, enter the difference; otherwise, enter -0-			21	
22	Subtract line 20 from line 15. If zero or less, enter -0-			22	
23	NOL deduction for losses from other years. Enter as a positive number			23	
24	**NOL.** Combine lines 1, 9, 17, 21, 22, and 23. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you **do not** have an NOL			24	**(50,300)**

Form **1045** (2004)

Step 2: Applying an NOL (Carryback versus Carryforward)

Step 2 requires the taxpayer to decide whether to carry the NOL back to a prior tax year or to forgo the carryback period and carry the loss forward. A loss is normally carried back two years and then forward 20 years.

Carryback Periods. Different carryback periods can be applied in the following situations:

1. **5-year** carryback period:
   - Farm losses
   - Losses occurring in tax years ending in 2002 or 2003
2. **3-year** carryback period:
   - Business and farm losses in areas declared to be a disaster by the President
   - Losses resulting from a casualty

Election to Forgo Carryback. To forgo the carryback period, **a taxpayer must make a formal election** by attaching a statement referencing IRC §172(b)(3) to a timely filed return, including extensions, for the year of loss, or on an amended return filed within six months after the **unextended** due date of the return. This election is **irrevocable**. A sample election statement is provided below.

> Pursuant to IRC §172(b)(3) the taxpayer elects to forgo the net operating loss carryback period for the tax year ending _________.

If the election is made on an amended return filed after the original due date, "FILED PURSUANT TO §301.9100-2" is added to the election form.

An election is binding on the NOL for which the election is made, but it does not affect an NOL arising from other years. Each NOL has its own carryback period and its own election. **If an election is not properly made, an NOL must be carried back.**

There are several questions to consider when deciding whether or not to carry an NOL back:

1. Does the taxpayer need cash now or will the NOL be worth more in the future?
2. What was the taxpayer's tax bracket in the carryback year(s) and what is the taxpayer's projected tax bracket for the potential carryover year(s)?
3. How much of the NOL will be lost in the carryback years without the taxpayer realizing a tax savings?

Forms Used to Claim Refunds from NOLs

An NOL is **carried forward** by entering it as a negative number on the "other income" line of the applicable year's Form 1040. It does not reduce self-employment taxes. An NOL is **carried back** on either Form 1045 or Form 1040X.

Form 1045. Form 1045 must be filed within one year from the close of the NOL year. Calendar-year taxpayers incurring a loss in 2005 have until December 31, 2006, to file Form 1045. The IRS is required to either issue a refund or to deny the claim within 90 days of receiving a correctly completed Form 1045 claim. They normally issue the refund first, then verify the information. If this verification results in a correction, the taxpayer must repay any difference plus interest.

Form 1040X. Form 1040X can be used any time within the normal three-year statute of limitations. A calendar-year taxpayer with an NOL arising in 2005 has until April 15, 2009, to file Form 1040X. The IRS normally verifies the information on the 1040X prior to issuing a refund.

For purposes of the NOL carryback, the statute of limitations is considered open on any carryback year as long as the statute is open for the **loss year**. While this does not open these carryback years for any other purpose, it does create a potentially serious ramification since **the carryback of an NOL opens up the carryback years to an IRS examination** for the statute that applies to the loss year. It does not allow the IRS to assess taxes in excess of the amounts they have refunded. However, the IRS is allowed to examine the carryback years' returns to verify the reported income is correct since this income is used to determine the amount of the NOL available to carry forward.

Example 4. A calendar-year-2004 NOL can be carried back to 2002 then carried forward until it is either exhausted or expires in 2024. Assuming it takes until 2024 for the loss to be used up, the IRS can examine all returns from 2002 through 2024 until April 15, 2028, which is three years after the due date of the last return in which the loss was carried forward.

> **Observation.** A taxpayer should keep all tax returns and supporting documents for the NOL year and each year affected by a carryback or carryforward, in case the IRS requests verification of income or expenses.

Recomputations Affecting Carryback or Carryforward Years

Some tax return items must be recomputed when preparing Form 1040X or Form 1045 for an NOL carryback year. Recomputation is required for any item on the carryback year's return that is affected by a change in the taxpayer's adjusted gross income (AGI) and/or tax, with the exception of charitable contributions. Contribution limits are not recomputed when an NOL is carried back. This is discussed later in this section.

Refiguring Tax. To refigure total tax liability for a carryback year, first refigure AGI for that year. Use AGI after applying the NOL deduction to refigure income or deduction items that are based on, or limited to, a percentage of AGI. Refigure the following items:

1. The special allowance for passive activity losses from rental real estate activities
2. Taxable social security and tier 1 railroad retirement benefits
3. IRA deductions
4. Excludable savings bond interest
5. Excludable employer-provided adoption benefits
6. Student loan interest deduction
7. Tuition and fees deduction

If more than one of these items apply, refigure them in the order listed above, using AGI after applying the NOL deduction and any previous item. Enter the NOL deduction on Form 1045, line 10. On line 11, using the "after carryback" column, enter AGI after applying the above refigured items but without the NOL deduction.

Next, refigure taxable income. On Form 1045, use lines 12 through 15 and the "after carryback" column. Use refigured AGI on Form 1045, line 11, using the "after carryback" column to refigure certain deductions and other items that are based on, or limited to, a percentage of AGI. Refigure the following items:

- The itemized deduction for medical expenses
- The itemized deduction for casualty losses
- Miscellaneous itemized deductions subject to the 2% limit
- The overall limit on itemized deductions
- The phaseout of the deduction for exemptions

Do not refigure the itemized deduction for charitable contributions.

Example 5. Use the same facts as **Example 3.** Glenn's NOL is carried back two years to 2002. This is the default procedure, so no election is required.

	Original Return	After NOL Carryback
AGI	$28,234	($22,066)
Itemized deductions	16,150	17,180

The medical deductions of $800 and miscellaneous expenses of $230 are increased due to the taxpayer's recomputed AGI. Glenn's 2002 Forms 1040 and 1045, and Schedule A are shown on the following pages.

For Example 5

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2002 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2002, or other tax year beginning , 2002, ending , 20 OMB No. 1545-0074

Label (See instructions on page 21.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE

Your first name and initial: **Glenn**	Last name: **Johnson**	**Your social security number:** 123 45 6789
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 21. **Main Street**	Apt. no.	**Important!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 21. **Chicago IL 60606**		

Presidential Election Campaign (See page 21.) **Note.** Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? . . . ▶ You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 21.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶). (See page 21.)

Exemptions

6a ☒ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a

b ☐ **Spouse**

No. of boxes checked on 6a and 6b: 1

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 22)
			☐
			☐
			☐
			☐
			☐

If more than five dependents, see page 22.

No. of children on 6c who: • lived with you • did not live with you due to divorce or separation (see page 22)
Dependents on 6c not entered above
Add numbers on lines above ▶ 1

d Total number of exemptions claimed

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		
8a	**Taxable** interest. Attach Schedule B if required		5,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9	Ordinary dividends. Attach Schedule B if required		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		25,000
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		
14	Other gains or (losses). Attach Form 4797		
15a	IRA distributions 15a; b Taxable amount (see page 25)	15b	
16a	Pensions and annuities 16a; b Taxable amount (see page 25)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		
18	Farm income or (loss). Attach Schedule F		
19	Unemployment compensation		
20a	Social security benefits 20a; b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		30,000

Adjusted Gross Income

23	Educator expenses (see page 29)		
24	IRA deduction (see page 29)		
25	Student loan interest deduction (see page 31)		
26	Tuition and fees deduction (see page 32)		
27	Archer MSA deduction. Attach Form 8853		
28	Moving expenses. Attach Form 3903		
29	One-half of self-employment tax. Attach Schedule SE	1,766	
30	Self-employed health insurance deduction (see page 33)		
31	Self-employed SEP, SIMPLE, and qualified plans		
32	Penalty on early withdrawal of savings		
33a	Alimony paid b Recipient's SSN ▶		
34	Add lines 23 through 33a		1,766
35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶		28,234

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 76. Cat. No. 11320B Form **1040** (2002)

9

For Example 5

Form 1040 (2002) **Glenn Johnson** **123-45-6789** Page **2**

Tax and Credits

Standard Deduction for—
- People who checked any box on line 37a or 37b **or** who can be claimed as a dependent, see page 34.
- All others:

Single, $4,700
Head of household, $6,900
Married filing jointly or Qualifying widow(er), $7,850
Married filing separately, $3,925

36	Amount from line 35 (adjusted gross income)			36	28,234
37a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 37a				
b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 37b ☐				
38	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			38	16,150
39	Subtract line 38 from line 36			39	12,084
40	If line 36 is $103,000 or less, multiply $3,000 by the total number of exemptions claimed on line 6d. If line 36 is over $103,000, see the worksheet on page 35			40	3,000
41	**Taxable income.** Subtract line 40 from line 39. If line 40 is more than line 39, enter -0-			41	9,084
42	**Tax** (see page 36). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972			42	1,061
43	**Alternative minimum tax** (see page 37). Attach Form 6251			43	
44	Add lines 42 and 43 ▶			44	1,061
45	Foreign tax credit. Attach Form 1116 if required	45			
46	Credit for child and dependent care expenses. Attach Form 2441	46			
47	Credit for the elderly or the disabled. Attach Schedule R	47			
48	Education credits. Attach Form 8863	48			
49	Retirement savings contributions credit. Attach Form 8880	49			
50	Child tax credit (see page 39)	50			
51	Adoption credit. Attach Form 8839	51			
52	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	52			
53	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify ________	53			
54	Add lines 45 through 53. These are your **total credits**			54	
55	Subtract line 54 from line 44. If line 54 is more than line 44, enter -0- ▶			55	1,061

Other Taxes

56	Self-employment tax. Attach Schedule SE	56	3,532
57	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	57	
58	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	58	
59	Advance earned income credit payments from Form(s) W-2	59	
60	Household employment taxes. Attach Schedule H	60	
61	Add lines 55 through 60. This is your **total tax** ▶	61	4,593

Payments

If you have a qualifying child, attach Schedule EIC.

62	Federal income tax withheld from Forms W-2 and 1099	62			
63	2002 estimated tax payments and amount applied from 2001 return	63	4,500		
64	**Earned income credit (EIC)**	64			
65	Excess social security and tier 1 RRTA tax withheld (see page 56)	65			
66	Additional child tax credit. Attach Form 8812	66			
67	Amount paid with request for extension to file (see page 56)	67			
68	Other payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	68			
69	Add lines 62 through 68. These are your **total payments** ▶			69	4,500

Refund

Direct deposit? See page 56 and fill in 71b, 71c, and 71d.

70	If line 69 is more than line 61, subtract line 61 from line 69. This is the amount you **overpaid**			70	
71a	Amount of line 70 you want **refunded to you** ▶			71a	
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings				
▶ d	Account number				
72	Amount of line 70 you want **applied to your 2003 estimated tax** ▶	72			

Amount You Owe

73	**Amount you owe.** Subtract line 69 from line 61. For details on how to pay, see page 57 ▶			73	93
74	Estimated tax penalty (see page 57)	74			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 58)? ☒ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ TAX PROFESSIONAL Phone no. ▶ (111) 111-1111 Personal identification number (PIN) ▶ 1 1 1 1 1

Sign Here

Joint return? See page 21. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
			( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN 111-11-1111
Firm's name (or yours if self-employed), address, and ZIP code	TAX SERVICES	EIN	11 1111111
	CHICAGO IL 60601	Phone no.	(111) 111-1111

Form **1040** (2002)

For Example 5

SCHEDULES A&B (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Schedule A— Itemized Deductions
(Schedule B is on back)
▶ Attach to Form 1040. ▶ See Instructions for Schedules A and B (Form 1040).

OMB No. 1545-0074
2002
Attachment Sequence No. 07

Name(s) shown on Form 1040: **Glenn Johnson**
Your social security number: 123 45 6789

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.				
	1	Medical and dental expenses (see page A-2)	1	800		
	2	Enter amount from Form 1040, line 36 [2] 28,234				
	3	Multiply line 2 by 7.5% (.075)	3	2,118		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4	0
Taxes You Paid (See page A-2.)	5	State and local income taxes	5	250		
	6	Real estate taxes (see page A-2)	6	2,900		
	7	Personal property taxes	7			
	8	Other taxes. List type and amount ▶	8			
	9	Add lines 5 through 8			9	3,150
Interest You Paid (See page A-3.)	10	Home mortgage interest and points reported to you on Form 1098	10	13,000		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11			
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12			
	13	Investment interest. Attach Form 4952 if required. (See page A-3.)	13			
	14	Add lines 10 through 13			14	13,000
Gifts to Charity If you made a gift and got a benefit for it, see page A-4.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-4	15			
	16	Other than by cash or check. If any gift of $250 or more, see page A-4. You **must** attach Form 8283 if over $500	16			
	17	Carryover from prior year	17			
	18	Add lines 15 through 17			18	
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-5.)			19	
Job Expenses and Most Other Miscellaneous Deductions	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You **must** attach Form 2106 or 2106-EZ if required. (See page A-5.) ▶	20			
	21	Tax preparation fees	21	230		
(See page A-5 for expenses to deduct here.)	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22			
	23	Add lines 20 through 22	23	230		
	24	Enter amount from Form 1040, line 36 [24] 28,234				
	25	Multiply line 24 by 2% (.02)	25	565		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26	0
Other Miscellaneous Deductions	27	Other—from list on page A-6. List type and amount ▶			27	
Total Itemized Deductions	28	Is Form 1040, line 36, over $137,300 (over $68,650 if married filing separately)? ☒ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter this amount on Form 1040, line 38. ☐ **Yes.** Your deduction may be limited. See page A-6 for the amount to enter. ▶			28	16,150

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11330X **Schedule A (Form 1040) 2002**

9

For Example 5

Form **1045** | **Application for Tentative Refund** | OMB No. 1545-0098
Department of the Treasury Internal Revenue Service
▶ See separate instructions.
▶ Do not attach to your income tax return—mail in a separate envelope.
▶ For use by individuals, estates, or trusts.
2004

Type or print

Name(s) shown on return: **Glenn Johnson**	Social security or employer identification number: **123-45-6789**
Number, street, and apt. or suite no. If a P.O. box, see page 2 of the instructions. **Main Street**	Spouse's social security number (SSN)
City, town or post office, state, and ZIP code. If a foreign address, see page 2 of the instructions. **Chicago IL 60606**	Daytime phone number ( )

1	This application is filed to carry back:	a Net operating loss (NOL) (Sch. A, line 24, page 2) $ **(50,300)**	b Unused general business credit $	c Net section 1256 contracts loss $
2a	For the calendar year 2004, or other tax year beginning , 2004, ending , 20		b Date tax return was filed **04-15-2005**	

3 If this application is for an unused credit created by another carryback, enter year of first carryback ▶

4 If you filed a joint return (or separate return) for some, but not all, of the tax years involved in figuring the carryback, list the years and specify whether joint (J) or separate (S) return for each ▶ **2002 S**

5 If SSN for carryback year is different from above, enter **a** SSN ▶ and **b** Year(s) ▶

6 If you changed your accounting period, give date permission to change was granted ▶

7 Have you filed a petition in Tax Court for the year(s) to which the carryback is to be applied? ☐ Yes ☒ No

8 Is any part of the decrease in tax due to a loss or credit from a tax shelter required to be registered? ☐ Yes ☒ No

9 If you are carrying back an NOL or net section 1256 contracts loss, did this cause the release of foreign tax credits or the release of other credits due to the release of the foreign tax credit (see page 2 of the instructions)? ☐ Yes ☒ No

Computation of Decrease in Tax (see page 3 of the instructions) **Note:** *If 1a and 1c are blank, skip lines 10 through 15.*	**2nd** preceding tax year ended ▶ **2002** Before carryback	After carryback	___ preceding tax year ended ▶ **2003** Before carryback	After carryback	___ preceding tax year ended ▶ Before carryback	After carryback
10 NOL deduction after carryback (see page 3 of the instructions)		50,300				
11 Adjusted gross income	28,234	(22,066)				
12 Deductions (see page 4 of the instructions)	16,150	17,180				
13 Subtract line 12 from line 11	12,084	(39,246)				
14 Exemptions (see page 4 of the instructions)	3,000	3,000				
15 Taxable income. Line 13 minus line 14	9,084	0				
16 Income tax. See page 4 of the instructions and attach an explanation	1,061	0				
17 Alternative minimum tax						
18 Add lines 16 and 17	1,061					
19 General business credit (see page 4 of the instructions)						
20 Other credits. Identify	0	0				
21 Total credits. Add lines 19 and 20						
22 Subtract line 21 from line 18	1,061					
23 Self-employment tax	3,532	3,532				
24 Other taxes						
25 Total tax. Add lines 22 through 24	4,593	3,532				
26 Enter the amount from the "After carryback" column on line 25 for each year	3,532					
27 Decrease in tax. Line 25 minus line 26	1,061					
28 Overpayment of tax due to a claim of right adjustment under section 1341(b)(1) (attach computation)						

Sign Here Under penalties of perjury, I declare that I have examined this application and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Keep a copy of this application for your records.

Your signature | Date

Spouse's signature. If Form 1045 is filed jointly, **both** must sign. | Date

Preparer Other Than Taxpayer Name ▶ | Date
Address ▶

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 7 of the instructions. Cat. No. 10670A Form **1045** (2004)

Capital Loss Carryover Adjustments. A capital loss carryover is calculated on a Form 1045, Schedule D worksheet. The amount of capital loss deemed used in a year is the smaller of:

- The taxpayer's taxable income immediately before the exemption deductions, but after **adding back** the capital loss claimed on the return, or
- The amount of capital loss claimed on the return.

If a capital loss carryover is adjusted because of an NOL carryback, the new capital loss carryover is used on the next year's return. If the next year is also a year reported on Form 1045, then the "After Carryback**"** column on line 10 of Form 1045 should reflect the new AGI using the new capital loss carryover.

Example 6. Samantha, a calendar-year taxpayer, has $20,000 of wages and a $1,000 capital loss in 2002. In 2003, she has $15,000 wages and no capital gains or losses. She has an NOL carryback from 2004 of $30,000.

The 2004 NOL carryback eliminates all of her 2002 income. Due to the NOL carryback, the revised capital loss carryover worksheet shows a negative income before exemptions and after adding back the $1,000 capital loss. Therefore, the entire $1,000 capital loss is now carried to 2003.

The 2003 AGI is now $14,000, netting the $15,000 of wages and the $1,000 of newly created capital loss carryover from the adjusted 2002 return. This $14,000 is reported in the "After Carryback" column on line 11 of Samantha's Form 1045 for the 2003 year.

Charitable Contribution Adjustments. The deduction for charitable contributions is not recomputed when an NOL is carried back. However, the charitable contribution deduction is subject to the normal limitations (50%, 30%, and 20% of AGI) when an NOL is carried forward to a year. If an NOL carryover reduces AGI to zero or below, then the charitable contribution deduction for that year is zero.

The charitable contributions made during that year, plus charitable contribution carryovers from prior years **must be adjusted** before they are carried to the following year.[1] This adjustment changes a charitable contribution carryover into an NOL carryover. This results in a longer carryover period, 20 years instead of five. It also results in an ordinary income deduction instead of an itemized deduction (NOL versus charitable contribution). The charitable contribution deduction is then recalculated as if the NOL had not been carried forward to the applicable year. This reduces the charitable contribution carryover and increases the NOL carryover.

Example 7. Bonnie has a 2004 AGI of $20,000 before taking into account an NOL carryover of $60,000 from 2003. She itemizes her deductions and has charitable contributions of $15,000 for the year, which qualify as 50% deductions.

The NOL carryover reduces Bonnie's AGI to negative $40,000. Consequently, she is not allowed a charitable contribution deduction for 2004. Bonnie would have been allowed a deduction of $10,000 ($20,000 × 50%) for her charitable contributions based on her 2004 AGI without factoring in the 2003 NOL carryover.

Bonnie's adjusted charitable contribution carryover is $5,000 ($15,000 minus the $10,000 that would have been allowed). After performing the normal calculations for her NOL carryover to 2005, the contribution carryover is increased by the $10,000.

Alternative Minimum Tax (AMT) Net Operating Loss Computation. It is just as important to compute the AMT NOL computation as it is to compute the regular tax NOL computation. Due to a decrease in regular tax caused by the NOL and no reduction in AMT income, additional tax may be assessed. The regular tax NOL is an add-back adjustment for AMT purposes. A taxpayer is permitted to deduct the AMT NOL, which only offsets AMT income. This is computed in the same manner as the regular tax NOL except it takes into account AMT adjustments and preferences.

1. Treas. Reg. §1.170A-10(d)

Example 8. Watson, a single taxpayer, has a Schedule C loss of $20,000 for regular tax purposes. He also has an AMT adjustment of $1,000 for depreciation. For AMT purposes, his Schedule C loss is only $19,000. His AMT NOL calculation uses this $19,000 loss since it reflects the true AMT Schedule C.

Example 9. Michaela, a single taxpayer, has an AGI of $50,000 for 2002. Her regular tax of $8,528 is higher than her tentative AMT of $6,630. When her $60,000 of NOL from 2004 is carried back to 2002, it reduces her regular tax to $0. Michaela must then calculate her AMT NOL to be used on Form 6251, *Alternative Minimum Tax — Individuals.* This will create a new tentative minimum tax. Calculating and utilizing her AMT NOL could reduce or eliminate any AMT.

The AMT NOL is normally limited to 90% of the alternative minimum taxable income. For the 2001 and 2002 calendar tax years, the limit was increased to 100%, but in 2003 the limit reverted back to 90%. Loss years prior to 1987 have an AMT NOL equal to the regular tax NOL.

An election to forgo the carryback period is effective for AMT NOL purposes as well as regular tax NOL. A taxpayer cannot elect to forgo the carryback period for the either the regular NOL or the AMT NOL and not for the other.

Filing Status Changes

A taxpayer who incurs an NOL in one year but has a different filing status in another year should refer to the regulations under IRC §172 and Rev. Rul. 80-6 for directions. Basically, these rules require married-filing-jointly (MFJ) taxpayers to determine their separate NOLs using the following steps:

1. Calculate each spouse's NOL as if they had filed as married filing separately (MFS).
2. Divide each individual NOL into the individual's total NOLs to determine respective ownership percentages.
3. Multiply the MFJ NOL by the respective ownership percentages to determine each person's share of the total NOL.

Note. MFJ NOLs are allocated according to §172 and Rev. Ruling 80-6.

Death of a Taxpayer with an NOL Carryover

Any NOL remaining at the death of a taxpayer is lost. If an NOL is not used on the taxpayer's final return and is not used up in the normal carryback years, the NOL terminates. It cannot be carried to another taxpayer's tax return.

Planning Tip. When filing a joint return for a decedent and surviving spouse, it is beneficial to accelerate income so that the taxpayer may utilize any NOL that will be lost.

CARRYOVER OF UNUSED NOL

When there is not enough income in the first carryback year to absorb an entire NOL, a preparer must compute the NOL available for carryover on Form 1045, Schedule B. As in the first carryback year, income and expense for the next year must be recomputed to determine the remaining carryover. Thus, itemized deductions may have to be computed three times:

1. On the original return,
2. For Form 1045/1040X purposes, and
3. For Form 1045, Schedule B purposes.

Line 5 of Form 1045, Schedule B, includes adjustments made to other types of income and expenses as a direct result of the NOL carryback. Taxpayers must attach a copy of the computations performed to arrive at the adjustment to the Form 1045. Examples of items that may need to be adjusted are as follows:

- Passive activity losses
- Taxable social security benefits
- IRA deductions
- Student loan interest adjustments
- Tuition and fees adjustments
- Excludable savings bond interest deductions
- Excludable employer-provided adoption benefits

After computing the NOL amount used in the second preceding year, any remaining NOL is carried to the next year. Another computation is performed to determine if the NOL is completely used in this year or whether any NOL remains to be carried forward. For example, if 2004 was the NOL loss year, the NOL is first carried back to 2002, then to 2003, and any remainder is carried forward to 2005, 2006, 2007, and so on.

Example 10. Use the same facts as **Example 3.** The following Form 1045 Schedule B computation shows the NOL carryover Glenn Johnson can apply to his 2003 return.

For Example 10

Form **1045**

Department of the Treasury
Internal Revenue Service

Application for Tentative Refund

▶ See separate instructions.
▶ Do not attach to your income tax return—mail in a separate envelope.
▶ For use by individuals, estates, or trusts.

OMB No. 1545-0098

2004

Type or print

Name(s) shown on return: **Glenn Johnson**	Social security or employer identification number: **123-45-6789**
Number, street, and apt. or suite no. If a P.O. box, see page 2 of the instructions.: **Main Street**	Spouse's social security number (SSN)
City, town or post office, state, and ZIP code. If a foreign address, see page 2 of the instructions.: **Chicago IL 60606**	Daytime phone number ( )

1 This application is filed to carry back:	**a** Net operating loss (NOL) (Sch. A, line 24, page 2) $ **(50,300)**	**b** Unused general business credit $	**c** Net section 1256 contracts loss $
2a For the calendar year 2004, or other tax year beginning , 2004, ending , 20		**b** Date tax return was filed **04-15-2005**	

3 If this application is for an unused credit created by another carryback, enter year of first carryback ▶

4 If you filed a joint return (or separate return) for some, but not all, of the tax years involved in figuring the carryback, list the years and specify whether joint (J) or separate (S) return for each ▶ **2002 S 2003 S**

5 If SSN for carryback year is different from above, enter **a** SSN ▶ and **b** Year(s) ▶

6 If you changed your accounting period, give date permission to change was granted ▶

7 Have you filed a petition in Tax Court for the year(s) to which the carryback is to be applied? ☐ Yes ☒ No

8 Is any part of the decrease in tax due to a loss or credit from a tax shelter required to be registered? ☐ Yes ☒ No

9 If you are carrying back an NOL or net section 1256 contracts loss, did this cause the release of foreign tax credits or the release of other credits due to the release of the foreign tax credit (see page 2 of the instructions)? ☐ Yes ☒ No

Computation of Decrease in Tax (see page 3 of the instructions) **Note:** *If 1a and 1c are blank, skip lines 10 through 15.*	**2nd** preceding tax year ended ▶ **2002**		**1st** preceding tax year ended ▶ **2003**		____ preceding tax year ended ▶	
	Before carryback	After carryback	Before carryback	After carryback	Before carryback	After carryback
10 NOL deduction after carryback (see page 3 of the instructions)		50,300		38,216		
11 Adjusted gross income	28,234	(22,066)	17,940	(20,276)		
12 Deductions (see page 4 of the instructions)	16,150	17,180	16,400	16,640		
13 Subtract line 12 from line 11	12,084	(39,246)	1,540	(36,916)		
14 Exemptions (see page 4 of the instructions)	3,000	3,000	3,050	3,050		
15 Taxable income. Line 13 minus line 14	9,084	0	(1,510)	0		
16 Income tax. See page 4 of the instructions and attach an explanation	1,061	0	0	0		
17 Alternative minimum tax						
18 Add lines 16 and 17	1,061					
19 General business credit (see page 4 of the instructions)						
20 Other credits. Identify	0	0	0	0		
21 Total credits. Add lines 19 and 20						
22 Subtract line 21 from line 18	1,061					
23 Self-employment tax	3,532	3,532	2,120	2,120		
24 Other taxes						
25 Total tax. Add lines 22 through 24	4,593	3,532	2,120	2,120		
26 Enter the amount from the "After carryback" column on line 25 for each year	3,532		2,120			
27 Decrease in tax. Line 25 minus line 26	1,061					
28 Overpayment of tax due to a claim of right adjustment under section 1341(b)(1) (attach computation)						

Sign Here

Keep a copy of this application for your records.

Under penalties of perjury, I declare that I have examined this application and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Your signature | Date

Spouse's signature. If Form 1045 is filed jointly, **both** must sign. | Date

Preparer Other Than Taxpayer Name ▶ | Date
Address ▶

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 7 of the instructions. Cat. No. 10670A Form **1045** (2004)

For Example 10

Form 1045 (2004) GLENN JOHNSON 123-45-6789 Page 3

Schedule B—NOL Carryover (see page 5 of the instructions)

Complete one column before going to the next column. Start with the earliest carryback year.	2nd preceding tax year ended ▶ 2002		1st preceding tax year ended ▶ 2003		____ preceding tax year ended ▶	
1 **NOL deduction** (see page 5 of the instructions). Enter as a positive number		50,300		38,216		
2 Taxable income before 2004 NOL carryback (see page 5 of the instructions). Estates and trusts, increase this amount by the sum of the charitable deduction and income distribution deduction	9,084		(1,510)			
3 Net capital loss deduction (see page 6 of the instructions)						
4 Section 1202 exclusion. Enter as a positive number						
5 Adjustment to adjusted gross income (see page 6 of the instructions)						
6 Adjustment to itemized deductions (see page 6 of the instructions)						
7 Individuals, enter deduction for exemptions. Estates and trusts, enter exemption amount	3,000		3,050			
8 Modified taxable income. Combine lines 2 through 7. If zero or less, enter -0-		12,084		1,540		
9 **NOL carryover** (see page 6 of the instructions). Subtract line 8 from line 1. If zero or less, enter -0-		38,216		36,676		
Adjustment to Itemized Deductions (Individuals Only) Complete lines 10 through 34 for the carryback year(s) for which you itemized deductions **only** if line 3 or line 4 above is more than zero.						
10 Adjusted gross income before 2004 NOL carryback	28,234		17,940			
11 Add lines 3 through 5 above						
12 Modified adjusted gross income. Add lines 10 and 11	28,234		17,940			
13 Medical expenses from Sch. A (Form 1040), line 4 (or as previously adjusted)						
14 Medical expenses from Sch. A (Form 1040), line 1 (or as previously adjusted)	800					
15 Multiply line 12 by 7.5% (.075)	2,118					
16 Subtract line 15 from line 14. If zero or less, enter -0-						
17 Subtract line 16 from line 13						

Form **1045** (2004)

9

For Example 10

Form 1045 (2004) GLENN JOHNSON 123-45-6789 Page 4

Schedule B—NOL Carryover *(Continued)*

Complete one column before going to the next column. Start with the earliest carryback year.	2nd preceding tax year ended ▶ 2002		1st preceding tax year ended ▶ 2003		___ preceding tax year ended ▶	
18 Modified adjusted gross income from line 12 on page 3	28,234		17,940			
19 Enter as a positive number any NOL carryback from a year before 2004 that was deducted to figure line 10 on page 3						
20 Add lines 18 and 19	28,234		17,940			
21 Charitable contributions from Sch. A (Form 1040), line 18 (or as previously adjusted)						
22 Refigured charitable contributions (see page 6 of the instructions)						
23 Subtract line 22 from line 21						
24 Casualty and theft losses from Form 4684, line 18 (or as previously adjusted)						
25 Casualty and theft losses from Form 4684, line 16 (or as previously adjusted)						
26 Multiply line 18 by 10% (.10)						
27 Subtract line 26 from line 25. If zero or less, enter -0-						
28 Subtract line 27 from line 24						
29 Miscellaneous itemized deductions from Sch. A (Form 1040), line 26 (or as previously adjusted)						
30 Miscellaneous itemized deductions from Sch. A (Form 1040), line 23 (or as previously adjusted)	230		240			
31 Multiply line 18 by 2% (.02)	565		359			
32 Subtract line 31 from line 30. If zero or less, enter -0-						
33 Subtract line 32 from line 29						
34 Complete the worksheet on page 8 of the instructions if line 18 is **more than** the applicable amount shown below (more than one-half that amount if married filing separately for that year). • $111,800 for 1994. • $114,700 for 1995. • $117,950 for 1996. • $121,200 for 1997. • $124,500 for 1998. • $126,600 for 1999. • $128,950 for 2000. • $132,950 for 2001. • $137,300 for 2002. • $139,500 for 2003. Otherwise, combine lines 17, 23, 28, and 33; enter the result here and on line 6 (page 3)						

Form **1045** (2004)

DOCUMENTS TO ATTACH TO FORMS 1045 OR 1040X

If applicable, copies of the following items from the taxpayer's return for the NOL year should be attached to Form 1040X or Form 1045:

- Form 1040 and Schedules A, D, and J
- All forms and schedules that are part of the NOL, such as Form 4797 and Schedules C, E, and F
- Any Schedule K-1 that reported a loss included in the NOL computation
- Any request for an extension that was filed
- Form 4952, *Investment Interest Expense Deduction*
- Form 8271, *Investor Reporting of Tax Shelter Registration Number*
- Form 8886, *Reportable Transaction Disclosure Number*
- Form 8302, *Electronic Deposit of Tax Refund of $1 Million or More*
- For carryover years, attach Form 1040 and any other forms or schedules that are changed because of the loss carryback, such as Schedule A and credits

COURT CASES

Substantiation Requirement

Mr. and Mrs. Green claimed deductions from an NOL carryover on their 1998 and 1999 tax returns. Neither of the returns provided any detail regarding the computation of the carryovers. Since 1980, the Greens computed their NOL carryover by deducting in full any NOL carried over to that year and treating the loss on the taxable income line of their income tax return as the NOL carryover to the next year.

A taxpayer claiming an NOL must file a concise statement explaining the amount of the NOL deduction claimed and all material and pertinent facts, including a detailed schedule showing the computations of the NOL deduction with his return.[2] Because Mr. and Mrs. Green did not substantiate their claimed deductions, either on the return or in court, the court disallowed their NOL carryovers.[3]

9

Proper Election

Susan Kilburg had an NOL arising from her 1996 income tax return. After talking with her CPA, Susan claimed she attached a handwritten note to her return stating:

The amount of $52,690 on line 22 of the 1040 enclosed is business losses for 1996 (see Schedule C). These losses will be carried forward to future years to offset future income.

Kilburg also claimed she attached a similar note to her amended 1996 return, as well as her 1997 and 1998 returns where she carried over the 1996 NOL.

The IRS claimed it did not possess a copy of the note and none of the copies of Kilburg's tax returns produced at trial contained the note. A note was given to an IRS auditor during the examination of the 1998 return; however, the amount of the loss mentioned in the note was $150,132, which is the corrected AGI calculated on the amended 1996 return.

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2. Treas. Reg. §1.172-1(c)

3. *Allan and Judy Green,* TC Memo 2003-244, August 14, 2003 (Same result as above for *Herschel and Roberta Hoopengarner,* TC Memo 2003-343, December 17, 2003)

The IRS denied Kilburg's carryover and required her to carry the NOL back to 1993 (a 3-year carryback period applied at that time). A review of her prior years' tax returns revealed the 1996 NOL would have been exhausted during the carryback period, leaving none available to be carried forward to her 1997 income tax return.

Although the court was not convinced that the IRS ever received the handwritten notes, it proceeded on the assumption they were timely submitted. However, since nothing in the handwritten notes mentioned an election to forgo the carryback period or referenced §172, the court concluded that the election was not properly filed and Kilburg was denied the carryover.[4]

In another case, the 5th Circuit Court held that *"at the very least, an election under IRC §172 must correctly cite §172"* in order to be valid.[5]

ISSUE 2: VEHICLE EXPENSES

For purposes of this section, the terms "vehicle," "automobile," and "car" are used interchangeably and are intended to meet the definition of a "passenger automobile" subject to the listed property restrictions.[6] A passenger automobile includes any four-wheeled vehicle or a part or component physically attached to such vehicle (but not including noncapitalized repairs), if the vehicle:

- Was made primarily for use on public roads
- Weighs 6,000 lbs. or less
    - Measured by unloaded gross vehicle weight for passenger automobiles
    - Measured by loaded gross vehicle weight (including passengers and cargo) for trucks and vans
- Is **not** one of the following:
    - A nonpersonal use truck or van that has been modified for business use, such as a delivery truck with seating for a driver only;
    - A vehicle for pay or hire used directly in the business of transporting people or property, such as a taxi; or
    - An ambulance or hearse, or combination ambulance-hearse, used directly in a business.

REQUIRED RECORDKEEPING

Travel expenses should be documented in a log book or journal, and recorded as close to the time of travel as possible. Documentation should include the date, distance traveled, location visited, and business purpose for each trip. Separate mileage records should be maintained for each vehicle the taxpayer uses for business.

Taxpayers should record odometer readings for each year the vehicle is in service. The readings are recorded on the first day the vehicle is placed in service and on December 31, or at the close of the taxpayer's fiscal year. There is no need to record mileage at the beginning of each subsequent year since there should be no difference between the December 31 and the January 1 odometer readings. Special rules apply when converting a vehicle from personal use to business use. The special rules are discussed under the depreciation heading in this section. A vehicle's total mileage for the tax year is calculated from these readings.

Observation. Oil change records or other maintenance receipts may contain information on odometer readings that can help reconstruct mileage records for taxpayers who have neglected to document their readings.

4. *Susan Kilburg,* TC Summary Opinion 2004-36, March 23, 2004

5. *Powers v Commr.,* US-CT-APP-5, 95-1 USTC ¶50,086, January 26, 1995

6. IRC §280F(d)(5)

Special Recordkeeping Rule for Farmers

Farmers who use their automobiles or light trucks for direct farming activities during their normal business day can deduct 75% of their automobile's expenses or mileage without keeping detailed records. **Direct farming activities** include cultivation; harvesting; raising, sheering, caring for, training, and managing animals; and driving to feed or supply stores. Farmers must opt to use this method in the first year their vehicle is placed in service and cannot switch to another method later. Farmers who can prove their vehicle exceeded 75% business use can deduct their actual percentage of expenses.

Cohan Rule

Taxpayers without adequate records may be able to invoke the **Cohan Rule.** Under this rule, the taxpayer presents the court with an estimate of expenses. The court then determines whether to accept the estimate, depending on the reason the records are not available and the taxpayer's occupation, income, and efforts shown in attempting to keep records. A foundation for a reasonable approximation can be established by using evidence to support oral and written statements. The court can accept, modify, or reject the taxpayer's estimate. Usually the court's estimate is lower than that presented by the taxpayer.

EXPENSE REPORTING

Employees report unreimbursed employment-related travel expenses on Form 2106, *Employee Business Expenses.* Expenses from this form are carried to Schedule A as miscellaneous itemized deductions, subject to the 2% limitation. Self-employed individuals report their business travel expenses on Schedules C or F. Other qualified travel expenses are deducted on the schedule appropriate for the income, such as Schedule E for travel expenses related to rental property. Taxpayers provide information on the number of business, commuting, and personal miles traveled during the year on page 2 of either their Schedule C or Form 4562, *Depreciation and Amortization.*

> **Note.** Expenses incurred for commuting to or from work or for parking at a regular work location are **not deductible.**

METHODS USED TO DEDUCT VEHICLE EXPENSES

Taxpayers can usually choose between the actual expenses method and the standard mileage rate method to report their vehicle expenses. However, certain circumstances prohibit taxpayers from using the standard mileage rate.

Actual Expenses Method

Actual expense deductions should be supported by receipts. Taxpayers must prorate expenses if they use their vehicles less than 100% for business. Expenses are prorated by multiplying the actual expenses incurred during the year by the vehicle's business-use percentage, determined by dividing business miles by total miles driven during the year. Exceptions for converting from business to personal use and for short tax years are discussed later.

Allowable expenses include items such as fuel, oil, tires, maintenance, repairs, insurance, parking fees, tolls, license fees, and registration fees. Depreciation and §179 elections can be claimed in addition to operating expenses, but may be subject to limitations. Self-employed individuals can also deduct the business-use portion of any interest paid on loans for their vehicles, but **employees cannot deduct interest on car loans.**

Example 11. Barbara drove her vehicle 30,000 miles during the year; 20,000 of these miles were business related. She incurred the following annual expenses:

Gas, oil, etc.	$2,800
License fee	100
Insurance	550
Repairs/maintenance	1,050
Total	$4,500

Barbara is allowed to deduct 66.67% (20,000 ÷ 30,000) of her vehicle's expenses on her Schedule C. Her deduction for operation and maintenance of her vehicle is $3,000 ($4,500 × 66.67%). Barbara is also allowed a deduction for depreciation and 66.67% of any interest she paid on her vehicle.

Planning Tip. To maximize allowable deductions, employees should deduct state and local personal property taxes paid on business-use automobiles on line 7 of Schedule A instead of Form 2106. Self-employed individuals should reduce their business income by the allowable percentage of these taxes and take the balance on Schedule A, if applicable.

Standard Mileage Rate Method

In lieu of reporting actual expenses, taxpayers may opt for the standard mileage rate method if they qualify. But taxpayers who want to use this method **must choose the standard mileage rate for the first year** they place their vehicle in service. The mileage rate for 2005 is **40.5¢ per mile**.

Restrictions on Using the Standard Mileage Rate Method. The standard mileage rate **cannot** be used if any of the following circumstances apply:

1. The vehicle was used for hire, such as a taxicab.
2. The vehicle was previously subject to any form of accelerated depreciation (i.e. MACRS, §179, or bonus depreciation).
3. The vehicle was provided by the taxpayer's employer (unreimbursed expenses may still be claimed as miscellaneous itemized deductions).
4. The vehicle was leased and the taxpayer claimed actual expenses on it after 1997.
5. The taxpayer operates a fleet of five or more cars at the same time.

Note. Alternating use of five or more cars is acceptable.

6. The taxpayer is a rural mail carrier who received a qualified (nontaxable) reimbursement.

Note. The American Jobs Creation Act of 2004 allows rural mail carriers to deduct actual expenses in excess of qualified reimbursements on Schedule A as a miscellaneous itemized deduction, subject to the 2% limitation. Form 2106 must be completed and attached.

Qualified reimbursements are equipment maintenance allowances (EMA) given to U.S. Postal Service employees at a rate contained in their 1991 collective bargaining agreement or any later agreement that does not increase the reimbursement amount by more than the rate of inflation.[7]

7. IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses,* page 15

Additional Deductions Allowed under the Standard Mileage Rate Method. Taxpayers opting for the standard mileage rate can also deduct expenses for business parking and tolls. However, fees paid to park at a place of employment are considered commuting expenses and are not deductible. Self-employed taxpayers can also deduct the business-use portion of any interest paid on their vehicles.

Taxpayers are **not allowed to take a depreciation deduction** for vehicles under this method because a depreciation allowance has been built into the standard rate. This deemed depreciation allowance is 17¢ per mile for 2005. Depreciation allowances for previous years are listed below:

Year(s)	Depreciation Rate per Mile
2003–2004	.16
2001–2002	.15
2000	.14
1994–1999	.12
1992–1993	.115
1989–1991	.11
1988	.105
1987	.10
1986	.09
1983–1985	.08
1982	.075
1980–1981	.07

These rates are used to determine the remaining basis upon disposition of a business-use auto for which a standard mileage rate deduction has been taken. To calculate the depreciation deduction deemed under the standard rate each year, multiply the business miles driven that year by the applicable depreciation rate per mile. Reduce the basis of the vehicle by the total amount of deemed depreciation allowed for all years, but never reduce the basis below zero.

Switching Methods

A taxpayer is usually allowed to switch from the standard mileage rate method to the actual expenses method, but cannot switch from actual to standard if the actual expenses method was used in the vehicle's first year. Taxpayers who opt to use the standard mileage rate for leased vehicles must use it for the entire lease period. For leases or renewals that began on or after December 31, 1997, the standard mileage rate must be used for the entire portion of the lease period occurring after 1997.

If a taxpayer opts to switch to the actual method, the vehicle's basis must be reduced by any deemed depreciation computed under the standard rate. Then the remaining balance is depreciated using the straight-line method over the estimated remaining useful life of the car.[8]

8. Treas. Reg. §1.167(a)-1(b)

Example 12. On January 2, 2005, Tammy paid $4,000 for a used Ford Escort with 75,000 miles on the odometer. She drove it a total of 25,000 miles during the year, 20,000 of which were business miles. Her 2005 deemed depreciation allowance is $3,400 (20,000 × .17) of the total $8,100 (20,000 × .405) she is allowed to deduct under the standard mileage rate.

Tammy's remaining basis in the Escort is $600 ($4,000 – $3,400). If she opts to switch to the actual expenses method in 2006, she must depreciate this $600 basis using the straight-line method over the estimated remaining useful life of her car. If Tammy estimates she will get 150,000 miles out of her Escort and she will continue to put 25,000 on it per year, her 2006 depreciation deduction would be $300, computed as follows:

Estimated useful life (in miles)	150,000
Less elapsed miles	(100,000)
Estimated useful miles remaining	50,000

Estimated remaining useful life = 50,000 remaining miles ÷ 25,000 miles per year = 2 years

2006 depreciation deduction = $600 remaining basis ÷ 2 years useful life = $300

DEPRECIATION AND §179 DEDUCTIONS

Taxpayers deducting automobile expenses under the actual expenses method are allowed a deduction for depreciation on the business-use portion of their vehicles and may be allowed an additional depreciation deduction under §179. However, these deductions are subject to limitations.

Three items must be established to determine a vehicle's depreciation deduction:

1. Vehicle's basis
2. Date the vehicle was placed in service
3. Depreciation method, including the recovery period

Basis

A vehicle's basis for depreciation is referred to as its **unadjusted basis.** However, this term is misleading. To arrive at the depreciable basis figure, the original cost of the vehicle must be modified as follows:

1. **Increase** the original cost by:
   - Amounts paid for sales tax, destination charges, and dealer preparation fees, and
   - The cost of any substantial improvements.
2. **Decrease** the original cost by:
   - Any §179 deduction or special bonus depreciation allowance claimed,
   - Any deductible casualty loss, and
   - Any amounts claimed for diesel fuel tax, gas guzzler tax, clean-fuel vehicle credit, or qualified electric vehicle credit.

Date

Depreciation begins when a car is placed in service for use in an income-producing activity, including business or investment activity. Depreciation cannot be claimed on a vehicle that is placed in service and disposed of within the same tax year.

Method

Vehicles are generally depreciated under MACRS using a 5-year recovery period. However, the straight-line method must be used if the vehicle's first-year expenses were determined under the standard mileage rate. The straight-line method must also be used any year a vehicle is used less than 50% for business.

Converted from Personal Use

Special rules apply when a vehicle is converted from personal use to business use. Basis in this situation is determined by the lesser of the vehicle's fair market value (FMV) or the taxpayer's adjusted basis in the vehicle on the date of conversion.

When a car is converted mid-year, the computation of deductible expenses is altered to reflect only expenses for the portion of the year when the vehicle was "in service." The following formula is used to calculate deductible expenses for vehicles converted from personal to business use:

1. The percentage of business use for the period following the conversion is determined by dividing the business miles by the total miles driven during that period.
2. The percentage in #1 is multiplied by a fraction, the numerator of which is the number of months the car is used for business and the denominator of which is 12.

Depreciation Limits on Listed Property

The IRS restricts depreciation deductions for certain items of listed property. Passenger automobiles are considered listed property and are subject to depreciation limitations. Although these depreciation caps are commonly referred to as **luxury auto limitations**, the term is misleading because it gives the impression that the caps apply only to expensive automobiles. In fact, these limitations apply to moderately priced vehicles, starting as low as $14,800 for automobiles and $16,300 for vans and trucks.

9

The limits are applied per vehicle and §179 and bonus depreciation deductions are included when calculating the maximum allowable deduction. Limits must be prorated by the business-use percentage of each vehicle used less than 100% for business. Taxpayers with **short tax years** are also required to prorate their maximum deductions by multiplying the applicable limit by a fraction, the numerator of which is the number of months and partial months in the short tax year and the denominator is 12.

Maximum deductions are determined by the vehicle's classification and the year in which it was placed in service. Different limits apply depending on whether a vehicle is classified as a car, truck, or van. The latter category includes certain light trucks as well as vans and passenger automobiles that are built on truck chassis, such as minivans and SUVs. Electric vehicles placed in service after August 5, 1997, and before January 1, 2007, are allowed deductions at three times the limit for regular automobiles.[9]

The 2005 maximum depreciation deduction limits for each category are provided in the following chart.

> **Note.** See Chapter 14, "Tax Rates and Useful Tables," for limits on vehicles purchased in prior years.

[9] IRC §280F(a)(1)(C)

Year Placed in Service: 2005	Automobiles	Light Trucks and Vans	Electric Vehicles
First (2005)	$2,960	$3,260	$ 8,880
Second (2006)*	4,700	5,200	14,200
Third (2007)*	2,850	3,150	8,450
Fourth and later (2008+)*	1,675	1,875	5,125

* If used each consecutive year for business

Vehicles Exempt from the Maximum Auto Limitations. A truck, van, or SUV is exempt from the maximum depreciation limitation if it is built on a truck chassis and meets one of the two following qualifications:

1. Weighs more than 6,000 lbs., gross loaded vehicle weight, or
2. If placed in service on or after July 7, 2003,
   - Weighs 6,000 lbs. or less, gross loaded vehicle weight, and
   - Meets the description of a "qualified nonpersonal use vehicle."

A **qualified nonpersonal use vehicle** is a vehicle designed specifically for business purposes. This includes trucks and vans that are specially modified so that they are unlikely to be used more than a minimal amount for personal purposes. This includes vehicles that regularly carry merchandise or equipment, have permanent shelving installed, and are painted to display advertising.

> **Note.** Chapter 7, "Depreciation," contains information about the depreciation limit change to heavy-duty SUVs.

Example 13. On January 2, 2005, Harvey placed in service an automobile he purchased for $20,000. He uses the actual-expenses method and wants to claim his maximum allowed depreciation deduction. He drives 25,000 miles during the year, 20,000 of which were for qualified business purposes. His business use percentage is 80% (20,000 ÷ 25,000). His basis for depreciation is $16,000 ($20,000 cost × 80% business-use).

Harvey's maximum allowed depreciation deduction for 2005 is $2,368, computed as follows:

Depreciable basis	$16,000
MACRS first-year depreciation rate; 5-yr. recovery period	× .20
MACRS first-year depreciation (before limitation)	$ 3,200
Maximum allowable depreciation deduction for 2005	$ 2,960
Prorated for the business-use percentage	× .80
Reduced maximum depreciation limit for 2005	$ 2,368

If his business-use percentage continues at 80%, Harvey is allowed the following depreciation deductions:

Year	Applicable MACRS %	MACRS Deduction (on $16,000)	Maximum Allowable Deduction	Maximum Deduction at 80%	Allowable Depreciation Deduction	Remaining Basis (from $16,000)
2005	20.00%	$3,200	$2,960	$2,368	$2,368	$13,632
2006	32.00%	5,120	4,700	3,840	3,840	9,792
2007	19.20%	3,072	2,850	2,280	2,280	7,512
2008	11.52%	1,843	1,675	1,340	1,340	6,172
2009	11.52%	1,843	1,675	1,340	1,340	4,832
2010	5.76%	922	1,675	1,340	922	3,910

If Harvey's business use continues to be 80% after 2010, he can continue to claim a depreciation deduction on the car until it is fully depreciated. His remaining basis for depreciation at the end of the MACRS recovery period is $3,910. Depreciation for 2011 and later is calculated as follows:

Year	Applicable Deduction	MACRS (on $16,000)	Maximum Allowable Deduction	Maximum Deduction at 80%	Allowable Depreciation Deduction	Remaining Basis (from $16,000)
2011	N/A	$0	$1,675	$1,340	$1,340	$2,570
2012	N/A	0	1,675	1,340	1,340	1,230
2013	N/A	0	1,675	1,340	1,230	0

Maximizing Deductions. The following worksheet can be used to determine the optimal §179 deduction to claim in order to provide a maximum basis for future depreciation deductions. This calculation only works for vehicles that are below the luxury auto cost limitation thresholds ($14,800 for cars; $16,300 for vans and trucks).

IRC §179 Deduction for Automobiles

Business use percentage = (Business use mileage ÷ total mileage) × 100
(__________ ÷ __________) × 100 __________%

Reminder: The §179 deduction is not allowed if business use is 50% or less.

Maximum possible §179 deduction

1. This vehicle's "luxury" auto limitation × business percentage 1. __________
   __________ × __________%
2. Cost or other adjusted basis × business percentage 2. __________
   __________ × __________%
3. Enter 1st year depreciation percentage 3. __________
   (20% if half-year convention, different % if mid-quarter)
4. Multiply line 2 by line 3 4. __________
5. Subtract line 4 from line 1 5. __________
   If the result is less than zero, do not take the IRC §179 deduction
6. Subtract the percentage shown on line 3 from 100% 6. __________
   (For example, if line 3 is 20%, enter 80% (100% − 20%)).
7. §179 deduction. Divide line 5 by line 6 7. __________

Example 14. Marlene purchased an automobile in 2005 for $11,000. It was used 75% for qualified business purposes. Using the actual-expenses method, she depreciates it under MACRS, applying a 5-year recovery period and a half-year convention. To maximize her basis for future years' deductions, Marlene's optimal §179 deduction for 2005 is $713, computed as follows:

IRC §179 Deduction for Automobiles

Business use percentage = (Business use mileage ÷ total mileage) × 100
(__________ ÷ __________) × 100 __________%

Reminder: The §179 deduction is not allowed if business use is 50% or less.

Maximum possible §179 deduction

1. This vehicle's "luxury" auto limitation × business percentage 1. $2,220
   $2,960 × 75%
2. Cost or other adjusted basis × business percentage 2. $8,250
   $11,000 × 75%
3. Enter 1st year depreciation percentage 3. 20%
   (20% if half-year convention, different % if mid-quarter)
4. Multiply line 2 by line 3 4. $1,650
5. Subtract line 4 from line 1 5. $570
   If the result is less than zero, do not take the IRC §179 deduction
6. Subtract the percentage shown on line 3 from 100% 6. 80%
   (For example, if line 3 is 20%, enter 80% (100% − 20%)).
7. §179 deduction. Divide line 5 by line 6 7. $713

By claiming a $713 deduction under the §179 deduction, Marlene has a remaining depreciable basis of $7,537 ($8,250 – $713). She is allowed to deduct $1,507 ($7,537 × 20%) for her regular MACRS deduction in 2005. Marlene's total §179 and MACRS deductions equal the $2,220 ($2,960 × 75%) maximum she is allowed to claim in 2005.

Depreciation Schedule — $7,537 Basis after the §179 Deduction

Year	Applicable MACRS %	MACRS Deduction (on $7,537)	Maximum Allowable Deduction	Maximum Deduction at 75%	Allowable Depreciation Deduction	Remaining Basis (from $7,537)
2005	20.00%	$1,507	$2,960	$2,220	$1,507	$6,030
2006	32.00%	2,412	4,700	3,525	2,412	3,618
2007	19.20%	1,447	2,850	2,138	1,447	2,171
2008	11.52%	868	1,675	1,256	868	1,303
2009	11.52%	868	1,675	1,256	868	435
2010	5.76%	434	1,675	1,256	434	1

By taking the §179 deduction, Marlene's first-year depreciation is increased, but her future depreciation deductions are reduced. The following tables illustrate her allowable deductions without claiming additional first-year depreciation and the difference between the two options.

Depreciation Schedule — $8,250 Basis without the §179 Deduction

Year	Applicable MACRS %	MACRS Deduction (on $8,250)	Maximum Allowable Deduction	Maximum Deduction at 75%	Allowable Depreciation Deduction	Remaining Basis (from $8,250)
2005	20.00%	$1,650	$2,960	$2,220	$1,650	$6,600
2006	32.00%	2,640	4,700	3,525	2,640	3,960
2007	19.20%	1,584	2,850	2,138	1,584	2,376
2008	11.52%	950	1,675	1,256	950	1,426
2009	11.52%	950	1,675	1,256	950	476
2010	5.76%	475	1,675	1,256	475	1

Difference between Depreciating Full Basis and Taking §179

Year	Allowable Depreciation without §179	Allowable Depreciation after §179	Reduced Annual Depreciation Deductions
2005	$1,650	$1,507	($143)
2006	2,640	2,412	(228)
2007	1,584	1,447	(137)
2008	950	868	(82)
2009	950	868	(82)
2010	475	434	(41)
Total	$8,249	$7,536	($713)

Vehicles Used Less than 50% for Business

Special rules apply to nonexempt vehicles when qualified business use is less than 50%. These rules depend on whether the vehicle was first placed in service with less than 50% business use, or whether the business-use percentage fell below 50% after the first year.

First Year Placed in Service. If a vehicle is used for business 50% or less in its first year, it cannot be expensed under §179. It must be depreciated using the straight-line method with a 5-year recovery period. This method must continue over the life of the vehicle, regardless of whether the business use percentage increases.

Later Years. If a vehicle was first used more than 50% for business, but later its business-use percentage falls to 50% or less, the taxpayer must switch to straight-line depreciation for **all** years remaining in the vehicle's recovery period. **Any accelerated depreciation, including §179 and bonus depreciation taken in excess of allowable straight-line depreciation must be recaptured and included in income in the year the vehicle's business usage drops to 50% or less.** This recaptured amount is added back to the basis of the property.

SALE OR EXCHANGE OF A VEHICLE

The MACRS deduction for a vehicle sold during the tax year is reduced according to the normal MACRS rules for the year of sale (applying either the half-year or mid-quarter convention). However, the maximum annual vehicle depreciation limit remains the same. For example, an automobile placed in service in 2005 has a maximum third-year depreciation limit of $2,850 even if it is sold in 2007. The allowable depreciation deduction for the year of sale is the **lesser of**:

1. The maximum annual limit multiplied by the vehicle's business use percentage, or
2. The vehicle's annual MACRS depreciation deduction, computed according to the rules for the applicable convention in the year of sale.

The remaining basis of a vehicle that is traded or involuntarily converted after February 27, 2004, can be treated in one of two ways:

1. The transaction can be "ignored," and the old (traded-in) vehicle can continue to be depreciated as if it had not been traded. The basis of the acquired vehicle (less the trade-in allowance) is then depreciated separately. **This is the default method.**

> **Note.** Taxpayers choosing this option **must** use Form 4562. They cannot use Form 2106, Part II, Section D.

Two different depreciation limits must be applied under this method. The depreciation deduction on the remaining balance of the old vehicle is limited to the amount that would have been allowed for that year. The limit on the acquired vehicle is the applicable first-year limit reduced by the depreciation allowance claimed on the old vehicle.

> **Note.** It is possible to have no depreciation remaining for the new vehicle if the old vehicle used up the entire listed property limitation. This usually happens only when the old vehicle is exchanged in its first or second year of business use.

2. An election can be made to treat the transaction as a tax-free disposition. If this election is made, the old vehicle is treated as if disposed of at the time of the trade. The old vehicle's remaining basis is added to the cash paid (boot) for the acquired vehicle and then the total is depreciated as a new asset, beginning on the date the acquired vehicle was placed in service.

   This election is made by completing Form 2106, Part II, Section D. The election must be made on a timely filed return, including extensions. Once made, the election may be revoked only with the consent of the Commissioner.[10]

> **Note.** A detailed example of this calculation is included in Chapter 10, "Like-Kind Exchanges."

LEASED VEHICLES

A taxpayer leasing a vehicle for business purposes can use either the actual-expenses method or the standard mileage rate for determining deductible vehicle expenses. When using the actual-expenses method, a "lease inclusion" adjustment must be made to limit the deduction, corresponding to the "luxury auto" limitations. Sole proprietors must add this lease inclusion amount to income. The lease inclusion amount is determined by the vehicle's FMV and the year of the lease.

> **Note.** An excerpt from the lease inclusion tables is included at the end of this section.

The lease inclusion amount is determined by using the lease inclusion charts found in IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses.* The steps used to determine the amount are as follows:

1. Locate the FMV of the vehicle for the first year it was placed in service.
2. Find the applicable year in the lease term.
3. Determine the intersection point of these two items. This is the lease inclusion amount (reduction amount for employees).
4. If the vehicle is used less than 100% for business, multiply this inclusion amount by the business-use percentage.
5. Prorate the inclusion amount by the number of days the vehicle was leased during the year.

Example 15. Tim leases an auto for his sole proprietorship on July 1, 2005, for four years. In 2005, he drives the vehicle 20,000 total miles, of which 15,000 (75%) were business miles. The FMV of the vehicle was $28,750. The lease payment for the six months of usage was $3,000. Tim deducts 75% of the lease payments as car expenses on his Schedule C. His business use percentage remains at 75% for the remainder of his lease. Tim includes the following lease inclusion amounts as "Other Income":

Year	Amount	Calculation
2005	$ 24	$63 × (15,000 ÷ 20,000) × (184 ÷ 365)
2006	104	$138 × 75%
2007	154	$205 × 75%
2008	185	$247 × 75%
2009	106	$285 × 75% × (181 ÷ 365)

10. Prop. Temp. Treas. Reg. §1.168(I)6T(j)

EMPLOYEE USE OF A COMPANY CAR[11]

When an employee uses a company car for personal purposes, he is deemed to have income from the personal use and his employer must include this deemed income on his Form W-2. Payroll taxes are assessed on the deemed income and withheld from the employee's pay at least annually, but can be deducted more frequently.

There are two methods used to compute the deemed income from personal use. The employer has the option of using either the IRS annual lease value, or a cents-per-mile calculation to determine the amount reported as income to the employee.

Note. The Annual Lease Value Table is found at the end of this section.

Annual Lease Value Tables

The annual lease value inclusion amount is determined by the vehicle's classification (i.e., auto, truck/van, or electric car), the FMV of the vehicle when it was first used by the employee, and the applicable year elapsed in the leasing period. The inclusion amount must be prorated if an employee does not have access to the car for the entire year.

The tables used to compute inclusion amounts[12] assume 100% personal use. The employer has the option to use 100% or make an adjustment. If an employee uses a vehicle less than 100% for personal use, the inclusion amount must be adjusted. If an employer adds the full annual lease value to an employee's income, the employee can claim a deduction for the business use of the vehicle on Form 2106. The deemed income included on the employee's Form W-2 is then considered the amount the employee paid for the "lease" of the vehicle.

The vehicle's FMV is determined the first year it is provided to an employee and remains constant for a period of four full years, plus the first year's fractional year. If an employee receives use of the vehicle after January 1, the period runs for four full years, plus the partial year. After this period, the vehicle is revalued for a new four-year period.

Some employers have employees switch cars merely for purposes of having a lower "first year provided to employee" valuation, to save on payroll taxes. However, the IRS discourages abuse of this method by continuing to use the first employee's valuation amount when determining the inclusion amount for the second employee.

The tables do not consider employer-provided fuel when determining the amount of the inclusion. If the employer is providing fuel for a company car, an additional inclusion amount is determined using either the actual cost of the fuel consumed by the employee for personal purposes or 5.5¢ per personal mile. In most cases, the 5.5¢-per-mile option results in the lowest inclusion amount, as the following chart demonstrates:

	Mileage (MPG)					
Fuel Price	**15**	**20**	**25**	**30**	**35**	**40**
2.10	0.140	0.105	0.084	0.070	0.060	0.053
2.15	0.143	0.108	0.086	0.072	0.061	0.054
2.20	0.147	0.110	0.088	0.073	0.063	0.055
2.25	0.150	0.113	0.090	0.075	0.064	0.056
2.30	0.153	0.115	0.092	0.077	0.066	0.058
2.35	0.157	0.118	0.094	0.078	0.067	0.059
2.40	0.160	0.120	0.096	0.080	0.069	0.060
2.45	0.163	0.123	0.098	0.082	0.070	0.061
2.50	0.167	0.125	0.100	0.083	0.071	0.063

11. Temp. Treas. Reg. §1.61-2T

12. Found in the Appendix of IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*

An employer who **owns** a fleet of 20 or more cars can use a fleet average for each car instead of determining separate inclusion amounts in the year following the year the employer reaches the 20-car ownership test.

> **Example 16.** Seminars Everywhere provides its employee, David, a company car for both business and personal use on January 1, 2005. The car has a FMV of $20,000 at the time it is provided to David. He traveled a total of 25,000 miles during the tax year, of which 5,000 (20%) were for personal purposes.
>
> The annual lease inclusion value for David is $5,600, assuming 100% first-year business use on a $20,000 FMV. If David provided his own fuel, Seminars Everywhere would include $1,120 ($5,600 × 20%) on David's Form W-2. If Seminars Everywhere provided all of the fuel, David's deemed compensation would be $1,395. The additional $275 in income would reflect 5,000 personal miles at 5.5¢ per mile.

Cents-Per-Mile

The cents-per-mile method determines deemed income simply by multiplying the employee's personal miles by the standard mileage rate in effect for the tax year (40.5¢ per mile in 2005). If an employee buys his own fuel, then the standard mileage rate is reduced by 5.5¢ per mile when determining the amount of deemed compensation to include on the employee's Form W-2 (35¢ for 2005 inclusion calculations).

> **Example 17.** Use the same facts as in **Example 16,** except Seminars Everywhere uses the cents-per-mile method to determine David's additional income. If the company provided the fuel, David's deemed compensation from the personal use of his company car is $2,025 (5000 × .405). If David provided the fuel for his company car, his deemed compensation is $1,750 (5000 × .35). David may be able to deduct the actual cost of fuel for the 20,000 business miles on Form 2106 as an unreimbursed employee business expense, but he cannot claim the standard mileage rate for these miles.

Restrictions on Using the Cents-Per-Mile Method. The cents-per-mile method cannot be used if any of the following circumstances apply:

1. The FMV of the vehicle exceeds the luxury auto limitations.
2. The employer does not expect the vehicle to be used regularly in the trade or business during the year.
3. The vehicle is driven 10,000 miles or less during the year.

> **Note.** See Chapter 13, "Rulings and Cases" for information on Rev. Proc. 2005-48 in the "Gross Income" section of the chapter.

Commuting Only

This method uses $1.50 per one-way trip between work and the employee's residence. The following requirements must be met in order to use this method:

1. The car must be used in the employer's trade or business.
2. The employee must be required to commute in the car for "bona-fide noncompensatory business reasons," such as for the safety of the car.
3. The employer must have a written policy restricting the car from being used for any other personal miles and must reasonably expect the rule to be followed.
4. The person using the vehicle cannot be a "control employee," such as an officer, director, or anyone owning a 1% interest or more in the business.

SPECIAL ISSUES

Commuting to and from work is generally not deductible, even if a taxpayer is required to have a car available for business activities. Commuting is not deductible whether a taxpayer drives two blocks or 300 miles, even if there is no habitable community near the job site.[13]

However, deductible "commuting" expenses can result from a temporary assignment. If a taxpayer works outside his general area on a temporary basis, he is allowed a deduction even if he returns home each evening.[14] However, a union worker who traveled between his home and different job sites was denied a deduction for his travel expenses because each job site was considered his tax home as long as it was in the general area.[15]

If an assignment is indefinite, travel expenses are nondeductible. A requirement to bid on an assignment every few months does not create a "temporary" status in situations where the taxpayer expected to receive the bid and, in fact, did receive the bid more than 80% of the time.[16]

Police officers have been allowed to deduct commuting expenses because they were expected to respond to emergencies, oversee subordinates, and check in and out with a dispatcher when leaving or arriving at home.[17]

A deduction is sometimes allowable for the expense of hauling tools and bulky equipment to a jobsite, but the deduction is limited to the extra expenses incurred and there must be a valid business reason for carrying the equipment. A fireman was denied a deduction since he could not establish the extra cost of transporting his 26-pound uniform.[18]

13. *Raymond A and Vadna M. Sanders, et al. v. Commr.,* 439 F2d 296 (9th Cir. 1971), March 3, 1971

14. *James E. Peurifoy, et. al. v. Commr.,* 358 US 59, November 10, 1958

15. *Gail P. Christensen and Marvel S. Christensen v. Commr.,* TC Memo 1987-96, February 17, 1987

16. *Norman A and Doris J. Presson v. Commr.,* TC Memo 1988-191, May 3, 1988

17. *John R. and Carol Pollei v. Commr.,* 877 F2d 838 (10th Cir. 1989), June 13, 1989

18. Letter Ruling 8025167, March 27, 1980

Lease Inclusion Table

REV. PROC. 2005-13 TABLE 4
DOLLAR AMOUNTS FOR PASSENGER AUTOMOBILES (THAT ARE NOT TRUCKS, VANS, OR ELECTRIC AUTOMOBILES) WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2005

Fair Market Value of Passenger Automobile		Tax Year During Lease				
Over	Not Over	1st	2nd	3rd	4th	5th & Later
$15,200	$15,500	3	6	9	11	13
15,500	15,800	4	9	13	17	19
15,800	16,100	5	12	18	22	26
16,100	16,400	7	15	22	27	32
16,400	16,700	8	18	27	32	39
16,700	17,000	9	21	32	38	44
17,000	17,500	11	25	38	45	52
17,500	18,000	14	30	45	54	63
18,000	18,500	16	35	52	63	73
18,500	19,000	18	40	60	72	83
19,000	19,500	20	46	67	80	94
19,500	20,000	23	50	75	90	104
20,000	20,500	25	55	82	99	115
20,500	21,000	27	61	89	108	125
21,000	21,500	30	65	97	117	135
21,500	22,000	32	70	105	125	146
22,000	23,000	35	78	116	139	161
23,000	24,000	40	88	131	156	182
24,000	25,000	44	98	146	175	202
25,000	26,000	49	108	161	192	223
26,000	27,000	54	118	175	211	244
27,000	28,000	58	128	191	228	265
28,000	29,000	63	138	205	247	285
29,000	30,000	67	149	220	264	306
30,000	31,000	72	159	234	283	326
31,000	32,000	77	168	250	300	348
32,000	33,000	81	179	265	318	367
33,000	34,000	86	189	279	336	389
34,000	35,000	90	199	295	354	409
35,000	36,000	95	209	309	372	430
36,000	37,000	99	219	325	389	451
37,000	38,000	104	229	339	408	471
38,000	39,000	109	239	354	426	491
39,000	40,000	113	249	370	443	512
40,000	41,000	118	259	384	462	533
41,000	42,000	122	269	400	479	554
42,000	43,000	127	279	414	497	575
43,000	44,000	132	289	429	515	595
44,000	45,000	136	299	444	533	616
45,000	46,000	141	309	459	551	636
46,000	47,000	145	320	473	569	657
47,000	48,000	150	329	489	587	678
48,000	49,000	154	340	504	604	699
49,000	50,000	159	350	518	623	719

Lease Inclusion Table

REV. PROC. 2005-13 TABLE 5 DOLLAR AMOUNTS FOR TRUCKS AND VANS WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2005						
Fair Market Value of Truck or Van		Tax Year During Lease				
Over	Not Over	1st	2nd	3rd	4th	5th and Later
$16,700	$17,000	3	6	8	10	11
17,000	17,500	4	10	14	17	20
17,500	18,000	7	15	21	26	30
18,000	18,500	9	20	29	35	40
18,500	19,000	11	25	37	43	51
19,000	19,500	14	30	44	52	61
19,500	20,000	16	35	51	62	71
20,000	20,500	18	40	59	71	81
20,500	21,000	20	45	67	79	92
21,000	21,500	23	50	74	88	103
21,500	22,000	25	55	81	98	113
22,000	23,000	28	63	92	111	129
23,000	24,000	33	73	107	129	149
24,000	25,000	38	83	122	147	169
25,000	26,000	42	93	137	165	190
26,000	27,000	47	103	152	183	210
27,000	28,000	51	113	167	201	231
28,000	29,000	56	123	182	218	253
29,000	30,000	60	133	197	237	272
30,000	31,000	65	143	212	254	294
31,000	32,000	70	153	227	272	314
32,000	33,000	74	163	242	290	335
33,000	34,000	79	173	257	308	355
34,000	35,000	83	184	271	326	376
35,000	36,000	88	193	287	344	397
36,000	37,000	93	203	302	361	418
37,000	38,000	97	214	316	380	438
38,000	39,000	102	223	332	397	459
39,000	40,000	106	234	346	415	480
40,000	41,000	111	244	361	433	500
41,000	42,000	115	254	376	451	521
42,000	43,000	120	264	391	469	542
43,000	44,000	125	274	406	487	562
44,000	45,000	129	284	421	505	583
45,000	46,000	134	294	436	523	603
46,000	47,000	138	304	451	541	624
47,000	48,000	143	314	466	558	645
48,000	49,000	148	324	481	576	666
49,000	50,000	152	334	496	594	687

Annual Lease Value Table

(1) Automobile FMV	(2) Annual Lease Value
$0 to 999	$ 600
1,000 to 1,999	850
2,000 to 2,999	1,100
3,000 to 3,999	1,350
4,000 to 4,999	1,600
5,000 to 5,999	1,850
6,000 to 6,999	2,100
7,000 to 7,999	2,350
8,000 to 8,999	2,600
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250

ISSUE 3: FORM 4797

Although the concept behind Form 4797 is taxpayer-friendly, many tax practitioners approach this form with trepidation because of its complexity. Part of this complexity is due to the concept of recharacterizing gains and losses from the sale or exchange of business assets. Since IRC §1221(2) excludes land, buildings, and equipment used in business from its definition of "capital assets," taxpayers would be prohibited from receiving favorable capital gain treatment on business and investment property. However, Form 4797 recharacterizes gains and losses from the sale or exchange of business assets, often to the taxpayer's advantage, by treating noncapital assets as capital assets and certain nonsale transactions as recognized sales.

This section focuses on:

- The purpose of Form 4797,
- How to classify assets according to the Code,
- Where to report transactions on the Form 4797, and
- Special applications of Form 4797.

PURPOSE OF FORM 4797

Form 4797, *Sales of Business Property (Also Involuntary Conversions and Recapture Amounts under Sections 179 and 280F(b)(2))*, is a multi-purpose form used to report a variety of transactions, such as:

1. The sale or exchange of:
   - Property used in trade or business,
   - Depreciable and amortizable property,
   - Oil, gas, geothermal, or other mineral properties, and
   - §126 property;
2. The involuntary conversion (from other than casualty or theft) of property used in a trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit;
3. The disposition of noncapital assets (other than inventory or property held primarily for sale to customers in the ordinary course of trade or business);
4. The disposition of capital assets not reported on Schedule D;
5. The gain or loss (including any related recapture) for partners and S corporation shareholders from certain §179 property dispositions by partnerships (other than electing large partnerships) and S corporations; and
6. The computation of recapture amounts under §§179 and 280F(b)(2) when the business use of §179 or listed property decreases to 50% or less.

INTERNAL REVENUE CODE CLASSIFICATIONS

To complete Form 4797, it is important to understand code classifications for property. Many tax software programs require users to identify the proper code section before entering information onto Form 4797.

IRC §1231 Property

Section 1231 property is long-term property used in a trade or business, or involuntarily converted capital assets held long-term in connection with a trade or business. This category includes all depreciable property and real property.

Property Used in a Trade or Business. The phrase "used in a trade or business" has a very specific meaning in the context of §1231. For an asset to meet this definition:

1. It must be held for more than one year (unless a longer holding period is specified);
2. It must be used in a trade or business and be either:
   - Depreciable property or
   - Real property; and
3. It cannot be inventory or property that is held for sale in the ordinary course of business.

The courts have further clarified this phrase to encompass assets that are "devoted to the trade or business" or bought with the expectation of use in a business, even if the business use never materialized due to circumstances beyond the taxpayer's control.[19] An asset's classification as business-use property is generally determined by its status at the time of sale rather than at the time of purchase.[20]

> **Note.** Generally, case law indicates that rental real estate is classified as §1231 trade or business property and not IRC §1221 investment property.

Holding Period. "Long-term" usually means held more than one year. However, cattle and horses require a two-year holding period to satisfy the requirements of §1231. Inherited property is considered held for the length of time that the estate and beneficiary, combined, held the property, but the holding period is automatically stepped up to "more than one year."[21] This usually satisfies the long-term holding requirement for §1231, but assets requiring a longer holding period for favorable tax treatment must actually be held for the longer period.

Example 18. Jack inherited breeding cattle from Cindy on July 1, 2005. If he sells the cattle anytime prior to July 1, 2006, he is considered to have held them for more than one year. However, cattle require a holding period of at least 24 months to obtain the long-term holding status required for §1231 capital gain treatment.

Jack must hold the cattle until July 1, 2007 to be eligible for the long-term capital gain rate. The special "stepped-up" holding provision for inherited property does not apply to property that requires a holding period in excess of one year to qualify for §1231 treatment.

Involuntary Conversion. Involuntary conversions for purposes of §1231 include conversions in any one of the following three groups:

1. Destruction by fire, storm, shipwreck, or other casualty, but only if the conversion gains exceed the conversion losses
2. Theft or seizure, but only if the conversion gains exceed the conversion losses
3. Condemnation, or the threat or imminence of condemnation

Casualty Losses. A casualty is defined as the damage, destruction, or loss of property resulting from an unforeseen event that is sudden, unexpected, or unusual. Examples include fires, thefts, storms, floods, tornadoes, vandalism, earthquakes, and hurricanes.

9

19. *Carter-Colton Cigar Co. v. Commr.,* 9 TC 219, August 20, 1947
20. *S.O. and Fannie Bynum v. Commr.,* 46 TC 295, June 3, 1966
21. IRC §1223(11)

Example 19. Because of a flood on July 1, 2005, Bradford's equipment used in his business was destroyed. He acquired the equipment on July 1, 1969, for $18,000. The equipment's FMV before the flood was $15,000. It was fully depreciated, resulting in a zero basis. He received $15,000 from the insurance company for the loss of the equipment. He decides not to replace the equipment. Bradford realizes a $15,000 gain, the difference between the insurance proceeds and his zero basis. He cannot defer the gain because he did not replace the equipment. Bradford reports the $15,000 as shown on the following Form 4684, *Casualties and Thefts*, and Form 4797.

The $15,000 gain is subject to the §1245 recapture rules and is reported as ordinary income on Form 4797. The $15,000 gain is carried from Form 4684, line 22 to Form 4797, Part III. The zero capital gain from Form 4797, line 32, is carried back to Form 4684, line 33.

For Example 19

Form 4684 (2005) Attachment Sequence No. **26** Page **2**

Name(s) shown on tax return. Do not enter name and identifying number if shown on other side. — Bradford

Identifying number 111-22-3333

SECTION B—Business and Income-Producing Property

Part I Casualty or Theft Gain or Loss (Use a separate Part I for each casualty or theft.)

19 Description of properties (show type, location, and date acquired for each property). Use a separate line for each property lost or damaged from the same casualty or theft.

Property **A** __________

Property **B** __________

Property **C** __________

Property **D** __________

		Properties A	B	C	D
20 Cost or adjusted basis of each property	20	0			
21 Insurance or other reimbursement (whether or not you filed a claim). See the instructions for line 3	21	15,000			
Note: *If line 20 is* ***more*** *than line 21, skip line 22*					
22 Gain from casualty or theft. If line 21 is **more** than line 20, enter the difference here and on line 29 or line 34, column (c), except as provided in the instructions for line 33. Also, skip lines 23 through 27 for that column. See the instructions for line 4 if line 21 includes insurance or other reimbursement you did not claim, or you received payment for your loss in a later tax year.	22	15,000			
23 Fair market value **before** casualty or theft	23				
24 Fair market value **after** casualty or theft	24				
25 Subtract line 24 from line 23	25				
26 Enter the **smaller** of line 20 or line 25	26	0			
Note: *If the property was totally destroyed by casualty or lost from theft, enter on line 26 the amount from line 20.*					
27 Subtract line 21 from line 26. If zero or less, enter -0-	27	0			

28 Casualty or theft loss. Add the amounts on line 27. Enter the total here and on line 29 **or** line 34 (see instructions) — 28 — 0

Part II Summary of Gains and Losses (from separate Parts I)

(a) Identify casualty or theft		(b) Losses from casualties or thefts (i) Trade, business, rental or royalty property	(b) (ii) Income-producing and employee property	(c) Gains from casualties or thefts includible in income
Casualty or Theft of Property Held One Year or Less				
29		( )	( )	
		( )	( )	
30 Totals. Add the amounts on line 29	30	( )	( )	
31 Combine line 30, columns (b)(i) and (c). Enter the net gain or (loss) here and on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions			31	
32 Enter the amount from line 30, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, partnerships, and S corporations, see instructions			32	
Casualty or Theft of Property Held More Than One Year				
33 Casualty or theft gains from Form 4797, line 32			33	
34		( )	( )	
		( )	( )	
35 Total losses. Add amounts on line 34, columns (b)(i) and (b)(ii)	35	( )	( )	
36 Total gains. Add lines 33 and 34, column (c)			36	
37 Add amounts on line 35, columns (b)(i) and (b)(ii)			37	
38 If the loss on line 37 is **more** than the gain on line 36:				
a Combine line 35, column (b)(i) and line 36, and enter the net gain or (loss) here. Partnerships (except electing large partnerships) and S corporations, see the note below. All others, enter this amount on Form 4797, line 14. If Form 4797 is not otherwise required, see instructions			38a	
b Enter the amount from line 35, column (b)(ii) here. Individuals, enter the amount from income-producing property on Schedule A (Form 1040), line 27, and enter the amount from property used as an employee on Schedule A (Form 1040), line 22. Estates and trusts, enter on the "Other deductions" line of your tax return. Partnerships (except electing large partnerships) and S corporations, see the note below. Electing large partnerships, enter on Form 1065-B, Part II, line 11.			38b	
39 If the loss on line 37 is **less** than or **equal** to the gain on line 36, combine lines 36 and 37 and enter here. Partnerships (except electing large partnerships), see the note below. All others, enter this amount on Form 4797, line 3			39	

Note: *Partnerships, enter the amount from line 38a, 38b, or line 39 on Form 1065, Schedule K, line 11. S corporations, enter the amount from line 38a or 38b on Form 1120S, Schedule K, line 10.*

Printed on recycled paper Form **4684** (2005)

9

For Example 19

Form 4797 (2005) Bradford 111-22-3333 Page 2

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	Equipment from 4684	07-01-1969	07-01-2005
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	15,000			
21	Cost or other basis plus expense of sale	21	18,000			
22	Depreciation (or depletion) allowed or allowable	22	18,000			
23	Adjusted basis. Subtract line 22 from line 21	23	0			
24	Total gain. Subtract line 23 from line 20	24	15,000			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	18,000			
b	Enter the **smaller** of line 24 or 25a	25b	15,000			
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975 (see instructions)	26a				
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c	Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d	Additional depreciation after 1969 and before 1976	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f	26g				
27	**If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a	Soil, water, and land clearing expenses	27a				
b	Line 27a multiplied by applicable percentage (see instructions)	27b				
c	Enter the **smaller** of line 24 or 27b	27c				
28	**If section 1254 property:**					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b	Enter the **smaller** of line 24 or 28a	28b				
29	**If section 1255 property:**					
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b	Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	15,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	15,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Section 1231 Treatment

One of the primary functions of Form 4797 is to determine which property qualifies for §1231 treatment. This is determined by aggregating all of a taxpayer's §1231 gain and loss transactions. If the total transactions result in a net gain, the net gain is treated as long-term capital gain. If the total of the transactions results in a net loss, the net loss is treated as an ordinary loss.

Qualifications. To qualify for §1231 treatment, property — such as land, building, and equipment — must be either:

1. Used in a trade or business, or
2. Subject to an involuntary conversion, and:
   - Used in a trade or business, or
   - A capital asset held for more than a year in connection with a trade or business, or a transaction entered into for profit.

Example 20. Scott's only §1231 transaction in 2005 was the sale of land he used in his business. He purchased the land on October 20, 1963, for $20,000. He sold it on November 8, 2005, for $30,000 and paid his broker a $1,400 commission. Since Scott's total §1231 transactions resulted in a net gain, his profit from the sale qualifies for capital gain treatment.

Scott computes his gain on the sale on Form 4797, Part I, as shown. The gain is carried to his Schedule D for computation of the tax on capital gains.

Form **4797** — **Sales of Business Property**
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
Department of the Treasury, Internal Revenue Service (99)
▶Attach to your tax return. ▶See separate instructions.
OMB No. 1545-0184 — **2005** — Attachment Sequence No. **27**

Name(s) shown on return: **Scott** — Identifying number: **123-45-6789**

1 Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	30,000

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)

	(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)
2	Land	10/20/1963	11/08/2005	30,000		21,400	8,600

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	8,600
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 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 from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

...y Gains and Losses (see instructions)

Property Specifically Identified for §1231 Treatment. The following list includes property specifically identified as §1231 property:[22]

1. Timber for which the owner made an IRC §631(a) election to treat the cutting as a sale or exchange
2. Timber, coal, or domestic iron ore sold under a contract that retains an economic interest for the taxpayer
3. Cattle and horses held for draft, breeding, dairy, or sporting purposes and **held for 24 months** or more
4. Other livestock, not including poultry, held for draft, breeding, dairy, or sporting purposes and held for 12 months or more
5. Unharvested crops that are:
   - On land used in the trade or business that has been held for more than one year, and
   - Sold or exchanged at the same time and to the same person as the land.

Property Specifically Excluded from §1231 Treatment.[23] The following property is not considered §1231 property:

1. Copyrights, literary, musical or artistic compositions, letters, memorandums, or similar property[24] held by:
   - A taxpayer whose personal efforts created the property,
   - Property produced for the taxpayer, such as a letter, memorandum, or similar property, or
   - Property from a taxpayer, described in the prior two bullets, in a transaction that gave him a carryover basis in the property.
2. A publication of the United States government that is received from the United States government, or any of its agencies, other than by purchase at the price at which it is offered for sale to the public,[25] and that is held by:
   - A taxpayer who received the publication from the United States government, or
   - A taxpayer who acquired the property from a taxpayer described in the above transaction that gave him a carryover basis in the property.

Losses from **involuntary conversions** are excluded from §1231 treatment if:

1. The involuntary conversion is due to theft, fire, storm, shipwreck, or other casualty, and
2. The losses from the conversions exceed the gains from the conversions for the taxable year.

Example 21. On July 10, 2005, the city acquired 10 acres of vacant land by condemnation from Teresa. Teresa purchased the land on December 13, 1991, for $100,000 to use as an investment. She paid an attorney $5,000 to represent her in the eminent domain proceeding. She received $75,000 for the land from the city.

Teresa reports her $30,000 loss from this involuntary conversion on Form 4797, Part I. She has no further transactions to report on her Form 4797. Therefore, this loss is carried to Part II and deemed an ordinary loss. Teresa deducts the full $30,000 in 2005.

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22. IRC §1231(b)
23. IRC §1231(b)(1)
24. IRC §1231(b)(1)(C)
25. IRC §1231(b)(1)(D)

For Example 21

Form **4797** Department of the Treasury Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶Attach to your tax return. ▶See separate instructions.

OMB No. 1545-0184 2005 Attachment Sequence No. 27

Name(s) shown on return: Teresa | Identifying number: 123-45-6789

1 Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . 1 | 75,000

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)

(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)
2 Land	12/13/1991	07/10/2005	75,000		105,000	(30,000)

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	(30,000)

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 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 from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9 Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7	11	((30,000))
12 Gain, if any, from line 7 or amount from line 8, if applicable	12	
13 Gain, if any, from line 31	13	
14 Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15 Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17 Combine lines 10 through 16	17	(30,000)

18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:

a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), 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 18a." See instructions	18a	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	(30,000)

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9

Observation. The characterization of this transaction as an ordinary loss provides an advantage to Teresa because she can deduct the full loss against current income. If the loss had been characterized as a capital loss, she would be limited to a $3,000 capital loss deduction per year.

IRC §1245

Section 1245 property is long-term depreciable property, which is also personal property. This category includes:

- Amortizable IRC §197 intangibles acquired after August 10, 1993 (or after July 25, 1991, if the election was made to apply §197 to the intangibles).
- Nonresidential real property for which regular ACRS deductions were taken. This includes real property placed in service after 1980 and before 1987 which was depreciated using regular (accelerated) ACRS. If straight-line depreciation was used, the property is classified §1250.
- A single-purpose agricultural structure, a storage facility used in connection with the distribution of petroleum products, or railroad grading or tunnel bore.

IRC §1250

Section 1250 property is any real property held long-term which is not §1245 property and is subject to an allowance for depreciation. This includes all intangible real property, such as leases for §1250 property or land.

Section 1250 property does not include real property which is used as an integral part of manufacturing, production, extraction or used to furnish transportation, communications, electrical energy, gas, water or sewage disposal services, or research or storage facilities used in connection with these activities.

Property Converted from §1250 to §1245. Property which began as §1250 property, but was later converted to §1245 property, remains §1245 property forever. This category includes nonresidential real estate except property for which regular ACRS deductions were taken. When regular (accelerated) ACRS deductions were taken, the nonresidential real estate was reclassified as §1245 property.

IRC §1252

Section 1252 property is farmland for which deductions were taken relating to soil and water conservation under IRC §175 and land clearing expenses under IRC §182.

IRC §1254

Section 1254 property is property that has had intangible drilling and development costs, mineral development expenditures, and mining expenditures charged against it; oil and gas properties subject to intangible drilling and development costs; or geothermal wells subject to intangible drilling costs.

IRC §1255

Section 1255 property is property that has been acquired, improved, or otherwise modified through cost sharing payments excludable from income under IRC §126.

REPORTING TRANSACTIONS ON FORM 4797

While many IRS forms provide preparers with step-by-step instructions on how to determine whether there is a gain or a loss on a transaction, Form 4797 requires preparers to know in advance whether there is a gain or a loss. Before entering a transaction on Form 4797, a preparer must establish whether a gain or loss has occurred, classify the property by code section, and determine whether the property satisfies the long-term holding requirements for its code section classification. Once this information is established, the following chart can be used to determine the appropriate section of Form 4797 (Part I, II, or III) on which to first enter the transaction.

Form 4797 — Location of First Entry

Type of Property	Held 1 Year or Less	Held More than 1 Year
1. Depreciable trade or business property		
Sold or exchanged at a gain	Part II	Part III (§1245, §1250)
Sold or exchanged at a loss	Part II	Part I
2. Depreciable residential rental property		
Sold or exchanged at a gain	Part II	Part III (§1250)
Sold or exchanged at a loss	Part II	Part I
3. Farmland held less than 10 years upon which soil, water, or land clearing expenses were deducted		
Sold at a gain	Part II	Part III (§1252)
Sold at a loss	Part II	Part I
4. Disposition of cost-sharing payment property described in §126	Part II	Part III (§1255)
	Held Less than 24 Months	**Held 24 Months or More**
5. Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes		
Sold at a gain	Part II	Part III (§1245)
Sold at a loss	Part II	Part I
Raised cattle and horses sold at a gain	Part II	Part I
	Held Less than 12 Months	**Held 12 Months or More**
6. Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes		
Sold at a gain	Part II	Part III (§1245)
Sold at a loss	Part II	Part I
Raised livestock sold at a gain	Part II	Part I

Form 4797, Part III

Unlike other IRS forms that begin on page 1 and continue to page 2, Form 4797 is frequently completed from the back page forward. Long-term business assets that are subject to depreciation recapture on their disposition are first reported in Part III. Any gain from Part III is brought forward to page 1. This gain may be divided between Parts I and II, depending on whether the gain is §1231 gain or ordinary gain.

Form 4797, Part II

Ordinary gains and losses flow from Part III of Form 4797 to Part II. All transactions involving short-term business assets are also reported in Part II, whether resulting in a gain or a loss. Other items reported in Part II include:

- Involuntary conversions of business-use property held short-term
- Losses up to $50,000 ($100,000 if MFJ) reported on the sale or exchange of IRC §1244 small business stock (excess §1244 stock losses are reported on Schedule D)
- Involuntary conversion of investment property held short-term and resulting in a loss
- Income from noncompete covenants

Individuals carry their ordinary gains and losses from Form 4797, Part II to Form 1040, page 1.

Form 4797, Part I

Part I of Form 4797 is where "left over" transactions are reported. Part I is used to report any §1231 (capital) transactions that are not required to be reported in Part III. Net §1231 gains are carried to Form 1040, Schedule D, for application of the preferential capital gains tax rate.

RECAPTURE OF NET IRC §1231 LOSSES FROM PRIOR YEARS

Section 1231 gains are normally treated as long-term capital gains. The term recapture refers to the recharacterization of §1231 gains as ordinary income.[26] Net §1231 gains incurred during the year must be reported as ordinary income to the extent that §1231 losses were deducted against ordinary income in the previous five years and have not been recaptured. This requires taxpayers to keep a running balance of all unrecaptured §1231 losses in order to calculate the net §1231 gain that must be reported as ordinary income. Prior years net §1231 losses are considered in Form 4797, Part I.

Example 22. Shane has the following IRC §1231 gains and losses:

Year	Gain (Loss)
2000	($10,000)
2001	(10,000)
2002	15,000
2003	10,000
2004	(7,000)
2005	12,000

Shane's §1231 recapture history is charted below:

Year	§1231 Income	Loss Recaptured	Remaining Loss to Recapture	Gain Reported	
				Ordinary	Capital
2000 loss	($10,000)	0	$10,000	$ 0	$ 0
2002 gain	15,000	10,000	0	10,000	0
2001 loss	(10,000)	0	10,000	0	0
2002 gain remainder	5,000	5,000	5,000	5,000	0
2003 gain	10,000	5,000	0	5,000	5,000
2004 loss	(7,000)	0	7,000	0	0
2005 gain	12,000	7,000	0	7,000	5,000

26. IRC §1231(c)

For Example 22

Form **4797** — Department of the Treasury, Internal Revenue Service (99)

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

►Attach to your tax return. ►See separate instructions.

OMB No. 1545-0184 — **2005** — Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Shane	345-67-8901

1 Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

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)

	(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)
2							

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	12,000
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	12,000

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 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 from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	7,000
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	5,000

Part II — Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	7,000
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	7,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), 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 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	7,000

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2005)

9

SECTION 1245 RECAPTURE

When §1245 property is sold or transferred, taxpayers are required to report as ordinary income the lesser of the gain realized or the depreciation previously claimed on the asset. In general, this rule applies to depreciable personal property and certain real property, such as single-purpose agricultural and horticultural structures and property used as an integral part of production.

The following items are considered depreciation subject to recapture:

- Regular depreciation deductions
- Any amount claimed as a §179 deduction or bonus depreciation deduction
- Any basis reduction connected to a discharge of indebtedness[27]
- The basis reduction from claiming the investment credit[28]
- The deduction for qualified clean-fuel vehicle property or refueling property[29]
- Deductions claimed for removal of architectural and transportation barriers to the handicapped and elderly;[30] deductions for tertiary injectant expenses;[31] or deductions for transfers of franchises, trademarks, and trade names, as in effect before Omnibus Budget Reconciliation Act of 1993.[32]

Example 23. On November 13, 2005, Erika sold a building for $40,000 that she used in her business. She incurred $1,500 of expenses to sell the building. She had purchased the building for $35,000 on June 30, 1985, and fully depreciated it under ACRS. Her gain on the sale is subject to §1245 recapture because she depreciated nonresidential real property under an accelerated method.

> **Note.** Land values have been excluded from this example.

Erika first enters this transaction on Form 4797, Part III, and completes lines 25a and 25b. Her net gain on the sale is $38,500 ($40,000 – $1,500). The portion of gain representing the $35,000 in recaptured depreciation is classified as ordinary income and carried to Form 4797, Part II, line 13. This gain is carried to Erika's Form 1040, line 14. The $3,500 balance is characterized as §1231 gain, and qualifies for capital gain treatment. Erika carries this amount from line 32 of Form 4797, Part III, to line 6 of Part I. It eventually is carried to her Schedule D for computation of the favorable tax on long-term capital gains.

RECAPTURE FROM A LIKE-KIND EXCHANGE

Gain recognized from a like-kind exchange is subject to the same recapture rules as gain recognized from a sale.

Section 1245 Property. Gain recognized from the exchange of §1245 property is ordinary income to the extent of depreciation claimed on the property. Gain in excess of the depreciation claimed is §1231 gain.

Section 1250 Property. Gain that is recognized from the exchange of §1250 property is ordinary income to the extent that depreciation claimed on the property exceeds straight-line depreciation. The remaining gain is §1231 gain.

> **Note.** If the §1231 gain from §1250 property is treated as long-term capital gain, the gain due to straight-line depreciation is subject to the 25% maximum capital gains rate. The gain in excess of depreciation claimed is subject to the more favorable capital gains tax rates of 5% or 15%, depending on the taxpayer's tax bracket.

27. IRC §108
28. IRC §50(c)(4)(A)
29. IRC §179A(e)(4)
30. IRC §190
31. IRC §193
32. IRC §§1253(d)(2) or (3)

Example 24. In 2005, Rachel traded in a combine with a FMV of $40,000 and an adjusted basis of $22,000. She purchased the combine for $50,000 and claimed $28,000 in depreciation on it. She traded it for $15,000 cash and a corn planter with a FMV of $25,000. The trade qualifies as a like-kind exchange since the combine and corn planter are both included in the same NAICS product class.

Rachel realized a gain of $18,000 on the exchange, computed as follows:

Trade-in value of combine	$40,000
Adjusted basis of combine	(22,000)
Gain realized	$18,000

However, recognized gain is limited to the lesser of gain realized or boot received. In this case, the recognized gain is limited to the $15,000 boot Rachel received. Since the depreciation claimed on the tractor exceeded the recognized gain, the full $15,000 is attributed to §1245 recaptured depreciation. The deferred gain on the exchange is $3,000 ($18,000 – $15,000).

To compute her §1245 recapture when she sells the planter, Rachel must add $13,000 of unrecaptured depreciation from the combine (figured below) to the total depreciation she claims on the corn planter.

Total depreciation claimed on combine	$28,000
Less recaptured depreciation included in 2004 income	(15,000)
Unrecaptured depreciation from trade	$13,000

Rachel's Form 8824, *Like-Kind Exchanges*, and Form 4797 are shown on the following pages:

9

For Example 24

Form **8824** Department of the Treasury Internal Revenue Service

Like-Kind Exchanges

(and section 1043 conflict-of-interest sales)

▶ Attach to your tax return.

OMB No. 1545-1190 2005 Attachment Sequence No. 109

Name(s) shown on tax return: **Rachel** | Identifying number: **333-22-1111**

Part I Information on the Like-Kind Exchange

Note: *If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.*

1 Description of like-kind property given up ▶ **Combine**

2 Description of like-kind property received ▶ **Corn Planter**

3	Date like-kind property given up was originally acquired (month, day, year)	3	07 / 01 / 2001
4	Date you actually transferred your property to other party (month, day, year)	4	04 / 01 / 2005
5	Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written notice requirement	5	04 / 01 / 2005
6	Date you actually received the like-kind property from other party (month, day, year). See instructions	6	04 / 01 / 2005

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . ☐ Yes ☒ No

Related Party Exchange Information

04

Form 8824 (2005) Page 2

Name(s) shown on tax return. Do not enter name and social security number if shown on other side. **Rachel** | Your social security number **333 22 1111**

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: *If you transferred* ***and*** *received* ***(a)*** *more than one group of like-kind properties or* ***(b)*** *cash or other (not like-kind) property, see* ***Reporting of multi-asset exchanges*** *in the instructions.*

Note: *Complete lines 12 through 14* ***only*** *if you gave up property that was not like-kind. Otherwise, go to line 15.*

12	Fair market value (FMV) of other property given up	12	
13	Adjusted basis of other property given up	13	
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale. **Caution:** *If the property given up was used previously or partly as a home, see* ***Property used as home*** *in the instructions.*	14	
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)	15	15,000
16	FMV of like-kind property you received	16	25,000
17	Add lines 15 and 16	17	40,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15 (see instructions)	18	22,000
19	**Realized gain or (loss).** Subtract line 18 from line 17	19	18,000
20	Enter the smaller of line 15 or line 19, but not less than zero	20	15,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)	21	15,000
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)	22	0
23	**Recognized gain.** Add lines 21 and 22	23	15,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24	3,000
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23	25	22,000

Deferral of Gain From Section 1043 Conflict-of-Interest Sales

For Example 24

Form **4797** Department of the Treasury Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶Attach to your tax return. ▶See separate instructions.

OMB No. 1545-0184 **2005** Attachment Sequence No. **27**

Name(s) shown on return: **Rachel** — Identifying number: **333-22-1111**

1 Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) . . . **1**

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)

(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)
2						

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	

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 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 from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	15,000
17	Combine lines 10 through 16	17	15,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), 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 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	15,000

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2005)

Note. A thorough discussion of like-kind exchanges appears in Chapter 10 of this workbook.

9

RECAPTURE UNDER THE INSTALLMENT SALE METHOD

Under the installment sale method, a taxpayer usually reports gain on a sale when payments are received instead of reporting the full gain in the year of sale.

> **Note.** A sale can qualify as an installment sale if only one payment is received after the close of the tax year.

Taxpayers must report only the portion of the principal payments received during the year that represent the gross profit ratio from the sale.

However, all depreciation recaptured from the sale of personal property must be taxed in the year of sale, regardless of the amount received on principal. Since §1245 property is rarely sold for more than its cost, all gain on the sale is usually attributed to recaptured depreciation. Therefore, an installment sale of §1245 property will more than likely result in the entire gain being taxed in the year of sale, making the installment method an unattractive option for sellers.

Unlike the §1245 depreciation recapture rules, §1250 does not require all depreciation to be recaptured in the year of sale. Thus, §1250 depreciation is recaptured as installment payments are received, with gains applied first to unrecaptured depreciation until the full amount is recaptured.

Example 25. In 2005, Joe Smith sold a shed used on his farm on contract for $8,000. Joe purchased the shed for $6,000 in 1994 and claimed $3,300 depreciation on it using MACRS ADS with a 20-year recovery period and a half-year convention.

Joe realized a gross profit of $5,300 on the $8,000 sale, making his gross profit ratio 66.25% ($5,300 ÷ $8,000). Joe received $1,000 in principal payments in 2005. He must report $663 ($1,000 × 66.25%) gain from the sale in 2005. The installment sale is reported on Form 6252, *Installment Sale Income,* and the gain is carried to Form 4797, line 4 as shown:

For Example 25

Form **6252** | **Installment Sale Income** | OMB No. 1545-0228

Department of the Treasury, Internal Revenue Service

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

2005 Attachment Sequence No. **79**

Name(s) shown on return: Joe Smith — Identifying number: 111-22-3333

1 Description of property ▶ Farm Shed
2a Date acquired (month, day, year) ▶ 06 / 11 / 1994 **b** Date sold (month, day, year) ▶ 08 / 11 / 2005
3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . ☐ Yes ☒ No
4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . ☐ Yes ☒ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated			5	8,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	8,000		
8	Cost or other basis of property sold	8	6,000		
9	Depreciation allowed or allowable	9	3,300		
10	Adjusted basis. Subtract line 9 from line 8	10	2,700		
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	2,700
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)			14	5,300
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	5,300
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	8,000

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions			19	.6625
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated			21	1,000
22	Add lines 20 and 21			22	1,000
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	663
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)			26	663

Part III **Related Party Installment Sale Income. Do not** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party ....

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /
b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
d ☐ The second disposition occurred after the death of the original seller or buyer.
e ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2005 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2005)

9

For Example 25

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶Attach to your tax return. ▶See separate instructions.

OMB No. 1545-0184

2005

Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Joe Smith	111-22-3333

1 Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1

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)

	(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)
2							

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	663
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	663

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 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 from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

For Example 25

Form 4797 (2005) **Joe Smith** **111-22-3333** Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Farm Shed	06/11/1994	08/11/2005
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	8,000			
21 Cost or other basis plus expense of sale	21	6,000			
22 Depreciation (or depletion) allowed or allowable	22	3,300			
23 Adjusted basis. Subtract line 22 from line 21	23	2,700			
24 Total gain. Subtract line 23 from line 20	24	5,300			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	0			
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

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

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Printed on recycled paper Form **4797** (2005)

9

RECAPTURE WHEN TRADING MACHINERY FOR LEASED ASSETS

The trade of purchased machinery for leased machinery does not qualify as a like-kind exchange. If purchased machinery is traded for leased machinery, the purchased machinery is treated as if it was sold and reported accordingly. The value (money or other property) received for the purchased machinery is considered to be a lease payment on the leased machinery. This lump-sum "lease" payment is deductible. However, it must be prorated to reflect only lease payments due during the tax year since prepaid lease payments are only deductible in the year for which they apply. This may result in trade-in allowances being spread over more than one year.

Example 26. On July 1, 2005, Spencer traded Machinery A for a 5-year lease on Machinery B. He purchased Machinery A for $50,000 on March 3, 1985, and it is fully depreciated. The lease requires an $18,000 payment each year for five years.

Spencer was given a credit of $15,000 on the trade. He must report this $15,000 as income in 2005 for the sale of Machinery A. However, since Spencer's lease payment is calculated at $1,500 per month ($18,000 ÷ 12 months), he is only allowed a lease deduction of $9,000 for the six months of the lease term in 2005. He can deduct the balance of $6,000 in 2006.

RECAPTURE OF IRC §179 DEDUCTIONS

Recapture of §179 is triggered when the business use of property placed in service in an earlier year falls to 50% or less during the recapture period. The recapture period is the entire recovery period of the qualifying §179 property.[33]

Recaptured §179 deductions are reported on Form 4797. The recapture amount equals the §179 expense deduction less the MACRS depreciation amount that would have been allowed on the §179 deduction from the time the property was placed in service, up to and including the year of recapture.[34]

DEPRECIATION RECAPTURE OF LISTED PROPERTY

If a §179 deduction was claimed on an item of listed property and the business use of that property later falls to 50% or less, the §179 deduction must be recaptured along with any excess depreciation.[35] Recapture rules[36] require the taxpayer to report as income the difference between:

1. The depreciation and §179 deductions that were claimed, and
2. The depreciation that would have been allowed using the alternative MACRS depreciation rules for years prior to the current year.

The following items are considered listed property subject to recapture provisions:

- Passenger automobiles
- Other property used for transportation
- Property of a type generally used for entertainment, recreation, or amusement, including photographic, phonographic, communication, and video recording equipment
- Computers and related peripheral equipment, **unless** used only at a regular business establishment and owned or leased by the person operating the establishment (an office in the home qualifies as a regular business establishment **if and only if** that portion of the home is used both regularly and exclusively for business)
- Cellular telephones, or similar telecommunication equipment, placed in service or leased in a tax year beginning after 1989

33. IRC §179(d)(10)
34. Treas. Reg. §1.179-1(e)(1)
35. IRC §280F(d)
36. IRC §280F(b)(2)

Example 27. Stacy paid $5,000 for a computer in 2001. She used the computer 80% for her direct sales business and 20% for personal use. Her basis in the business portion of the computer is $4,000 ($5,000 × 80%). Since her office is located in the corner of her kitchen, her computer is considered listed property.

Stacy claimed a $3,000 §179 deduction for the computer on her 2001 income tax return. She depreciates the remaining $1,000 basis using MACRS with a 5-year recovery period and a half year convention. She claimed the following depreciation deductions:

Year	Depreciation Rate	Depreciable Basis	Depreciation
2001	20.00%	$1,000	$ 200
2002	32.00%	1,000	320
2003	19.20%	1,000	192
Total regular depreciation claimed			$ 712
2001 §179 deduction claimed			3,000
Total deprecation claimed on computer			$3,712

In 2004, Stacy's sales slumped and her business use of the computer fell to only 40%. Because her business-use percentage for this listed property item fell below 50%, Stacy must recapture her §179 deduction and any MACRS depreciation claimed in excess of the amount allowed under alternative MACRS. The alternative MACRS method for computers requires a straight-line depreciation over an ADS recovery period of six years. Stacy's depreciation recapture is $2,044, calculated as follows:

Year	Depreciation Rate	Depreciable Basis	Depreciation
2001	8.34%	$4,000	$ 334
2002	16.67%	4,000	667
2003	16.67%	4,000	667
Total depreciation under MACRS ADS			$1,668
Total depreciation claimed on computer			$3,712
Less total allowable depreciation (ADS)			(1,668)
Excess depreciation to be recaptured			$2,044

Stacy reports this recapture as ordinary income on Form 4797, Part IV. She must include the $2,044 of recaptured depreciation as "other income" on her 2004 Schedule C. Stacy's 2004 depreciation deduction for her computer is calculated as follows:

Original (unadjusted) basis	$5,000
2004 business use %	× .40
Basis for depreciation in 2004	$2,000
MACRS ADS rate	× .1667
2004 depreciation deduction	$ 333

Note. Recaptured depreciation on property used in a trade or business is subject to self-employment tax, and should be included on the taxpayer's Schedule C or F as "other income."

Observation. The basis in property is increased by the amount of recaptured depreciation included in income. However, this basis adjustment only applies to the computation of gain or loss on the disposition of the asset. Depreciation is computed on the unadjusted basis of an asset multiplied by the applicable business use percentage for the year.

9

DEPRECIATION RECAPTURE FOR PROPERTY OTHER THAN LISTED PROPERTY

If the business use of property other than listed property falls to 50% or less, taxpayers must report as ordinary income the difference between the §179 expense claimed and the depreciation that would have been allowed if the asset had not been expensed under §179.

The following steps are taken to calculate the recapture amount:

1. Calculate depreciation that would have been allowed on the amount of the §179 deduction, beginning with the year the property was placed in service and ending with the year of recapture.
2. Subtract the depreciation figured in step (1) from the amount of the §179 deduction claimed.

Example 28. Jerry bought a livestock trailer for $10,000 in 2002. He used the trailer 100% for hauling cattle for his farming operations in 2002 and 2003. He claimed $2,000 of his $10,000 basis as a §179 deduction in 2002, and depreciated the remaining $8,000 business basis using the 150% declining-balance method.

Jerry began using his trailer to haul horses for pleasure riding in 2004, thereby reducing his business use of the trailer to 40%. Since his business use was reduced below 50%, Jerry is required to recapture his excess §179 deduction as other income on his 2004 Schedule F. The excess §179 deduction is calculated as follows:

Year	Depreciation Rate	§179 Claimed	Business Use %	Allowable Depreciation
2002	10.71%	$2,000	100%	$ 214
2003	19.13%	2,000	100%	383
2004	15.03%	$2,000	40%	120
Total depreciation allowable on $2,000 §179 deduction				$ 717
Total §179 deduction claimed in 2002				$2,000
Total regular depreciation allowable on $2000				(717)
Excess §179 to be recaptured				$1,283

Jerry's adjusted basis for gain or loss on disposition of the trailer is increased by this $1,283 of recaptured depreciation, but his basis for depreciation will be reduced to reflect the applicable business use percentage. His 2004 depreciable basis is $4,000 ($10,000 × 40% business use).

IRC §197 INTANGIBLES RECAPTURE

Goodwill and other §197 assets purchased after August 9, 1993, are classified as §197 property and are amortizable by the buyer on a straight-line basis over 15 years. The sale of a §197 asset is reported on Form 4797 as §1245 property. Any gain up to the amortization allowed is carried to Form 4797, Part II, and is taxable as ordinary recapture income. Any excess gain is carried to Form 4797, Part I, and is eligible for capital gain tax rates.

Goodwill **created** by the taxpayer is still reported directly on Schedule D as a business capital asset.

Example 29. Ronald purchased an existing tax business for $100,000 on January 8, 1995. The entire purchase price was designated goodwill since there were no physical assets other than copies of tax returns. Ronald claimed $63,333 of amortization for the goodwill through the date of the sale.

Ronald sold the business on July 1, 2005, for $250,000, with the entire amount designated as goodwill. Following is Ronald's Form 4797 for the sale.

Note. More information on §197 intangibles can be found in Chapter 12, "New Legislation," on page 459.

For Example 29

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶Attach to your tax return. ▶See separate instructions.

OMB No. 1545-0184

2005

Attachment Sequence No. **27**

Name(s) shown on return: **Ronald**

Identifying number: **222-33-4444**

1	Enter the gross proceeds from sales or exchanges reported to you for 2005 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

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)

	(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)
2							

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	150,000

Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 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 from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	63,333
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	63,333
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), 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 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	63,333

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2005)

9

For Example 29

Form 4797 (2005) Ronald 222-33-4444 Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Goodwill	01/08/1995	07/01/2005
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	250,000			
21 Cost or other basis plus expense of sale	21	100,000			
22 Depreciation (or depletion) allowed or allowable	22	63,333			
23 Adjusted basis. Subtract line 22 from line 21	23	36,667			
24 Total gain. Subtract line 23 from line 20	24	213,333			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a	63,333			
b Enter the **smaller** of line 24 or 25a	25b	63,333			
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	213,333
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	63,333
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	150,000

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

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

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RECAPTURE FOR NONRESIDENTIAL USE OF TAXPAYER'S RESIDENCE (OFFICE IN THE HOME)

When a taxpayer uses part of her principal residence for a business activity, the sale-of-residence exclusion under §121 may or may not apply. When the nonresidential portion is not attached to the dwelling unit, the sale must be treated as two separate sales. One sale is of the principal residence, and the other is a sale of business property.

When the nonresidential portion is part of the dwelling unit, the gain on the entire property can be excluded under §121, **except for depreciation applicable for the period after May 6, 1997.** Gain from depreciation allowed or allowable on any business or rental usage of the property after May 6, 1997, is not eligible for the §121 exclusion.

The taxpayer's basis in the property is reduced by all depreciation allowed/allowable, not just the depreciation claimed after May 6, 1997. Gain on the sale is calculated based on this adjusted basis, then reduced by the depreciation allowed/allowable after May 6, 1997. Net gain after this reduction is eligible for the §121 exclusion.

S CORPORATION AND PARTNERSHIP REPORTING

Provided a §179 deduction was not claimed on an asset, an S corporation reports the sale of business assets on Form 4797 in the same manner as individuals. The Schedule K-1 (Box 9, Form 1120S) reports the net §1231 gains or losses from an S corporation. This amount is passed through to the shareholder and reported on the shareholder's Form 4797.

Net gain is carried to the shareholder's Schedule D for potential favorable tax treatment, but the shareholder must first apply nonrecaptured §1231 loss carryover rules to the gain. If a net loss is passed through, it offsets the shareholder's other §1231 gains, if any, before being carried to the bottom of the shareholder's Form 4797 and eventually to his Form 1040.

Information should be provided with the individual Schedules K-1 informing shareholders of the amount of unrecaptured §1250 gain included on their Schedule K-1. Shareholders need this information to properly calculate their tax on Form 1040 Schedule D.

If a §179 deduction was claimed on the disposed property, the S corporation does not report the sale on the corporate return, but instead separately states the following information:

- The property's description, purchase date, sales date, and sales price
- The amount of depreciation allowed or allowable for the property, **not** counting any §179 expense deduction
- The amount of the §179 expense deduction previously reported to the shareholder on Schedule K-1, along with the year it was passed-through to the shareholder

A **partnership** reports these sales in the same manner as an S corporation.

Example 30. DG Corporation is an S corporation with two equal shareholders, Cole and Emma. The corporation purchased equipment for $30,000 on February 18, 2002, and elected to expense $24,000 under §179. DG correctly passed the §179 deduction through to its shareholders in 2002. The corporation then claimed $1,592 in depreciation on the remaining basis of $6,000 ($857 in 2003 and $735 in 2004).

DG Corporation sold the property for $28,000 on June 28, 2004. Since a §179 deduction was claimed on the equipment, DG does not complete a Form 4797. Instead, DG separately states the required information for each shareholder, according to the shareholder's percentage of ownership in the corporation. Cole and Emma then report their respective percentage of the sale on their individual returns.

As 50% shareholders, Cole and Emma each receive the following information with their 2004 Schedules K-1, reflecting their respective halves of the transaction:

Equipment purchased 02/18/2002	$15,000
Equipment sold 06/28/2004	14,000
Depreciation allowed/allowable	796
§179 passed through in 2002	12,000

Cole claimed the §179 pass-through on his 2002 return, so he reports his depreciation allowed/allowable as $12,796 on Form 4797, line 22. Since Cole's adjusted basis in the equipment is $2,204 ($15,000 – $12,796), his net gain from the sale of the equipment is $11,796 ($14,000 – $2,204).

Emma did not claim the §179 pass-through on her 2002 return, so she reports only $796 as her depreciation allowed/allowable on her Form 4797, line 22. Since Emma's adjusted basis in the equipment is $14,204 ($15,000 – $796), she reports a net loss of $204 ($14,000 – $14,204) on the sale of this equipment.

Note. When preparing the corporate or partnership Schedule M-2 for such transactions, the effect of such sales need to be reflected properly so as to be able to track inside basis.