

Chapter 3: Small Business Issues

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Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

In recent years, the IRS has updated regulations and created new programs, including several programs that affect small businesses. In addition to the pronouncements discussed in 2012 Volume A, Chapter 4: IRS Update, and Volume B, Chapter 6: Rulings and Cases, the significant issue of capitalization was recently addressed by the IRS. The issue of capitalization for tax purposes is discussed in Issue 1 of this chapter.

Although not covered in this chapter, another noteworthy occurrence was the creation of the **voluntary classification settlement program (VCSP)**. This program encourages prospective compliance from employers who have been incorrectly classifying employees as independent contractors. The VCSP allows eligible taxpayers to obtain relief similar to that currently available through the classification settlement program (CSP). The CSP is designed for taxpayers under examination, but the **VCSP is available for taxpayers before they are audited**. The incentives for voluntary compliance under this program are substantial. The VCSP is covered in more detail in 2012 Volume C, Chapter 4: Schedule C.

Some issues in this chapter cover topics that many practitioners find perplexing. The author provides insight into tax planning and proper reporting for these issues.

ISSUE 1. GUIDANCE ON TANGIBLE PROPERTY (TD 9564)

In December 2011, the IRS issued TD 9564, *Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property*.¹ This Treasury decision sets forth temporary regulations which replace the proposed regulations issued in 2008. Several components in these regulations differ from the 2008 proposed regulations.

The temporary regulations cover a significant number of historically contentious tax issues related to tangible property, such as the proper treatment of the following.

- Materials and supplies
- General asset accounts
- Acquisitions
- Repairs versus capital improvements

The regulations generally apply to amounts paid or incurred in tax years **beginning on or after January 1, 2012**. Taxpayers who want to change to a method of accounting permitted in these regulations must apply for approval. Rev. Procs. 2012-19 and 2012-20 explain the procedures by which taxpayers may apply for approval under the automatic consent rules.

¹ TD 9564, 2012-14 IRB 614.

MATERIALS AND SUPPLIES

General Rule

In general, amounts paid for materials and supplies are deductible in the tax year in which the materials and supplies are **used or consumed** in the taxpayer's operations.² The following types of property are included in materials and supplies.

1. A component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer
2. Material consisting of fuel, lubricants, water, and similar items, which are reasonably expected to be consumed in 12 months or less
3. A unit of property that has an economic useful life of 12 months or less
4. A unit of property that has an acquisition or production cost of \$100 or less

Incidental Materials and Supplies

Incidental materials and supplies may be deducted in the year purchased, even if they are not consumed by the end of the tax year. The characteristics of incidental materials and supplies are as follows.

- The items are kept on hand for the taxpayer's operations.
- No record of consumption is kept.
- No physical inventories are taken.

Example 1. Venus Airlines purchases a stock of spare parts in 2012 for maintenance of its fleet of airplanes. The mechanics keep a record of consumption of these parts. Because the company tracks the use of the parts, they do **not** qualify as incidental. Therefore, the costs of the parts are not deductible until they are consumed.

De Minimis Rule

Instead of treating materials and supplies under these rules, some taxpayers may qualify to use the de minimis rule,³ which is explained later in this chapter.

Election to Capitalize and Depreciate

A taxpayer may **elect** to capitalize and depreciate any items that would otherwise not qualify as deductible until they are consumed. However, if the material/part is a component of another material/part that is **not** being capitalized, the election is not allowed. The election is made by capitalizing the material/part on an original return filed by the tax return filing deadline (including extensions). It is revocable only by filing a private letter ruling request and obtaining the IRS's consent.

Rotable and Temporary Parts

Rotable parts are materials and supplies that meet the following criteria.⁴

1. Acquired for installation on a unit of property
2. Removable from that unit of property
3. Generally repaired or improved, and either reinstalled on the same or other property or stored for later installation

² Temp. Treas. Reg. §1.162-3T.

³ Temp. Treas. Reg. §1.263(a)-2T(g).

⁴ Temp. Treas. Reg. §1.162-3T(c)(2).

Temporary spare parts are considered materials and supplies if they are used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation.

Accounting for Rotable and Temporary Spare Parts. Rotable and temporary spare parts are considered used or consumed in the year in which the taxpayer **disposes** of the parts. Therefore, the costs are not deductible until the parts are no longer fit for service.

Example 2. Use the same facts as **Example 1**. In 2013, Venus Airlines installs the parts it purchased in 2012. In 2014, the parts are removed, refurbished, and reinstalled in different airplanes. In 2015, the parts are removed and scrapped. The costs of the parts are not deductible until 2015.

Optional Method of Accounting for Rotable and Temporary Spare Parts. The following optional method may be used to account for rotatable and temporary spare parts.

1. Deduct the costs of the parts when they are placed in service.
2. When the parts are removed from the unit of property:
 - a. Declare a gain based on the fair market value of the parts;
 - b. Capitalize the amount declared as a gain **plus** the cost of removing the parts; and
 - c. Capitalize any amounts paid to maintain, repair, or improve the parts.
3. Deduct the remaining basis when the parts are utilized again or when the parts are discarded.

Sale or Disposition of Materials and Supplies

If the taxpayer sells an item that was treated as a material or supply under the above rules, the asset **is not** treated as a sale of an asset qualifying for capital gain treatment unless the taxpayer elected to capitalize and depreciate the asset. The sale should be reported on the same form that was used when the deduction was originally taken.

GENERAL ASSET ACCOUNTS

It is often impractical to track every item purchased during the year as a fixed asset for depreciation purposes. Subject to certain requirements, assets may be grouped together in one or more general asset accounts. Special rules apply for assets generating foreign source income.⁵ These rules are not covered in this material.

The rules for general asset accounts included in the new temporary regulations⁶ apply to tax years beginning on or after January 1, 2012. **The rules expire on December 23, 2014.**

Each general asset account may only include assets that:

1. Are placed in service in the same taxable year, and
2. Have the same applicable:
 - a. Depreciation method,
 - b. Recovery period, and
 - c. Convention.

⁵. See Temp. Treas. Reg. §1.168(i)-1T(f) for more information.

⁶. Temp. Treas. Reg. §1.168(i)-1T.

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The following assets may **not** be included in a general asset account.

1. Assets used both in a trade or business and in a personal activity at any time during the tax year in which the asset is placed in service.
2. Assets placed in service and disposed of during the same taxable year.

In addition, the following rules apply.

1. Assets subject to the **mid-quarter convention** may only be grouped with assets that are placed in service in the same quarter of the tax year.
2. Assets subject to the **mid-month convention** may only be grouped with assets that are placed in service in the same month of the tax year.
3. Passenger automobiles for which the depreciation allowance is limited must be grouped into a separate general asset account.
4. Assets not eligible for the bonus depreciation deduction must be grouped into a separate general asset account. This group may also include assets for which the taxpayer elected out of bonus depreciation.
5. Listed property must be grouped into a separate general asset account. Passenger automobiles subject to depreciation limits may not be grouped with other types of listed property.
6. Assets for which the depreciation allowance is calculated using a method other than the MACRS tables may not be grouped with assets whose depreciation is calculated using the MACRS tables.
7. Mass assets must be grouped into a separate general asset account. Mass assets are depreciated using an ACRS Standard Mortality Dispersion Table. The term **mass assets**⁷ refers to a group of individual items of recovery property that have the following characteristics.
 - a. The assets are not necessarily homogenous.
 - b. Each asset's value is minor compared to the total value of the mass or group.
 - c. The assets are numerous in quantity.
 - d. The assets are usually accounted for only on a total dollar or quantity basis.
 - e. Separate identification of the assets is impracticable.
 - f. The assets have the same present class life.
 - g. The assets are placed in service in the same tax year.
8. Assets for which the use has changed must be grouped separately if:
 - a. The change results in a shorter recovery period or a more accelerated depreciation method, and
 - b. The depreciation allowance for the year of change is not determined by using an optional depreciation table.

Disposition of an Asset from a General Asset Account

A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account. The retirement of a structural component of a building may also be considered a disposition.

⁷ Prop. Treas. Reg. §1.168-2(h)(2).

General Rules for Disposition. The general rules for a disposition are as follows.

1. **No immediate recovery of basis.** In general, for disposition purposes, any individual asset in a general asset account is treated as having an adjusted depreciable basis of zero. Therefore, no loss is realized on the disposition of an asset from a general asset account.
2. **Treatment of amount realized.** In general, any amount realized on a disposition is recognized as ordinary income. However, if the total gains recognized in all tax years exceed the original basis of the total general asset account, the excess gains are not recognized as ordinary income; instead, they qualify for capital gain treatment.
3. **Effect of disposition on a general asset account.** The unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected as a result of a disposition of an asset from the general asset account.

Example 3. Furious Feathers is a calendar-year taxpayer. In May 2012, the company acquired 100 turbo slingshots and 300 rescue stretchers for use in its recreational facilities. The total cost of these purchases is \$40,000. Furious Feathers elected to group all the 2012 purchases into one general asset account and depreciate the assets using MACRS, 7-year class,⁸ half-year convention. It elected out of bonus depreciation and did not elect to take any §179 deduction for these assets. The 2012 depreciation amount is \$5,714.

In June 2013, the company sells 40 of the turbo slingshots for \$10,000. Under rule 1, the basis of these 40 slingshots is zero for purposes of calculating the gain/loss on their sale. Under rule 2, Furious Feathers reports \$10,000 as ordinary income on its 2013 return.

Note. See the observation box following **Example 7** for an optional method which allows taxpayers to elect to reduce a proportional amount of basis of the general asset account sold, which will result in a reduced recognized taxable gain on the sale.

4. **Coordination with nonrecognition provisions.** In general, for purposes of determining the basis of an asset that is acquired in a transaction to which a nonrecognition section of the Code applies, the basis of the exchanged asset is zero and the amount of ordinary income recognized is the amount of gain recognized on the disposition.

Example 4. Use the same facts as **Example 3**. In 2013, Furious Feathers trades 200 of the rescue stretchers. It receives 70 slingshots and \$5,000 in exchange. The basis in the 70 slingshots is zero. The amount of gain recognized from the trade is the boot of \$5,000, and all the gain is ordinary income.

5. **Manner of disposition.** The manner of disposition of an asset in a general asset account (for example, normal, abnormal, ordinary, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain or loss is recognized.
6. **Disposition by transfer to a supplies account.** If a taxpayer made an election to treat the cost of any material and supply item as a capital expenditure subject to the allowance for depreciation and also made an election to include that material and supply item in a general asset account, the taxpayer can dispose of the material and supply item by transferring it to a supplies account **only if the taxpayer has obtained the consent of the IRS to revoke the election.**⁹
7. **Leasehold improvements.** If leasehold improvements by a lessor or lessee are included in a general asset account, these rules apply when the leasehold improvements are disposed of or upon termination of the lease.

⁸. Asset class 79.0. Table B-2 of IRS Pub. 946, *How to Depreciate Property*.

⁹. See Temp. Treas. Reg. §1.162-3T(d)(3) for details on this election and its revocation.

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Disposition of All Assets Remaining in a General Asset Account. Upon the disposition of all assets or the last asset in a general asset account, a taxpayer may recover the adjusted depreciable basis of the general asset account. The amount of gain or loss for the general asset account is determined by subtracting the basis of the general asset account at the time of the disposition from the amount realized from the disposition.

Example 5. Use the same facts as **Example 4**. For 2013, Furious Feathers deducts \$9,796 of depreciation expense related to the general asset account. At the end of 2013, the following facts apply concerning the general asset account established in 2012 by Furious Feathers.

	Slingshots	Stretchers	General Asset Account	Ordinary Income Recognized
Original purchase	100	300	\$40,000	
2012 depreciation			(5,714)	
2013 changes/depr.	<u>30</u>	<u>(200)</u>	<u>(9,796)</u>	<u>\$15,000</u>
Net totals	130	100	\$24,490	\$15,000

In 2014, Furious Feathers discards the remaining slingshots and stretchers. It claims a half year of depreciation totaling \$3,499. The accumulated depreciation at the time of disposition is \$19,009 (\$5,714 + \$9,796 + \$3,499). The remaining basis of \$20,991 (\$40,000 – \$19,009) is claimed as a loss on Part I of Form 4797, *Sales of Business Property*.

Upon disposition of a general asset account, the recognition and character of the gain or loss are determined under the applicable Code provisions. (See Issue 5 of this chapter for more information about the character and tax treatment of different types of gains defined by the Code.) However, the amount of gain subject to IRC §§1245 or 1250 is limited to the combination of the following.

- The total amount of the depreciation allowed or allowable for the general asset account
- Less any amounts previously recognized as ordinary income under these rules

Example 6. Use the same facts as **Example 5**, except in 2014, Furious Feathers sells the remaining slingshots and stretchers for \$30,000.

The amount of gain realized is \$9,009 (\$30,000 – \$20,991). The amount of gain subject to ordinary income treatment under §1245 is limited to \$4,009 as calculated below.

Accumulated depreciation	\$19,009
Less: amounts previously recognized as ordinary income	<u>(15,000)</u>
Ordinary income under §1245	\$ 4,009

The remaining \$5,000 of gain is recognized as §1231 gain and **may** qualify for capital gain treatment.

Optional Method for a Qualifying Disposition. There is an **optional method** of calculating gain or loss for a qualifying disposition of an asset included in a general asset account. A qualifying disposition is one that meets the following conditions.

1. Does not involve all the assets or the last asset in the general asset account
2. Is not considered an abusive transaction (An abusive transaction is one in which the principal purpose of the disposition was to achieve a tax result that would not otherwise be available.)
3. Does not require that the transferee's basis be determined with reference to the transferor
4. Does not involve like-kind exchanges and involuntary conversions
5. Does not involve a technical termination of a partnership

Note. For additional guidance on the special rules that apply to a technical termination of a partnership, a like-kind exchange, an involuntary conversion, or to the disposition of an asset with a transferred basis, see Temp. Treas. Regs. §§1.168(i)-1T(e)(3)(iv)–(vi).

Under this optional method, general asset account treatment for the **disposed asset** terminates as of the first day of the tax year in which the qualifying disposition occurs. In essence, the original purchase price and all depreciation activity pertaining to the disposed asset are separated from the totals of the general asset account and accounted for separately as if the asset had never been included in the general asset account.

Example 7. Time Travelers Unlimited (TTU) makes the following purchases in 2012: a computer for \$15,000 in May, a disrupter for \$10,000 in July, and a projector for \$5,000 in December. On TTU's 2012 return, these electronic devices are combined into one general asset account with a cost basis of \$30,000. TTU elects to take \$15,000 of §179 deduction but elects out of bonus depreciation. The depreciation is \$3,000 on the remaining basis using MACRS, 5-year life, 200 declining-balance method, half-year convention.

In May 2013, TTU sells the disrupter for \$4,500. The company does not want to declare the entire \$4,500 as ordinary income in 2013, so it elects to use the optional method to calculate the gain/loss from this disposition.

One-third of the costs included in the general asset account are attributable to the disrupter (\$10,000 out of \$30,000). Therefore, one-third of the §179 deduction is also attributable to the disrupter. If it had been listed separately on the 2012 return, the 2012 depreciation attributable to the disrupter would have been \$5,000 of the §179 deduction plus \$1,000 of the regular depreciation. Therefore, the accumulated depreciation attributable to this equipment as of December 31, 2012, is \$6,000. On the 2013 return, both the cost of the disrupter and the related depreciation are excluded from the totals attributable to the general asset account.

The 2013 depreciation on the disrupter alone is \$800. The remaining basis at the time of the sale is \$3,200 (\$10,000 cost – \$6,000 depreciation for 2012 – \$800 depreciation for 2013). The reportable gain from the sale is shown below.

Sales price	\$4,500
Less: remaining basis	(3,200)
Ordinary gain	\$1,300

The 2013 depreciation for the general asset account is based on \$20,000, the cost of the assets remaining in the general asset account.

Observation. The result in **Example 3** would have been different if Furious Feathers had made this election. It would not have paid taxes on the full \$10,000 sale price of the assets included in its general asset account.

Assets Subject to Recapture

If the basis of an asset in a general asset account is increased as a result of the recapture of any allowable credit or deduction, general asset account treatment for the asset terminates as of the first day of the tax year in which the recapture event occurs. Consequently, the taxpayer must separate the asset and its accumulated depreciation from the general asset account and reduce the balances of the general asset account and related accumulated depreciation accordingly.

Note. Examples of recapture amounts under this rule are amounts recaptured under IRC §§30(d)(2), 50(c)(2), 168(l)(7), 168(n)(4), 179(d)(10), 179A(e)(4), or 1400N(d)(5).

Changes in Use

If the use of an asset in a general asset account changes during the year, the asset must be removed from the general asset account as of the first day of the tax year in which the change occurs. Consequently, the taxpayer must separate the asset and its accumulated depreciation from the general asset account and reduce the balances of the general asset account and related accumulated depreciation accordingly.

Changes that require this separation include converting an asset to personal use or reducing the percentage of business- or income-producing use of an asset. For information on changes in use that result in different recovery periods or depreciation methods, see Temp. Treas. Reg. §1.168(i)-1T(h).

Redetermination of Basis

Sometimes a taxpayer must redetermine the basis of an asset after the tax year in which the asset is placed in service. Examples of situations that would cause a redetermination include a contingent purchase price or discharge of indebtedness. If such a redetermination occurs, the election to account for the asset in a general asset account also applies to the resulting increase or decrease in basis.

For the tax year in which the increase or decrease in basis occurs, the taxpayer must establish a new general asset account for the amount of the change. The applicable recovery period for the change in basis is the recovery period of the asset **remaining** as of the beginning of the tax year in which redetermination is made.

The depreciation method and convention for the change in basis are the same depreciation method and convention applicable to the asset that applies during the tax year in which the redetermination occurs. The increase or decrease in basis is deemed to be placed in service in the same tax year as the asset.

Identifying Which Asset Is Disposed of or Converted

For purposes of identifying which asset in a general asset account is disposed of or converted, a taxpayer must identify the asset by using one of the following methods.

1. **The specific identification method of accounting.** Under this method of accounting, the taxpayer can determine the tax year in which the asset disposed of or converted was placed in service.
2. **A first-in, first-out method of accounting.** Under this method, the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the tax year, but the taxpayer cannot readily determine from its records the unadjusted depreciable basis of the asset.
3. **A modified first-in, first-out method of accounting.** This method is used if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the tax year and the unadjusted depreciable basis of the asset disposed of or converted.
4. **A mortality dispersion table.** This method is used if the asset is a mass asset accounted for in a separate general asset account **and** if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the tax year.
5. **Any other method the Secretary of the Treasury may designate.** For this purpose, a last-in, first-out method of accounting is not a designated method.

Disposed or Converted Asset Basis

After identifying which asset in a general asset account is disposed of or converted, the taxpayer may use any reasonable method that is consistently applied to all its general asset accounts for purposes of determining the unadjusted depreciable basis of a disposed or converted asset.

AMOUNTS PAID TO ACQUIRE OR PRODUCE TANGIBLE PROPERTY

The proper classification of whether an expenditure is a current expense or a capital item is an issue that has plagued tax practitioners, taxpayers, and the IRS for many years. Numerous court cases have been litigated over the issue because the difference in net tax can be significant depending on how the expenditures are treated. Recent IRS guidance attempts to clarify this issue.¹⁰

The rules for capitalization included in the new temporary regulations apply to tax years beginning on or after January 1, 2012. The rules expire on December 23, 2014.

De Minimis Rule

The new de minimis rule benefits taxpayers who issue **qualified financial statements** and have written accounting procedures. Taxpayers who do not meet these conditions cannot use the de minimis rule; instead, they may only expense items that qualify under the **incidental** rules for materials and supplies as explained earlier in this chapter.

The de minimis rule allows taxpayers to take a current year deduction for items costing less than “a certain amount” even though the items are capital in nature. The dollar amount of the threshold is established **by the taxpayer** in their written accounting procedures for financial reporting purposes. However, the total amounts deductible under this rule may not exceed the greater of:

1. One-tenth of a percent of the taxpayer’s gross receipts for the tax year as determined for federal income tax purposes, or
2. Two percent of the taxpayer’s total depreciation and amortization expense for the tax year as determined in the **applicable financial statement (AFS)**.

Example 8. Bseen Services is a company that specializes in recovering lost and hidden items. It has a written policy to expense any items costing less than \$500 each for financial reporting purposes. In 2012, it purchased 200 pairs of thermo goggles for \$300 each, for a total of \$60,000.

The company’s total receipts for 2012 tax purposes are \$7 million and the total depreciation and amortization expense on its 2012 certified financial statements is \$500,000. The maximum amount that it can expense under this rule is \$10,000, calculated as shown below.

	2012 Actual	Limit %	Calculated Limit
Gross receipts	\$7,000,000	0.1%	\$ 7,000
Depreciation/amortization per AFS	500,000	2.0%	10,000
Greater of limit based on gross receipts versus depreciation and amortization			\$10,000

Bseen elects to capitalize \$50,000 of the cost of the goggles and expense the remaining \$10,000 of cost under the de minimis rules.

¹⁰ Temp. Treas. Reg. §1.263(a)-2T.

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Definition of Qualified Financial Statement. The following qualify as financial statements for purposes of applying the de minimis rule.

1. A financial statement required to be filed with the Securities and Exchange Commission (SEC)
2. A certified **audited** financial statement that is accompanied by the report of an independent CPA that is used for:
 - a. Credit purposes;
 - b. Reporting to shareholders, partners, or similar persons; or
 - c. Any other substantial nontax purpose.
3. A financial statement **other than a tax return** required to be provided to the federal or a state government or any federal or state agencies

Example 9. Hidden Treasures operates a small retail store. To apply for a loan, the owner hires a CPA to prepare a set of financial statements. The CPA prepares the financial statements, but she does **not** perform an audit of the financial information. The CPA issues a **compilation** report. These financial statements do **not** meet the requirements for applying the de minimis rule.

Sale or Disposition of De Minimis Items. If a taxpayer sells an item that was treated as de minimis under these rules, the asset **is not** treated as a sale of a §§1221 or 1231 asset, unless the taxpayer elected to capitalize and depreciate the asset. The sale should be reported on the same form as the original deduction.

Requirement to Capitalize

Generally, a taxpayer must capitalize amounts paid to acquire real or personal property, including the following.

- Leasehold improvement property
- Land and land improvements
- Buildings, machinery, and equipment
- Furniture and fixtures

Amounts paid to acquire or produce property include the invoice price, transaction costs, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer. They also include amounts paid to investigate and/or facilitate the acquisition or production of real or personal property.

Acquisition costs that **must** be capitalized include the following.

1. Transporting the property (e.g., shipping fees and moving costs)
2. Securing an appraisal or determining the value or price of property
3. Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition
4. Application fees, bidding costs, or similar expenses
5. Preparing and reviewing the documents related to the acquisition of the property
6. Examining and evaluating the title of property
7. Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees
8. Conveying property between the parties, including sales and transfer taxes and title registration costs

9. Finders' fees or brokers' commissions, including amounts paid that are contingent on the successful closing of the acquisition
10. Architectural, geological, engineering, environmental, or inspection services pertaining to particular properties
11. Services provided by a qualified intermediary or other facilitator of an IRC §1031 exchange

Special Rules. The following rules also apply to amounts paid to acquire or produce tangible property.

- A taxpayer may use any reasonable allocation to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property.
- Costs of defending or perfecting title to real or personal property are also considered acquisition costs that must be capitalized even if the costs are incurred years after the property was purchased.
- Costs incurred to facilitate an acquisition must be capitalized even if the property under consideration is not eventually procured.

Exception for Acquisitions of Real Property

Acquisition costs do not include amounts paid by the taxpayer in the process of deciding to acquire real property and deciding which real property to acquire.

Example 10. Gardens from Time owns several retail stores in Canton. The company decides to examine the feasibility of opening a new store in Mt. Vernon. In 2012, it hires a development consulting firm to analyze the prospects in Mt. Vernon. The consulting firm performs market surveys, evaluates zoning and environmental requirements, and makes preliminary recommendations as to which areas of town that the company should consider. After receiving the consultant's recommendations, the company hires an appraiser to determine a fair offering price on each of two different sites. In March 2013, the firm decides to acquire one of these two sites for the location of its new store.

Gardens from Time is not required to capitalize the amounts paid to the **development consultant** in 2012 because these amounts relate to activities performed in the process of deciding to acquire real property. However, the company must capitalize the amounts paid in 2012 to the **appraiser** because appraisal costs are specifically required to be capitalized by the regulations.

The costs allocable to the property that the company ultimately purchased are capitalized in 2012 and depreciated starting in 2013. The appraisal costs for the property that the company did **not** purchase are capitalized in 2012, when paid, and deducted in 2013, when the company decides not to purchase it.

Employee Compensation and Overhead Costs

Generally, amounts paid for employee compensation and overhead are not treated as acquisition costs that must be capitalized. However, if the property is produced by the taxpayer or acquired for resale, these costs might be subject to the capitalization requirements of IRC §263A.

A taxpayer may **elect** to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. A taxpayer makes the election by capitalizing the amounts on their timely filed original income tax return (including extensions) for the tax year during which the amounts are paid. This election may only be revoked by filing a request for a private letter ruling and obtaining the IRS's consent to revoke the election.

AMOUNTS PAID TO IMPROVE TANGIBLE PROPERTY

Distinguishing between repairs and improvements is a frequently contested area of tax law. This is especially true when money spent on real property structures may require up to 39 years to recoup. In an attempt to reduce the uncertainty over the proper tax treatment of specific types of costs, the new regulations contain nearly 20 pages of guidance and examples.¹¹

The regulations regarding improvements that are included in the new temporary regulations apply to tax years beginning on or after January 1, 2012. The rules expire on December 23, 2014.

General Rules for Improvements

Generally, a taxpayer must capitalize amounts paid to improve a unit of property owned or leased by the taxpayer. A unit of property is considered improved if the amounts paid accomplish any of the following.

1. Result in **betterment** of the unit of property
2. **Restore** the unit of property
3. **Adapt** the unit of property to a new or different use

Determining the Unit of Property for Assets Other Than Buildings. In general, the unit of property determination is based on the **functional interdependence standard**. This standard provides that components of property are functionally interdependent if placing one component in service by the taxpayer is dependent on placing the other component in service by the taxpayer.

However, special rules apply to buildings, plant property, network assets, leased property, and improvements to property. Additional rules apply if a taxpayer assigns different MACRS classes or depreciation methods to components of property or subsequently changes the class or depreciation method of a component or other item of property. Property that is aggregated or subject to a general asset account election or accounted for in a multiple asset account (i.e., pooled) may not be treated as a single unit of property.

Determining the Unit of Property for Buildings. In general, a building and its structural components are considered a single unit of property. An amount is considered paid for an improvement to a building if the amount paid results in an improvement to any of the following.

1. Building structure
2. Building system — Each of the following structural components constitutes a building system that is separate from the building structure. Any improvement to these components is considered an improvement to the building.
 - a. Heating, ventilation, and air conditioning (HVAC) systems (including motors, compressors, boilers, furnaces, chillers, pipes, ducts, and radiators)
 - b. Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures)
 - c. Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line to and between buildings and other permanent structures)
 - d. Escalators and elevators

¹¹ Temp. Treas. Reg. §1.263(a)-3T.

- e. Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and firefighting equipment, such as extinguishers and hoses)
- f. Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, and associated wiring and conduits)
- g. Gas distribution systems (including associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures)
- h. Other structural components as identified by the IRS

Example 11. Farkel owns an office building that contains an HVAC system. The HVAC system incorporates 10 roof-mounted units that service different parts of the building. The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior. Farkel upgrades **all** the HVAC units. The upgrade is considered an improvement to the building that must be depreciated over 39 years.

Note. See **Example 21** under “Capitalization of Restorations” later in the chapter. In that example, the taxpayer does not replace all the units and, therefore, does not have to capitalize the upgrades.

Determining Units of Property for Special Types of Assets. **Plant property** is functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process. Industrial processes include manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities. The unit of property determined under the general rule is further divided into smaller units composed of **each component that performs a discrete and major function** or operation within the functionally interdependent machinery or equipment.

The term **network assets** means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The unit of property is determined by the taxpayer's particular facts and circumstances except as otherwise provided in published guidance.

A unit of property for **leased property** is determined under the rules applicable to each type of property, **except** the unit of property may not be larger than the unit of leased property.

An **improvement** to a unit of property, other than a leasehold improvement, is **not a unit of property separate** from the unit of property improved.

Special Rules for Determining Improvement Costs

Improvements to Leased Property. In general, improvements to leased property must be capitalized under the same rules applicable to the type of property being leased, except to the extent that IRC §110 applies to a construction allowance received by the lessee for the purpose of such improvement or when the improvement constitutes a substitute for rent.¹²

Compliance with Regulatory Requirements. A federal, state, or local regulator's requirement that a taxpayer perform certain repairs or maintenance on a unit of property to continue operating the property is not relevant in determining whether the amount paid improves the unit of property.

¹² See Treas. Reg. §1.61-8(c) for the treatment of lessee expenditures that constitute a substitute for rent.

Certain Costs Incurred During an Improvement. A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that are incurred because of an improvement. However, indirect costs that are not incurred because of an improvement are not required to be capitalized, even if they are incurred at the same time as an improvement.

Safe Harbor for Routine Maintenance on Property Other Than Buildings. In general, routine maintenance is deemed not to improve a unit of property. Routine maintenance is the recurring activities that a taxpayer expects to perform to keep the property in its ordinarily efficient operating condition.

Routine maintenance activities include the following.

- Inspection
- Cleaning
- Testing
- Replacing parts of the unit with comparable, commercially available, reasonable replacement parts

The activities are **routine only** if, at the time the unit of property is placed in service, the taxpayer reasonably expects **to perform the activities more than once during the class life of the property**. Among the factors considered in determining whether a taxpayer is performing routine maintenance are the recurring nature of the activity, industry practice, manufacturers' recommendations, the taxpayer's experience, and the taxpayer's treatment of the activity on its applicable financial statements.

Example 12. In January 2012, Slingum Accounting Services purchased a used copy machine for use in its office. When it purchased the copier, the company expected to perform manufacturer-recommended scheduled maintenance on the machine approximately every three years.

The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable, commercially available, and reasonable replacement parts. However, at the time Slingum purchased the machine, it had already approached the end of a 3-year scheduled maintenance period. In February 2012, Slingum had the scheduled maintenance performed.

Because the costs were incurred primarily as a result of the prior owner's use of the property and not Slingum's use, the maintenance does not fall under the safe harbor provisions. The company acquired the machine just before it needed its 3-year scheduled maintenance. Accordingly, **if** the amounts paid result in **betterment** of the machine, the costs of the scheduled maintenance must be capitalized.

Routine maintenance does **not** include the following.

1. Amounts paid for restorations (as defined later in this chapter)
2. **Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use**
3. Amounts paid for repairs, maintenance, or improvement of rotatable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotatable and temporary spare parts

Example 13. Gary Zinga owns and operates a farm that has an irrigation system that provides water for crops. Each canal in the irrigation system is a single unit of property and has a class life of 20 years. At the time he placed the canals into service, Gary expected to have to perform major maintenance on the canals every three years to keep the canals in their ordinarily efficient operating condition.

Gary placed the canals into service in 2006 but does not perform any maintenance on the canals until 2012. By this time, the canals have fallen into a state of disrepair and no longer function for irrigation. In 2012, Gary hires a contracting company to drain the canals and to do extensive cleaning, repairing, reconditioning, and part replacement. The work performed on his canals is similar to the activities that he expected to perform, but did not perform, every three years. However, the costs of these activities do not fall within the routine maintenance safe harbor because the property had deteriorated to a state of disrepair and was no longer functioning for its intended use. Accordingly, these costs must be capitalized.

Capitalization of Betterments

In general, a taxpayer **must capitalize** amounts paid that result in the betterment of a unit of property. Betterment only results if one of the following occurs.

1. A material condition or defect that existed prior to the taxpayer's acquisition of the property is improved, whether or not the taxpayer was aware of the condition or defect at the time of acquisition.
2. A material addition (including a physical enlargement, expansion, or extension) to the unit of property occurs.
3. A material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the property or of the output of the property occurs.

Example 14. Marvin Zuckerman owns a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. In 2012, Marvin realizes that certain areas of asbestos-containing insulation have begun to deteriorate and could eventually pose a health risk to employees.

Zuckerman has the asbestos insulation removed from the building and replaced with new insulation that is safer for employees but no more efficient or effective than the asbestos insulation. Although the asbestos is unsafe under certain circumstances, the asbestos is not a material defect of the building structure. In addition, the removal and replacement of the asbestos does not result in a material addition to the building or in a material increase in capacity, productivity, efficiency, strength, or quality of the building. Therefore, the amount paid to remove and replace the asbestos insulation does not result in betterment to the building.

Exception for Betterments Required for a Particular Event. In cases in which a particular event necessitates an expenditure, the determination of whether the expenditure results in betterment of the unit of property is made by comparing the following.

1. The condition of the property immediately **prior to the circumstances** necessitating the expenditure
2. The condition of the property immediately **after** the expenditure

If the expenditure is made to correct the effects of normal wear and tear to the property, the condition of the property **immediately prior** to the circumstances necessitating the expenditure is considered the condition of the property **after the last time** the taxpayer corrected the effects of normal wear and tear. If the taxpayer has not previously corrected the effects of normal wear and tear, the immediately prior condition is the condition of the property when placed in service by the taxpayer.

Example 15. Use the facts from **Example 12**. The amount that Slingum paid for the scheduled maintenance was a result of the prior owner's use of the copier. Furthermore, the maintenance improved conditions or defects that existed at the time Slingum purchased the machine.

However, considering the facts and circumstances, including the purpose and minor nature of the work performed, this amount does not improve a **material condition** or defect in the copier, result in a material addition to the machine, or result in a material increase in the capacity, productivity, efficiency, strength, or quality of the copier or its output. Therefore, Slingum is not required to capitalize the amount paid for the scheduled maintenance.

If the expenditure is made as a result of a **particular event**, the "condition of the property immediately prior" is what existed immediately prior to that event.

Example 16. Jewel Blitzer owns a small retail shop. A storm damages the roof of her shop by displacing numerous wooden shingles. Jewel pays a contractor to replace all the wooden shingles on the roof with new wooden shingles. The event necessitating the expenditure was the storm. Prior to the storm, the building structure was functioning for its intended use. Jewel is not required to treat the amount paid to replace the shingles as betterment because it does not result in a material addition or material increase in the capacity, productivity, efficiency, strength, or quality of the building compared to the condition of the building structure prior to the storm.

If a taxpayer needs to replace a part that cannot be replaced with the same type of part (e.g., because of technological advancements or product enhancements), the replacement of the part with a comparable, albeit improved part does not, by itself, result in betterment of the unit of property.

Example 17. Use the same facts as **Example 16**, except wooden shingles are not currently available on the market. Jewel pays a contractor to replace all the wooden shingles with comparable asphalt shingles. The amount that she pays to reshingle the roof with asphalt shingles does **not** result in betterment to the building, even though the asphalt shingles may be stronger than the wooden shingles. Therefore, it is not an improvement to the building and it can be deducted currently as a repair.

Example 18. Use the same facts as **Example 17**, except instead of replacing the wooden shingles with asphalt shingles, Jewel pays a contractor to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating. These shingles result in betterment to the building because they are a material increase in the quality of the building as compared to the condition of the building prior to the storm. Therefore, Jewel must capitalize the amounts paid for the purchase and installation of the new shingles.

Capitalization of Restorations

In general, a taxpayer **must capitalize** amounts paid to restore a unit of property. An amount paid to restore any structural part of a building is considered a restoration of the building.

An amount is paid to restore a unit of property only if it satisfies one of the following conditions.

1. The amount paid is for replacement of a component of the property if the taxpayer has properly deducted a loss for that component.
2. The amount paid is for replacement of a component if the taxpayer has properly taken into account the component's adjusted basis in realizing gain or loss resulting from the sale or exchange of the component.
3. The amount paid is for repair of damage to the property for which the taxpayer has properly taken a basis adjustment as a result of a casualty.
4. The expenditure returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functioning for its intended use.

5. The expenditure results in rebuilding the property to a like-new condition **after the end of its class life**.
6. The amount is for replacement of a part or a combination of parts that compose a major component or a substantial structural part of the property.

Note. See Tables B-1 and B-2 in IRS Pub. 946, *How to Depreciate Property*, to determine the class life of an asset. Practitioners are advised to review both tables carefully when classifying a specific property. There are assets that appear at first glance to belong to a particular class, but because of the type of activity in which the property is used, the property is in a different class. The table most applicable to each situation is the one to use.

Example 19. MightyMotion owns a fleet of freight cars. Freight cars have a recovery period of seven years and a class life of 14 years. In 2002, the company purchased freight car 19. In 2012, it rebuilds car 19. The rebuilding includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment.

MightyMotion modifies the car to upgrade various components to the latest engineering standards. The freight car essentially is stripped to the frame, with all its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled.

At the end of the rebuilding process, the freight car has been restored to rebuilt condition under the manufacturer's specifications. However, MightyMotion is **not** required to capitalize the rebuild because the amounts were **paid before the end of the class life of the freight car**.

To determine if an amount is for the replacement of a part that composes a major component or a substantial structural part of the property, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative or qualitative significance of the part in relation to the property. A major component or substantial structural part includes parts that compose a large portion of the physical structure of the property or that perform a discrete and critical function in the operation of the property. The replacement of a minor component of the property, even though the component may affect the function of the property, does not generally, by itself, constitute a major component or substantial structural part.

Example 20. Eggs Zeptional owns a warehouse. What appeared to be a pinprick leak leads to the discovery of damage to a portion of the roof. In the end, Eggs replaces a large portion of the decking, insulation, and membrane of the roof. The portion of the roof replaced encompasses a substantial portion of a structural part of the building. Therefore, Eggs must capitalize the amount for the roof replacement.

Observation. The facts of this example, which were taken from the regulations,¹³ are comparable to the facts in *Campbell v. Comm'r*.¹⁴ In that case, Ms. Campbell successfully argued that the only purpose of the roof replacement done on her rental property was "to prevent the leakage and keep her rental house in operating condition and not to prolong the life of the property, increase its value, or make it adaptable to another use." It appears that under the new temporary regulations, Ms. Campbell would not have prevailed in court.

¹³ See Temp. Treas. Reg. §1.263(a)-3T(i)(5), examples 12 and 13.

¹⁴ *Nevia Campbell v. Comm'r*, TC Summ. Op. 2002-117 (Sep. 6, 2002).

Example 21. Hamlet owns an office building. The building contains an HVAC system that incorporates 10 roof-mounted units that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior.

Hamlet's maintenance crew replaces two of the roof-mounted units. No work is performed on the other roof-mounted heating and cooling units, the duct work, or the controls. The HVAC system, including the two roof-mounted units, is considered a building system. The two roof-mounted heating and cooling units, by themselves, are not considered a large portion of the physical structure of the HVAC system nor do the units perform a discrete and critical function in the operation of the system. Therefore, Hamlet is not required to capitalize the amount paid to replace the two units.

Note. If the building had only one unit, that unit **would** perform a critical function of the HVAC system. In that case, the cost of its replacement would have to be capitalized.

Capitalization of Amounts Paid to Adapt Property to a New or Different Use

In general, a taxpayer must capitalize amounts paid to adapt property to a new or different use. This occurs when the adaptation is not consistent with the taxpayer's intended ordinary use of the property at the time it was originally placed in service by the taxpayer. Adaptation of any of a building's structural components qualifies as an adaptation of the building.

Depreciation of Leased Property

Capital expenditures to build or make permanent improvements on leased property are capitalized and depreciated without regard to the period of the lease.¹⁵

Example 22. Swineheart, Inc., sells helmets. In 2012, they enter into a 1-year lease for two acres of ground which are owned by Rovio Finn. Swineheart builds a retail outlet store on the acreage. The store building must be depreciated over 39 years even though Finn could refuse to renew the lease after the first year.

MAXIMIZING DEPRECIATION DEDUCTIONS IN 2012

Note. For a comprehensive review of depreciation issues, see Chapter 1 of the 2011 *University of Illinois Federal Tax Workbook*.

Bonus depreciation, the §179 deduction, MACRS, ACRS, and straight-line depreciation are all means of recovering the cost of property for tax purposes. Each method has benefits and pitfalls that tax practitioners should consider when advising clients about choices to consider for a particular tax year.

The elections to use bonus depreciation and the §179 deduction are similar but not the same. The table on the following page may be useful when choosing which method to use.

¹⁵ Temp. Treas. Reg. §1.167(a)-4T.

2012 Bonus Depreciation versus §179 Deduction

	50% Bonus Depreciation	§179 Deduction
Tax years	Expires 12/31/2012	No expiration
2012 expense limits	None	\$139,000
2012 investment limit	None	Allowable deduction reduced if purchases exceed \$560,000
Limited to business income	No	Yes
Can create/increase NOL	Yes	No
Proratable (can take part of qualifying amount)	No	Yes
Business use requirement, in general	None	>50% business use
Business use requirement for listed property	>50% business use	>50% business use
Original use requirement	New only	New or used
Eligible property	<ul style="list-style-type: none"> • Tangible property with a recovery period of 20 years or less, depreciated under MACRS • Water utility property • Off-the-shelf computer software • Certain leasehold improvements between unrelated parties 	<ul style="list-style-type: none"> • Tangible personal property • Other tangible property used in utility industries • Single purpose agricultural (livestock) or horticultural structures • Storage facilities used in connection with distributing petroleum • Off-the-shelf computer software
Available for assets used in rental activities	Yes	No
Election available	Elect out by class of property on timely-filed original return or amended return filed prior to the extended due date	Elect in by specific asset on original return (does not have to be timely-filed) or amended return
Revocable	Only by requesting a letter ruling	Yes, by amending for tax years beginning before 2013
SUV limit	None	\$25,000
Passenger vehicle limits	Increased by \$8,000 above otherwise applicable limits	Eligibility for §179 does not change limits
Like-kind exchanges	Basis of traded asset and cash price included in cost basis	Cash price only

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The first step in maximizing depreciation deductions is to separate the taxpayer's current year asset purchases into three categories.

1. Purchases that qualify for only bonus depreciation
2. Purchases that qualify for both the §179 deduction and bonus depreciation
3. Purchases that qualify for only the §179 deduction

Example 23. Superior Friends is a for-profit crime-fighting coalition. Despite the superior powers of the members of the force, the company must purchase some equipment for snaring all archvillains. During 2012, Superior Friends made the following investments.

Investment	Recovery Period	New/Used	Amount	Eligible
Qualified leasehold improvements	39 years ¹⁶	New	\$ 60,000	Bonus
Super computer	5 years	New	100,000	Both
Lasso of Honesty	7 years	Used	80,000	§179

The 2012 limit for §179 deductions is \$139,000, and by law this election is applied before bonus depreciation is calculated. Assuming that Superior Friends has sufficient profits, it is most advantageous to use the §179 election first on property that does not qualify for bonus depreciation. Then, the remainder of the annual §179 limit can be used for property that qualifies for both.

Example 24. Use the same facts as **Example 23**. Superior Friends' profit before considering its current year asset purchases is \$500,000. On its 2012 return, it first elects to expense the Lasso of Honesty under §179. The \$80,000 purchase price is subtracted from the annual limit of \$139,000, leaving \$59,000 available to elect to apply to another asset.

It then elects to expense \$59,000 of the purchase price of the super computer under §179. **The total depreciation deduction for the company in 2012 is \$194,273** as calculated below.

Investment	Cost	§179 Elected	Remaining Basis	50% Bonus Depreciation	Regular Depreciation
Qualified leasehold improvements	\$ 60,000	n/a	\$60,000	\$30,000	\$ 673
Super computer	100,000	\$ 59,000	41,000	20,500	4,100
Lasso of Honesty	80,000	80,000	0	0	0
Totals by depreciation option		\$139,000		\$50,500	\$4,773

¹⁶ IRC §168(e)(3)(E)(iv), which classified qualified leasehold improvements as 15-year property, applies only to improvements placed in service before January 1, 2012. The Act (PL 111-312) that extended bonus depreciation for 2012 purchases did not extend this provision.

Example 25. Use the same facts as **Example 24**. If Superior Friends had applied the §179 deduction first to the super computer, its 2012 depreciation deduction would only be **\$175,530** as calculated below.

Investment	Cost	§179 Elected	Remaining Basis	50% Bonus Depreciation	Regular Depreciation
Qualified leasehold improvements	\$ 60,000	n/a	\$60,000	\$30,000	\$ 673
Super computer	100,000	\$100,000	0	0	0
Lasso of Honesty	80,000	39,000	41,000	0	5,857
Totals by depreciation option		\$139,000		\$30,000	\$6,530

Observations and Cautions

- Many states have decoupled from the bonus depreciation provisions and/or the increased §179 limits. If the taxpayer is located in a state that does not recognize the full amount of depreciation as calculated on the federal return, the tax preparer should consider the state ramifications as well when deciding which elections to make.
- The §179 deduction is limited to business income and any excess is carried forward. **However, bonus depreciation can be used to create a net operating loss which may be carried back or forward.** If the potential depreciation deductions exceed the taxpayer's current year income, the tax preparer should consider the taxpayer's future prospects and past tax burdens in determining the best course of action to recommend.
- For assets acquired via a like-kind exchange, only the cash boot is eligible for the §179 election. However, if the replacement property is qualified, the **carryover basis of the exchanged asset is also eligible for bonus depreciation.**
- The §179 deduction gives the tax preparer more flexibility in achieving a targeted income level than the bonus depreciation option.
 - The taxpayer may elect to use any portion of the qualifying purchase for the §179 deduction, from \$1 to the full purchase price. However, the bonus depreciation option is applied **in full or not at all** to the basis remaining after the §179 deduction, if any.
 - The §179 deduction is elected on an asset by asset basis, while the bonus depreciation option is applied **to every purchase within an asset class or to no purchases within that class.**
 - For 2012, the election to use or revoke the §179 deduction may be changed by amending the return. However, the option to elect out of bonus depreciation may only be changed by requesting a letter ruling from the IRS.
- Using bonus depreciation for vehicle purchases increases the maximum amount of first-year depreciation under the luxury auto rules. **In addition, the \$25,000 maximum deduction for SUVs that applies to the §179 deduction does not apply to bonus depreciation.**
- There may be times when maximizing the depreciation deduction is not the best long-term tax strategy.

ISSUE 2. TAXATION OF BUSINESS-OWNED LIFE INSURANCE

Businesses may purchase life insurance coverage on key employees when the business is the owner **and** beneficiary of the policy. A company may want to do this if the death of the employee would be a substantial burden to the business operations. This type of insurance may also be a mechanism to provide the firm with the means to purchase an employee-owner's share of the business in the event of the employee-owner's death.

Note. Even though the business-owned life insurance is for the protection of the company and the cost of the premiums is a legitimate business expense, the **premiums are not deductible.**¹⁷ Guidance on the taxation of business-owned life insurance is found in IRC §§101(j) and 6039I. Further IRS guidance is provided in IRS Notice 2009-48, 2009-24 IRB 1085.

In most situations, when the death of the insured results in a payout of a life insurance contract, the proceeds are not taxable. However, for an employer-owned life insurance contract, the excludable amount is limited to the sum of the premiums and other amounts paid by the policyholder for the contract.

An employer-owned life insurance contract is a life insurance contract that fulfills both of the following criteria.

1. It is owned by a person¹⁸ engaged in a trade or business and under which such person is directly or indirectly a beneficiary under the contract.
2. It covers the life of an insured who is an employee of the trade or business on the date the contract is issued.

This limited exclusion does not apply if certain requirements and qualifications are met. The requirements involve notice to and consent of the insured. The qualifications involve the status of the insured **or** the use of the proceeds of the contract.

NOTICE AND CONSENT REQUIREMENTS

The notice and consent requirements apply to contracts issued after August 17, 2006. To be eligible for the exception to the limited exclusion, prior to the contract's issuance, **the company must do all of the following.**

1. Notify the employee in writing that it intends to insure the employee's life and what the maximum face amount is for which the employee could be insured at the time the contract is issued.
2. Notify the employee in writing that the company will be a beneficiary of any proceeds payable upon the death of the employee.
3. Receive written consent from the employee to be insured and consent to continue the coverage after the insured terminates employment.

QUALIFICATIONS

There are **two types** of situations that qualify the employer-owned life insurance contract proceeds as tax exempt. The **first type** is based on the insured's relationship to the business and the **second type** is based on who ultimately receives the proceeds of the policy. There are two tests under each situation. Only one of the four tests must be met in order for the proceeds to be exempt.

¹⁷ IRC §264(a)(1).

¹⁸ In IRS Notice 2009-48, the IRS specifies that "person" as used in the Code includes partnerships and sole proprietorships. The wording in the notice implies that corporations are also included: "ownership of the contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract."

Exception Based on Status of the Insured

For life insurance proceeds to be excluded from income based on the status of the insured, the insured person must have one of the following relationships to the business.

1. The insured was an employee of the policy owner at any time during the 12-month period before the insured's death.
2. At the time the contract is issued, the insured was one of the following.
 - a. A director
 - b. A highly compensated employee
 - c. A highly compensated individual

Highly Compensated Employee. The term **highly compensated employee** means any employee who:

- Was a 5% owner at any time during the current year or the preceding year, **or**
- In the preceding year had compensation from the employer in excess of the inflation-adjusted amount for IRC §414(q). (The 2011 amount was \$110,000, and the 2012 amount is \$115,000.)¹⁹

Former employees are treated as highly compensated employees if they were highly compensated employees when they separated from service or at any time after they attained age 55.

Highly Compensated Individual. The term **highly compensated individual** means an individual who is:

- One of the **five highest paid officers**,
- A shareholder who owns **more than 10% in value** of the employer's stock, or
- Among the **highest paid 35%** of all employees.

Exception Based on Amounts Paid to the Insured Heirs

The proceeds of the life insurance policy are not included in income to the extent of either of the following.

1. The proceeds are paid to any of the following.
 - a. A member of the insured's family²⁰ (specifically, a sibling, spouse, ancestor, and/or lineal descendant)
 - b. Any individual (other than the policy owner) who was designated as a beneficiary by the insured
 - c. A trust established for the benefit of any such member of the family or designated beneficiary
 - d. The estate of the insured
2. The proceeds are used to purchase an ownership interest in the business from any person described in the preceding exception.

FILING REQUIREMENTS

Every employer-policyholder must file Form 8925, *Report of Employer-Owned Life Insurance Contracts*, with its income tax return for each year during which the policyholder has an employer-owned life insurance contract in force. This requirement does not apply to contracts issued before August 18, 2006.

¹⁹ IRS Announces Pension Plan Limitations for 2012. [www.irs.gov/newsroom/article/0,,id=248482,00.html] Accessed on Jun. 6, 2012.

²⁰ As defined by IRC §267(c)(4).

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Form **8925**
(Rev. January 2010)
Department of the Treasury
Internal Revenue Service (99)

Report of Employer-Owned Life Insurance Contracts

OMB No. 1545-2089

► Attach to the policyholder's tax return—See instructions.

Attachment
Sequence No. **160**

Name(s) shown on return		Identifying number	
Name of policyholder, if different from above		Identifying number, if different from above	
Type of business			
1	Enter the number of employees the policyholder had at the end of the tax year	1	
2	Enter the number of employees included on line 1 who were insured at the end of the tax year under the policyholder's employer-owned life insurance contract(s) issued after August 17, 2006. See <i>Section 1035 exchanges</i> on page 2 for an exception	2	
3	Enter the total amount of employer-owned life insurance in force at the end of the tax year for employees who were insured under the contract(s) specified on line 2	3	
4a	Does the policyholder have a valid consent (see instructions) for each employee included on line 2? <input type="checkbox"/> Yes <input type="checkbox"/> No		
b	If "No," enter the number of employees included on line 2 for whom the policyholder does not have a valid consent	4b	

General Instructions

Section references are to the Internal Revenue Code, unless otherwise indicated.

that employs the person insured under the employer-owned life insurance contract and (b) the direct or indirect

reasonably expects to purchase with regard to the employee during the course of the employee's tenure.

Note. Although an employer-policyholder is required by law to file Form 8925 annually, failure to file this form does **not** make otherwise tax-exempt proceeds taxable. There is no stated penalty in the Code or regulations for failure to file this form.

ISSUE 3. THE DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

Under IRC §199, the domestic production activities deduction (DPAD) can amount to a significant deduction for qualified taxpayers. Subject to various limitations, the DPAD can be as high as 9% of the taxpayer's taxable income for 2012.

One of the most limiting requirements for small businesses is that the deduction is generally capped at 50% of qualified wages paid by the taxpayer during the year. Businesses that do not have employees cannot take this deduction unless they meet one of the following **exceptions to the wage requirement**.

1. Patrons of an agricultural or horticultural cooperative may deduct the DPAD calculated by the cooperative and passed through to them as reported on Form 1099-PATR, *Taxable Distributions Received From Cooperatives*.
2. Members of expanded affiliated groups calculate their portion of the deduction based on their proportion of qualifying income, regardless of the amount of W-2 wages paid by the members.

Note. These exceptions are not covered in this material. For more information on the exception related to cooperatives, see Issue 7 in Chapter 12 of the 2009 *University of Illinois Federal Tax Workbook*. This can be found at www.TaxSchool.illinois.edu/taxbookarchive. For more information on the exception related to affiliated groups, see Treas. Reg. §1.199-7.

WHICH BUSINESS ACTIVITIES QUALIFY

To qualify for the deduction, a business must be engaged in specific types of activities and those activities must be located in the United States. The challenge for the IRS has been defining the broad terms used by Congress when it defined which types of businesses are eligible for the deduction. The challenge for tax practitioners is applying a taxpayer's specific business activities to the nuances of the applicable Treasury Regulations.

Qualifying industries include the following.

- Manufacturing
- Farming
- Construction of real property
- Engineering or architectural services
- Film production
- Extraction of natural commodities

Examples of Qualifying and Nonqualifying Activities

The IRS provides substantial guidance in connection with the types of activities that qualify for the DPAD. While Treas. Reg. §1.199-3 provides several examples, some additional examples follow.

Manufacturing. Xenax purchases automobiles from unrelated persons and customizes them by adding ground effects, spoilers, custom wheels, specialized paint and decals, sunroofs, roof racks, and similar accessories. Xenax does not manufacture any of the accessories. The activity is minor assembly that does not qualify as manufacturing.

Farming. Alvin, Bev, and Clyde are unrelated persons. Bev grows agricultural products and sells them to Alvin, who stores the agricultural products in his grain bins. Alvin has the benefits and burdens of ownership of the agricultural products while they are being stored. Alvin sells the agricultural products to Clyde, who processes them into refined agricultural products in the United States. The activities of all three taxpayers qualify for the DPAD.

Construction of Real Property. *Example A.* Angela normally works as a trade contractor. She purchases a building and retains Bob, an unrelated person, to oversee a substantial renovation of the building. Although not licensed as a general contractor, Bob performs general contractor level work and activities related to management and oversight of the construction process such as approvals, periodic inspection, and required job modifications. Bob retains Cynthia as a general contractor to oversee day-to-day operations and hire subcontractors. Cynthia hires Doug to install a new electrical system in the building as part of that substantial renovation. The income that Bob, Cynthia, and Doug receive is all qualified for DPAD. The income that Angela receives for selling the property does not, because she did not participate in the construction activity.

Example B. Zoe owns an electrical contracting business. She purchases the wires, conduits, and other electrical materials that are installed in construction projects around the United States. In a particular construction project, all the wires, conduits, and other electrical materials that she installs for the building's operation are considered structural components of the building. Her gross receipts derived from installing the property are qualifying income for DPAD purposes. In addition, the gross receipts derived from the purchased materials qualify because they are consumed during the construction of the building or become structural components of the building.

Example C. Xander is engaged in the business of land development. He buys unimproved land and gets the land zoned for residential housing. He grades the land and sells the land to home builders who construct houses on the land. Some of the gross receipts that Xander receives from the sale of the land qualify for DPAD and others do not. Those that are attributable to the grading qualify because those services are undertaken in connection with a construction project in the United States. The portion of the gross receipts derived from capitalized costs in the land does not qualify.

Example D. The facts are the same as in *Example C*, except Xander constructs roads, sewers, and sidewalks, and installs power and water lines on the land. He conveys the roads, sewers, sidewalks, and power and water lines to the local government and utilities. The additional gross receipts that Xander receives that are attributable to the construction of the roads, sewers, sidewalks, and power and water lines also qualify for DPAD.

Engineering or Architectural Services. Elizabeth owns an engineering firm. Randy hires Elizabeth to provide engineering services for roads, sewers, sidewalks, and power and water lines that will be constructed on his unimproved land. Elizabeth's gross receipts from engineering services for the infrastructure qualify for the DPAD. Her gross receipts from engineering services relating to land do not qualify.

PASS-THROUGH DPAD REPORTED ON K-1s

Note. The 2005 and 2006 *University of Illinois Federal Tax Workbooks* each contain an entire chapter on the IRC §199 deduction. These can be found at www.TaxSchool.illinois.edu/taxbookarchive. In addition, Issue 6 in Chapter 6 of the 2009 *University of Illinois Federal Tax Workbook* covers the methods of calculating the deduction. This can be found at the same web address.

To determine the taxpayer's net income attributable to qualifying activities, the taxpayer must allocate indirect expenses proportionately between qualifying and nonqualifying income. In addition, if the taxpayer uses one of the safe-harbor methods, the cost of goods sold and direct expenses may also be allocated proportionately.

Gross receipts from all trades and businesses of the taxpayer must be included in the total gross receipts to properly allocate these expenses. Therefore, partnerships and S corporations must report to each owner the amounts to be used in the DPAD calculation even if the partnership does not engage in any qualifying activities.

The Schedules K-1 from each type of entity include a box and code that direct the recipient to an additional information statement. For partners, the DPAD code T is entered in box 13. For S corporation shareholders, the code P is entered in box 12.

The statement includes the following information.

- Gross receipts from all sources and the gross receipts attributable to domestic production activities
- Total cost of goods sold and the cost of goods sold in domestic production activities
- Total deductions directly allocable to nonqualifying activities and those directly allocable to domestic production
- Total deductions not directly allocable
- Form W-2 wages related to domestic production

The amounts disclosed in this statement must be included in the totals reported on Form 8903, *Domestic Production Activities Deduction*. The DPAD amount calculated on Form 8903 is then reported on the taxpayer's return.

Note. Although each statement should include the above information, there is no standard format for the disclosure. This can make entering the information into tax preparation software time consuming. However, it may not even be necessary to enter the information.

One quick way to eliminate the need for translating the statement is to look for W-2 wages attributable to DPAD. If the taxpayer is not involved in any other qualifying businesses and the Schedule K-1 wages are \$0, no DPAD is allowed.

ISSUE 4. LIKE-KIND EXCHANGE PLANNING

3

IRC §1031, which allows taxpayers to defer the gain on property traded in a like-kind exchange, is a powerful tool for postponing taxes from a gain resulting from the transfer of property. Probably the most common like-kind exchange is the trade-in of a used car or truck for a newer vehicle. When the trade occurs in one transaction with one other party, the exchange is easy to accomplish and easy to report for tax purposes.

However, like-kind exchanges are often more complicated. In addition to the basic two-party exchanges, the Code also allows more complicated transactions to be treated as like-kind exchanges but **only** if all the protocols are precisely followed. The most important thing that a taxpayer can do to ensure that the transaction is handled properly is to retain qualified professional advisors.

Note. See IRS Pub. 544, *Sales and Other Dispositions of Assets*, for more information on like-kind exchanges. Also see Chapter 4 of the 2007 *University of Illinois Federal Tax Workbook* for comprehensive coverage of §1031 exchanges. This can be accessed online at www.TaxSchool.illinois.edu/taxbookarchive.

While the basic rules for a like-kind exchange have not changed, taxpayers continue to have “failed exchanges” as illustrated by some recent court cases. The following court cases illustrate the pitfalls of failing to follow all the requirements for nonrecognition of gain in a like-kind exchange.

RELATED PARTIES SHOULD BEWARE

Ocmulgee Fields, Inc. v. Comm’r, 132 TC No. 6 (Mar. 31, 2009)

Facts. This court case concerned a deferred like-kind exchange. As part of the exchange, real estate owned by a corporation was sold to an unrelated party, and the proceeds of the sale were deposited with a qualified intermediary (QI). Later via the QI, the corporation acquired replacement property from a limited liability company (LLC) that was **related** to the corporation.

The corporate taxpayer reported that the transactions qualified as a like-kind exchange, and it did not include the gain in its taxable income. The LLC reported a capital gain on the sale of its property, which it passed through to its partners.

Note. Corporate taxpayers do not qualify for reduced capital gain rates. Capital gains recognized by corporations are taxed at the corporations’ marginal tax rates. However, reduced capital gain rates do apply to income passed through to individuals by partnerships.

Result. Unfortunately for the taxpayer, the court found that the corporation had **failed to prove that the principal purpose of the series of transactions was anything but tax avoidance**. The additional tax due was \$2,015,862.

However, the court also found that the corporate taxpayer’s reliance on its CPA was reasonable cause for the underpayment. Therefore, the court did **not** impose an accuracy-related penalty of \$403,172.

BASIS MUST BE DOCUMENTED

William J. and Alicia T. Licha v. Comm’r, TC Memo 2011-275 (Nov. 17, 2011)

Facts. The taxpayers received boot in a series of like-kind exchanges of real estate. However, the taxpayers failed to provide sufficient documentation demonstrating the basis in the exchanged properties.

Result. The court found that the taxpayers failed to report capital gains of \$123,778 for 2003 and \$123,720 for 2006. It also held the taxpayers liable for accuracy-related penalties of 20% of the underreported taxes.

PRINCIPAL RESIDENCE IS NOT INVESTMENT PROPERTY

Tony R. and Denelda Sims Goolsby v. Comm'r, TC Memo 2010-64 (Apr. 1, 2010)

Facts. The taxpayers sold real estate that they had held for investment and through a QI reinvested the gain into replacement real estate. They tried for less than two months to rent the replacement property, then they moved into the property for use as their personal residence.

Result. The court was not convinced that the taxpayers purchased the replacement property for investment or for productive use in a trade or business at the time of the exchange. Therefore, the gain from the sale of the investment real estate was included in income and the court imposed the **20% accuracy-related penalty**.

Note. In *Reesink v. Comm'r*,²¹ the taxpayers also converted replacement property to personal use after attempting to find renters for the property. However, the taxpayers left the property available for rent longer and made more attempts to find renters. Based on all the facts presented, they were able to prove to the court that they purchased the replacement property with the intent to hold it for investment purposes and only converted it to personal use after they were unable to rent the property. For more information about *Reesink*, see 2012 Volume B, Chapter 6: Rulings and Cases.

WHAT IS CONSIDERED LIKE-KIND

Donald Wiechens, et al. v. United States, 228 F.Supp. 2d 1080 (D. Ariz. 2002)

Facts. The taxpayers owned certain water rights for access to the Colorado River. They sold the rights for \$567,810. Through a QI, the proceeds were reinvested into farmland.

Result. The court agreed that water rights are considered an interest in real property. However, the court also determined that the water rights sold by the taxpayers were limited in priority, quantity, and duration. Because of these narrow restrictions, the water rights were not sufficiently similar to the fee-simple interest they acquired in the farmland to qualify as like-kind property. Additional taxes assessed on all partners totaled \$199,381. The interest on the underpayment of tax was \$73,534.

PROPERTY MUST BE RELINQUISHED

Donald and Doris DeCleene v. Comm'r, 115 TC No. 457 (Nov. 17, 2000)

Facts. The taxpayers used cash realized from the sale of one real estate parcel (M Street) to construct a new building on unimproved land they already owned. In order to avoid taxes on the sale of M Street, the taxpayers transferred the title to the unimproved lot to the party that wished to buy M Street. The buyer built the building that the taxpayers wanted, then traded the new building and lot for the M Street property.

Result. The court determined that the taxpayers never truly divested themselves of beneficial ownership of the unimproved lot. As such, they could not acquire the lot and new building as replacement property in exchange for the M Street property. The additional tax due was \$23,796.

However, the court also found that the taxpayers' reliance on their CPA and attorney was reasonable cause for the underpayment. Therefore, the court did not impose an accuracy-related penalty of \$4,759.

²¹ *Reesink v. Comm'r*, TC Memo 2012-118 (Apr. 23, 2012).

THE ESCROW IS UNTOUCHABLE

Florida Industries Investment Corporation and Subsidiaries v. Comm'r, TC Memo 1999-346 (Oct. 19, 1999)

Facts. Funds from the sale of real estate were deposited with an escrow agent to be held until the funds could be reinvested in qualifying like-kind property. Contrary to the provisions of the escrow agreement, the taxpayer withdrew funds from the escrow account and authorized nonqualifying uses of the money.

Result. Based on the degree of control the taxpayer exercised over the escrow funds, the court found that **all** the money deposited to the escrow account was constructively received by the taxpayer. Therefore, **none of the proceeds qualified for like-kind exchange treatment** even though some of the money was spent on qualifying replacement property within the proper time limits. Accuracy-related penalties also applied.

ABIDE BY DEADLINES AND NEVER FABRICATE DOCUMENTS

David and Naomi Dobrich v. Comm'r, TC Memo 1997-477 (Oct. 20, 1997)

Facts. The taxpayers failed to identify the replacement property within 45 days from the date the relinquished property was transferred. In an attempt to “cure” missing the deadline, they directed their real estate agent to backdate their offer on one of the replacement properties and to redate its purchase contract. They also obtained a fraudulent letter from another real estate agent backdated to demonstrate that they had expressed interest in another replacement property during the replacement period.

Result. The Appeals Court agreed with the Tax Court that none of the properties were identified in the required time frame. The courts determined that the evidence provided clear and convincing proof of the taxpayers’ fraudulent intent. The taxpayers were liable for the fraud penalty in addition to the underreported taxes. The additional taxes due were \$1,030,663 and the fraud penalty was \$772,997.

ISSUE 5. DISPOSITION OF A SMALL BUSINESS

Most businesses have many types of assets, both tangible and intangible. Tax consequences vary based on the types of assets that a company sells.

TYPES OF GAINS

Gains from the sale of business assets must be grouped by category to determine the applicable tax rates. The following Code sections define the tax treatment for specific types of gains realized from selling business assets.

- **IRC §1231** applies to gains/losses from business assets after taking into account the provisions of IRC §§1245 and 1250. Any gains not subject to the recapture provisions are considered §1231 gains.
- **IRC §1239** applies to gains from the sale of depreciable property between certain related taxpayers.
- **IRC §1245** applies to gains/losses from the sale of depreciable personal property, both tangible and intangible.
- **IRC §1250** applies to land, buildings, and improvements.
- **IRC §1252** applies only to sales of farmland owned for less than 10 years and only to the extent of conservation expenses previously deducted.
- **IRC §1254** applies only to sales of interests in oil, gas, geothermal, or other mineral properties.
- **IRC §1255** applies only to the extent that certain conservation-related payments were previously excluded from gross income in the last 10 years.

Most gains relating to small businesses fall under IRC §§1245, 1250, and 1231. The remainder of this section addresses only these types of gains.

2012 Workbook

Example 26. Unlike some independently wealthy superheroes, Batguy is always compensated for his services. In 2011, he decides to retire. He enters into an agreement with his younger sidekick, Sparrow, to sell the following business assets for \$200,000, allocated as shown below.

Asset	Type	Applicable Code Section	Sales Price
Batcoupe	Vehicle >6,000 lbs GVW, personal property	1245	\$ 20,000
Batvoice	Telephone, personal property	1245	5,000
Batgrotto	Hideout, real estate	1250	100,000
Batroll	Contacts list, goodwill (self-created)	1231	75,000

DEPRECIATION RECAPTURE

For tax purposes, the term “depreciation recapture” is used in several different contexts and the consequences of the recapture vary by context.

- **Section 179 depreciation recapture** applies when the business use of an asset falls below 50%, but it does **not** apply when the asset is sold. This recapture requires that excess depreciation be claimed on the form on which the deduction was originally taken. Consequently, the taxpayers may have to pay self-employment (SE) tax on the recapture if they have net SE income in the year of the recapture.
- **Section 1245 depreciation recapture** applies when an asset is sold and applies to **all** depreciation claimed on the asset, including bonus depreciation and §179 depreciation. This recapture requires that all the depreciation previously claimed be taxed as ordinary income to the extent of the gain. However, it is not subject to SE tax.
- **Section 1250 depreciation recapture** applies only to the amount of depreciation claimed on real property that is above the amount that would have been claimed using straight-line depreciation. This recapture applies to bonus depreciation. The amount recaptured is reported as ordinary income but is not subject to SE tax. The recapture amount is limited to the amount of gain recognized.

Note. To the extent of any gain recognized on the sale of real estate, the portion of the gain attributable to the straight-line depreciation previously allowed is subject to a **maximum** capital gains tax rate of 25%. This is not considered a recapture of the depreciation; rather, this portion of the gain is simply another type of capital gain. It is commonly referred to as the 25% rate gain.

Example 27. Use the same facts as **Example 26**. For each asset, the following chart shows the amounts Batguy paid, the depreciation allowed (including the depreciation applicable to the year of sale), the remaining basis, and the depreciation subject to recapture. The depreciation amounts have been rounded to the nearest \$1,000 for this example for ease of discussion.

Asset	Original Cost	Depreciation Allowed	Basis	Subject to Recapture
Batcoupe	\$50,000	\$42,000	\$ 8,000	\$42,000
Batvoice	500	500	0	500
Batgrotto	30,000	11,000	19,000	0
Batroll	0	0	0	0

Observations:

1. The Batcoupe is §1245 property. The entire amount of depreciation claimed up to the date of sale is subject to recapture. However, because the sales price is **less** than the original cost, the amount recaptured is limited to the amount of the gain.
2. The Batvoice is also §1245 property. The entire amount of depreciation claimed up to the date of sale is subject to recapture. Because the sales price is **greater** than the original cost, the entire amount of depreciation is recaptured. However, the amount of the sales price that is greater than the original cost is taxed as a capital gain.
3. The Batgrotto is §1250 property. None of the investment in the grotto qualified for bonus depreciation. All the depreciation allowed was calculated using the **straight-line method**. Therefore, none of the depreciation is subject to recapture.
4. The Batroll is §1231 property. Because the client list was self-created, there was no amortizable cost. All the gain is taxed as capital gain.

TAX RATES FOR GAINS REALIZED BY INDIVIDUALS

For 2012, ordinary income may be taxed at rates as low as 10% or as high as 35%. Capital gains rates range between 0% and 15% for most types of long-term capital gains.²² However, long-term capital gains attributable to depreciation on real property may be taxed at a maximum rate of 25%. In addition, a maximum rate of 28% applies to gains from collectibles and small business stock.

Example 28. Use the same facts as **Example 27**. For each asset that Batguy sold, the following chart shows the amount of gain realized, the ordinary income reportable, the long-term capital gain, and the **maximum tax rate that applies**. The recapture amount in column (e) equals the **lesser** of the gain or the amount subject to recapture as shown in **Example 27**. Column (h) equals the amount of depreciation previously claimed on the real estate, which is also shown in **Example 27**.

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
Asset	Sales Price	Basis	Gain	Recap.	Max Rate on Recap.	Unrecap. Gain (d-e)	25% Gain	15% Gain (g-h)
Batcoupe	\$ 20,000	\$ 8,000	\$ 12,000	\$12,000	35%	\$ 0	\$ 0	\$ 0
Batvoice	5,000	0	5,000	500	35%	4,500	0	4,500
Batgrotto	100,000	19,000	81,000	0	n/a	81,000	11,000	70,000
Batroll	75,000	0	75,000	0	n/a	75,000	0	75,000
Totals	\$200,000	\$27,000	\$173,000	\$12,500		\$160,500	\$11,000	\$149,500
Applicable maximum rate				35%			25%	15%
Maximum tax by type				\$ 4,375			\$ 2,750	\$ 22,425

Batguy is not subject to AMT. Therefore, the maximum amount of federal taxes that he will pay because of this sale is \$29,550 (\$4,375 + \$2,750 + \$22,425).

²² IRC §1(h).

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Example 29. Use the same facts as **Example 28**. Batguy's tax advisor, Taxwoman, advised him to sell on January 1, 2011, so that the gains would not be included in income in the same year as profits from his business. Based on his usual level of profits, if he sold at the end of a year, the gains would be taxed at the maximum rates. However, by selling in a year that his income does not include his business profits, the gains are taxed at the lowest rates for each type of asset.

In 2011, he does not have any other income or deductible expenses for the year except those related to the sale. His Schedule C shows a \$2,000 loss because of the depreciation on the Batcoupe and Batgrotto that is deductible in the year of the sale. The following forms show how this transaction is reported on his 2011 return and the calculation of his federal tax, which totals **\$20,429**. To understand the flow of the return, the forms are shown in the order that they are completed. Page 2 of Form 4797 is prepared first, followed by page 1 of Form 4797, and then Schedule D.

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For Example 29

Form 4797 (2011)

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 Batcoupe	06/30/09	01/01/11
	B Batvoice	06/30/08	01/01/11
	C Batgrotto	09/01/96	01/01/11
	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 20,000	5,000	100,000	
21	Cost or other basis plus expense of sale	21 50,000	500	30,000	
22	Depreciation (or depletion) allowed or allowable	22 42,000	500	11,000	
23	Adjusted basis. Subtract line 22 from line 21.	23 8,000	0	19,000	
24	Total gain. Subtract line 23 from line 20	24 12,000	5,000	81,000	
25	If section 1245 property:				
	a Depreciation allowed or allowable from line 22	25a 42,000	500		
	b Enter the smaller of line 24 or 25a	25b 12,000	500		
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, mining exploration costs, and depletion (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	98,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	12,500
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	85,500

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	

Form **4797** (2011)

2012 Workbook

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 <div style="font-size: 2em; font-weight: bold;">2011</div> Attachment Sequence No. 27					
Name(s) shown on return Batguy East		Identifying number 010-27-2829					
1 Enter the gross proceeds from sales or exchanges reported to you for 2011 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)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	Batroll	Created	01/01/11	75,000		0	75,000
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 85,500
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						7 160,500
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 12,500
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 12,500
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 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions . . .							
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							
							18a
							18b 12,500

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 130861 Form **4797** (2011)

2012 Workbook

For Example 29

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on return

Batguy East

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).
► Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074

2011

Attachment
Sequence No. **12**

Your social security number

010-27-2829

3

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

Complete Form 8949 before completing line 1, 2, or 3.

This form may be easier to complete if you round off cents to whole dollars.

	(e) Sales price from Form(s) 8949, line 2, column (e)	(f) Cost or other basis from Form(s) 8949, line 2, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I		()		
2 Short-term totals from all Forms 8949 with box B checked in Part I		()		
3 Short-term totals from all Forms 8949 with box C checked in Part I		()		
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions				6 ()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back				7

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

Complete Form 8949 before completing line 8, 9, or 10.

This form may be easier to complete if you round off cents to whole dollars.

	(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		()		
9 Long-term totals from all Forms 8949 with box B checked in Part II		()		
10 Long-term totals from all Forms 8949 with box C checked in Part II		()		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11 160,500
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back				15 160,500

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11338H

Schedule D (Form 1040) 2011

2012 Workbook

For Example 29

Form	1040	Department of the Treasury—Internal Revenue Service (99)	2011	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.																									
For the year Jan. 1–Dec. 31, 2011, or other tax year beginning , 2011, ending , 20																														
Your first name and initial Batguy		Last name East		See separate instructions.																										
If a joint return, spouse's first name and initial		Last name		Your social security number 0 1 0 2 7 2 8 2 9																										
Home address (number and street). If you have a P.O. box, see instructions. PO Box 30		Apt. no.		Spouse's social security number																										
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Brooklyn, NY 11201				<div style="border: 1px solid black; padding: 2px;"> ▲ Make sure the SSN(s) above and on line 6c are correct. </div>																										
Foreign country name		Foreign province/county		Foreign postal code																										
<div style="display: flex; justify-content: space-between;"> <div style="width: 45%;"> Filing Status 1 <input checked="" type="checkbox"/> Single 2 <input type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. ► Check only one box. </div> <div style="width: 45%;"> 4 <input type="checkbox"/> Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ► 5 <input type="checkbox"/> Qualifying widow(er) with dependent child </div> </div>																														
Exemptions 6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a b <input type="checkbox"/> Spouse																														
<div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> c Dependents: <table border="1" style="width:100%; border-collapse: collapse; font-size: 8pt;"> <thead> <tr> <th style="width: 30%;">(1) First name</th> <th style="width: 20%;">Last name</th> <th style="width: 15%;">(2) Dependent's social security number</th> <th style="width: 15%;">(3) Dependent's relationship to you</th> <th style="width: 20%;">(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td><input type="checkbox"/></td></tr> </tbody> </table> </div> <div style="width: 35%;"> Boxes checked on 6a and 6b No. of children on 6c who: • lived with you • did not live with you due to divorce or separation (see instructions) Dependents on 6c not entered above Add numbers on lines above ► </div> </div>						(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)					<input type="checkbox"/>					<input type="checkbox"/>					<input type="checkbox"/>					<input type="checkbox"/>
(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions)																										
				<input type="checkbox"/>																										
				<input type="checkbox"/>																										
				<input type="checkbox"/>																										
				<input type="checkbox"/>																										
d Total number of exemptions claimed 1																														
Income 7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 8a Taxable interest. Attach Schedule B if required 8a b Tax-exempt interest. Do not include on line 8a 8b 9a Ordinary dividends. Attach Schedule B if required 9a b Qualified dividends 9b 10 Taxable refunds, credits, or offsets of state and local income taxes 10 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 (2,000) 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ► <input type="checkbox"/> 13 160,500 14 Other gains or (losses). Attach Form 4797 14 12,500 15a IRA distributions 15a 15b Taxable amount 15b 16a Pensions and annuities 16a 16b Taxable amount 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 20b Taxable amount 20b 21 Other income. List type and amount 21 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ► 22 171,000																														
Adjusted Gross Income 23 Educator expenses 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE 27 28 Self-employed SEP, SIMPLE, and qualified plans 28 29 Self-employed health insurance deduction 29 30 Penalty on early withdrawal of savings 30 31a Alimony paid b Recipient's SSN ► 31a 32 IRA deduction 32 33 Student loan interest deduction 33 34 Tuition and fees. Attach Form 8917 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 35 36 37 Subtract line 36 from line 22. This is your adjusted gross income ► 37 171,000																														

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2011)

2012 Workbook

For Example 29

Form 1040 (2011)		Batguy East		010-27-2829		Page 2	
Tax and Credits	38	Amount from line 37 (adjusted gross income)		38	171,000		
	39a	Check <input type="checkbox"/> You were born before January 2, 1947, <input type="checkbox"/> Blind. Total boxes					
		if: <input type="checkbox"/> Spouse was born before January 2, 1947, <input type="checkbox"/> Blind. checked ▶ 39a					
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b <input type="checkbox"/>					
	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)		40	5,800		
	41	Subtract line 40 from line 38		41	165,200		
	42	Exemptions. Multiply \$3,700 by the number on line 6d		42	3,700		
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	161,500		
	44	Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> 962 election		44	20,429		
	45	Alternative minimum tax (see instructions). Attach Form 6251		45	0		
46	Add lines 44 and 45		46	20,429			
47	Foreign tax credit. Attach Form 1116 if required		47				

Schedule D (Form 1040) 2011 Batguy East 010-27-2829 Page 2

Part III Summary

16	Combine lines 7 and 15 and enter the result	16	160,500
	<ul style="list-style-type: none"> If line 16 is a gain, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. If line 16 is a loss, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22. 		
17	Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.		
18	Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet in the instructions	18	
19	Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet in the instructions	19	11,000
20	Are lines 18 and 19 both zero or blank? <input type="checkbox"/> Yes. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). Do not complete lines 21 and 22 below. <input checked="" type="checkbox"/> No. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Schedule D Tax Worksheet in the instructions. Do not complete lines 21 and 22 below.		

2012 Workbook

For Example 29

Schedule D Tax Worksheet

Keep for Your Records



Complete this worksheet only if line 18 or line 19 of Schedule D is more than zero. Otherwise, complete the Qualified Dividends and Capital Gain Tax Worksheet in the Instructions for Form 1040, line 44 (or in the Instructions for Form 1040NR, line 42) to figure your tax.

Exception: Do not use the Qualified Dividends and Capital Gain Tax Worksheet or this worksheet to figure your tax if:

- Line 15 or line 16 of Schedule D is zero or less **and** you have no qualified dividends on Form 1040, line 9b (or Form 1040NR, line 10b); or
- Form 1040, line 43 (or Form 1040NR, line 41) is zero or less.

Instead, see the instructions for Form 1040, line 44 (or Form 1040NR, line 42).

1. Enter your taxable income from Form 1040, line 43 (or Form 1040NR, line 41). (However, if you are filing Form 2555 or 2555-EZ (relating to foreign earned income), enter instead the amount from line 3 of the Foreign Earned Income Tax Worksheet in the Instructions for Form 1040, line 44)	1.	161,500
2. Enter your qualified dividends from Form 1040, line 9b (or Form 1040NR, line 10b)	2.	
3. Enter the amount from Form 4952 (used to figure investment interest expense deduction), line 4g	3.	
4. Enter the amount from Form 4952, line 4e*	4.	
5. Subtract line 4 from line 3. If zero or less, enter -0-	5.	
6. Subtract line 5 from line 2. If zero or less, enter -0-**	6.	
7. Enter the smaller of line 15 or line 16 of Schedule D	7.	160,500
8. Enter the smaller of line 3 or line 4	8.	
9. Subtract line 8 from line 7. If zero or less, enter -0-**	9.	160,500
10. Add lines 6 and 9	10.	160,500
11. Add lines 18 and 19 of Schedule D**	11.	11,000
12. Enter the smaller of line 9 or line 11	12.	11,000
13. Subtract line 12 from line 10	13.	149,500
14. Subtract line 13 from line 1. If zero or less, enter -0-	14.	12,000
15. Enter: • \$34,500 if single or married filing separately; • \$69,000 if married filing jointly or qualifying widow(er); or • \$46,250 if head of household }	15.	34,500
16. Enter the smaller of line 1 or line 15	16.	34,500
17. Enter the smaller of line 14 or line 16	17.	12,000
18. Subtract line 10 from line 1. If zero or less, enter -0-	18.	1,000
19. Enter the larger of line 17 or line 18	19.	12,000
20. Subtract line 17 from line 16. This amount is taxed at 0%.	20.	22,500
If lines 1 and 16 are the same, skip lines 21 through 33 and go to line 34. Otherwise, go to line 21.		
21. Enter the smaller of line 1 or line 13	21.	149,500
22. Enter the amount from line 20 (if line 20 is blank, enter -0-)	22.	22,500
23. Subtract line 22 from line 21. If zero or less, enter -0-	23.	127,000
24. Multiply line 23 by 15% (.15)	24.	19,050
If Schedule D, line 19, is zero or blank, skip lines 25 through 30 and go to line 31. Otherwise, go to line 25.		
25. Enter the smaller of line 9 above or Schedule D, line 19	25.	11,000
26. Add lines 10 and 19	26.	172,500
27. Enter the amount from line 1 above	27.	161,500
28. Subtract line 27 from line 26. If zero or less, enter -0-	28.	11,000
29. Subtract line 28 from line 25. If zero or less, enter -0-	29.	0
30. Multiply line 29 by 25% (.25)	30.	
If Schedule D, line 18, is zero or blank, skip lines 31 through 33 and go to line 34. Otherwise, go to line 31.		
31. Add lines 19, 20, 23, and 29	31.	161,500
32. Subtract line 31 from line 1	32.	0
33. Multiply line 32 by 28% (.28)	33.	0
34. Figure the tax on the amount on line 19 . If the amount on line 19 is less than \$100,000, use the Tax Table to figure the tax. If the amount on line 19 is \$100,000 or more, use the Tax Computation Worksheet	34.	1,379
35. Add lines 24, 30, 33, and 34	35.	20,429
36. Figure the tax on the amount on line 1 . If the amount on line 1 is less than \$100,000, use the Tax Table to figure the tax. If the amount on line 1 is \$100,000 or more, use the Tax Computation Worksheet	36.	38,837
37. Tax on all taxable income (including capital gains and qualified dividends). Enter the smaller of line 35 or line 36. Also include this amount on Form 1040, line 44 (or Form 1040NR, line 42). (If you are filing Form 2555 or 2555-EZ, do not enter this amount on Form 1040, line 44. Instead, enter it on line 4 of the Foreign Earned Income Tax Worksheet in the Form 1040 instructions)	37.	20,429

*If applicable, enter instead the smaller amount you entered on the dotted line next to line 4e of Form 4952.

**If you are filing Form 2555 or 2555-EZ, see the footnote in the Foreign Earned Income Tax Worksheet in the Instructions for Form 1040, line 44, before completing this line.

ASSET ACQUISITION STATEMENT

Not only does the type of asset determine the rate of tax that the seller pays, the type of asset determines the amount of depreciation that the buyer may claim each year. Therefore, there is an inherent conflict between the buyer and seller in allocating the purchase price of a business among the assets involved.

Ideally, this allocation is negotiated at the same time as the sales price. Tax professionals should encourage their clients to consult with them before entering into these types of negotiations.

In an attempt to ensure that the buyer and seller treat the asset acquisition equitably, the Code²³ requires that **each party** to the sale of a group of assets constituting a business **attach a disclosure statement** to their tax return for the year of the transaction. The regulations require that this disclosure be made using Form 8594, *Asset Acquisition Statement Under Section 1060*.²⁴ Exceptions to this requirement apply to like-kind exchanges and purchases of partnership interests.

Assets reported on Form 8594 are grouped into seven distinct classes. The following definitions apply to each class.

- Class I.** **Class I** assets are savings and checking accounts held in banks, savings and loan associations, and other depository institutions (but not certificates of deposit).
- Class II.** **Class II** assets are actively traded personal property (any personal property which has an established financial market), certificates of deposit, and foreign currency. Class II assets do not include stock of target affiliates, whether or not actively traded, other than actively traded “preferred” stock. Examples of Class II assets include U.S. government securities and publicly traded stock.
- Class III.** **Class III** assets are accounts receivable, debt instruments, and assets that the taxpayer marks-to-market at least annually for federal income tax purposes. However, Class III assets do not include the following.
 - Debt instruments issued by persons related to the purchased business as of the day following the acquisition date
 - Most contingent debt instruments
 - Debt instruments convertible into the stock or other property of the issuer
- Class IV.** **Class IV** assets are property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business (inventory).
- Class V.** **Class V** assets are all assets not included in Classes I, II, III, IV, VI, and VII. Furniture and fixtures, buildings, land, vehicles, and equipment are generally Class V assets.
- Class VI.** **Class VI** assets are all IRC §197 intangibles, except goodwill and going concern value. IRC §197 intangibles include the following.
 - Workforce in place
 - Business books and records, operating systems, or any other information base, process, design, pattern, know-how, formula, or similar item
 - Any customer-based intangible
 - Any supplier-based intangible
 - Any license, permit, or other right granted by a governmental unit
 - Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business
 - Any franchise (other than a sports franchise), trademark, or trade name
- Class VII.** **Class VII** assets are goodwill and going concern value.

²³ IRC §1060.

²⁴ Treas. Reg. §1.1060-1(e)(1)(ii).

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Note. If an asset can be included in more than one class, it should be included within the lowest numbered class. The allocation of the purchase price is made in the order of the classes based on the fair market value of the assets included in that class.

Example 30. After another humiliating defeat, Lux Lexor decides it's time to throw in the towel. He reaches an agreement with The Wit to sell all of the assets held by his company, Lexor Misdeeds. The agreement is consummated on August 25, 2012, for \$75,000. In addition, The Wit pays Lux \$25,000 to enter into a noncompete agreement. Lux pays \$1,000 to his attorney for legal services relating to the sale.

The parties agree to the following amounts.

		Class
Noncompete agreement	\$25,000	VI
Market value of assets of Lexor Misdeeds		
Cash in bank	2,000	I
Mutual funds	3,000	II
Accounts receivable	10,000	III
Power rings for resale	1,000	IV
Furniture and fixtures	5,000	V
Franchise license	12,000	VI
Goodwill	42,000	VII
Total market value of assets of Lexor Misdeeds	\$75,000	

The Wit has not incurred any additional costs related to the purchase and therefore reports this transaction on Form 8594 as follows.

2012 Workbook

For Example 30

Form 8594 (Rev. December 2012) Department of the Treasury Internal Revenue Service	Asset Acquisition Statement Under Section 1060 ▶ Attach to your income tax return. ▶ Information about Form 8594 and its separate instructions is at www.irs.gov/form8594	OMB No. 1545-1021 Attachment Sequence No. 169
Name as shown on return THE WIT		Identifying number as shown on return 969-66-9696
Check the box that identifies you: <input checked="" type="checkbox"/> Purchaser <input type="checkbox"/> Seller		
Part I General Information		
1 Name of other party to the transaction LUX LEXOR		Other party's identifying number 777-77-7777
Address (number, street, and room or suite no.) PO BOX 5		
City or town, state, and ZIP code METROPOLIS, IL 62960		
2 Date of sale 08/25/2012		3 Total sales price (consideration) \$100,000
Part II Original Statement of Assets Transferred		
4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	\$ 2,000	\$ 2,000
Class II	\$ 3,000	\$ 3,000
Class III	\$ 10,000	\$ 10,000
Class IV	\$ 1,000	\$ 1,000
Class V	\$ 5,000	\$ 5,000
Class VI and VII	\$ 79,000	\$ 79,000
Total	\$ 100,000	\$ 100,000
5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
If "Yes," attach a statement that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.		
For Paperwork Reduction Act Notice, see separate instructions.		
Cat. No. 63768Z		Form 8594 (Rev. 12-2012)

Note. By checking "Yes" for line 6, the taxpayer is required to attach a schedule reporting the additional information required on that line. Line 6 applies to both the purchaser and the seller. To determine the maximum consideration to be paid, any contingencies specified in the agreement are assumed to have been met. If the maximum consideration cannot be determined at the time the form is filed, the schedule will show how the consideration will be computed and the payment period. The required description is not shown for this example.

2012 Workbook

Lux Lexor must adjust the consideration received by the amount of costs incurred in the sale. Rather than realizing \$100,000, he realized \$99,000 after selling expenses. Using the residual method, the market value of each class is subtracted from the sales price, until the remaining balance of the consideration is less than the market value of the class.

Compare the Form 8594 for Lux to the Form 8594 for The Wit. Under the column labeled "Allocation of sales price," the amount allocated to Class VI and VII has been reduced by the \$1,000 selling costs. Like The Wit, Lux is required to attach a schedule for line 6.

Form 8594 (Rev. December 2012) Department of the Treasury Internal Revenue Service	Asset Acquisition Statement Under Section 1060 ▶ Attach to your income tax return. ▶ Information about Form 8594 and its separate instructions is at www.irs.gov/form8594	OMB No. 1545-1021 Attachment Sequence No. 169
Name as shown on return LUX LEXOR		Identifying number as shown on return 777-77-7777
Check the box that identifies you: <input type="checkbox"/> Purchaser <input checked="" type="checkbox"/> Seller		
Part I General Information		
1 Name of other party to the transaction THE WIT		Other party's identifying number 969-66-9696
Address (number, street, and room or suite no.) 69 ARKHAM LANE		
City or town, state, and ZIP code GOTHAM, NY 11566		
2 Date of sale 08/25/2012		3 Total sales price (consideration) \$99,000
Part II Original Statement of Assets Transferred		
4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	\$ 2,000	\$ 2,000
Class II	\$ 3,000	\$ 3,000
Class III	\$ 10,000	\$ 10,000
Class IV	\$ 1,000	\$ 1,000
Class V	\$ 5,000	\$ 5,000
Class VI and VII	\$ 78,000	\$ 78,000
Total	\$ 99,000	\$ 99,000
5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
If "Yes," attach a statement that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.		

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 63768Z

Form **8594** (Rev. 12-2012)

INSTALLMENT SALES

Note. See IRS Pub. 537, *Installment Sales*, for more information on this topic.

Instead of exchanging the entire consideration in one year, the buyer and seller may enter into an installment agreement whereby the seller receives compensation over a period of years. There are common reasons for this type of agreement.

1. The buyer is unable to finance the entire purchase price in the year of the sale.
2. The seller wishes to spread the tax consequences of the sale over more than one year.

This type of arrangement can be advantageous to the seller if other income would cause portions of the sale to be taxed in higher brackets during the tax year in which the sale occurs. However, there are a number of provisions that must be considered when reporting installment sale income.

If the seller realizes a gain on an installment sale, they generally report only the applicable portions of the gain each year. The installment method cannot be used to report a loss.

The factors that impact the amount of gain recognized in any given year include the following.

1. Depreciation recapture
2. Principal payment received
3. Gross profit percentage

The seller may elect to report the entire gain in the year of the sale. The election is made by reporting the entire gain on the return for the year of sale. It must be made by the due date (including extensions) of the return for the year of the sale. Once made, the election can only be revoked with IRS approval.

The interest portion of each payment is reported in the year received regardless of whether the agreement resulted in a gain/loss or if the taxpayer elected to report the entire gain in the year of the sale. If the agreement calls for zero interest or an interest rate below the applicable federal rate, interest must be imputed.²⁵

Related Parties

With any transaction that is subject to favorable tax treatment, Congress attempts to limit the ability of related parties to manipulate the situation to a more favorable tax result than otherwise intended. Using the installment method to report gains between related parties is one of the tools that might allow taxpayers to manufacture tax savings.

There are **two primary restrictions** that apply to the availability of the method for transactions involving **related parties**.

1. If the related buyer resells the property within two years of the sale, all the proceeds received by the original buyer are also reported as received by the original seller in the year the buyer resells the property. This rule does not apply if the taxpayers can show to the satisfaction of the IRS that neither the first disposition to the related person nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, acceptable circumstances for a second disposition include involuntary conversions, death, or economic results similar to the original agreement.
2. If the related party transaction involves depreciable property, the installment method may not be used unless no significant tax deferral benefit will be derived from the sale. The taxpayer must be able to convince the IRS that avoidance of federal income tax was not one of the principal purposes of the sale. If the installment method is prohibited, all payments to be received are treated as received in the year of sale.

²⁵ For further information on imputed interest rates, see IRS Pub. 537, *Installment Sales*, “Unstated Interest and Original Issue Discounts.”

2012 Workbook

Escrow Account

In some cases, the sales agreement or a later agreement may call for the buyer to establish an irrevocable escrow account from which the remaining installment payments are to be made. These sales cannot be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account.

However, if an escrow arrangement imposes a substantial restriction on the seller's right to receive the sale proceeds, the sale can be reported on the installment method. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the **buyer**, such as restricting payments from the escrow account until the seller has met certain obligations.

Depreciation Recapture Income

If the sale includes depreciable property, any depreciation recapture must be **reported in full** as income in the year of sale, whether or not an installment payment was received that year. Only the gain greater than the recapture income is reported on the installment method. The recapture income that is reported in the year of sale is included in the installment sale basis in calculating the gross profit on the installment sale.

Example 31. In 2011, Oliver Green sold a farm building via contract for deed for \$200,000. The underlying land was sold in a separate transaction. According to the terms of the agreement, Oliver received \$10,000 in 2011, and he will receive the balance in equal installments amortized over 20 years at 8% interest.

Oliver acquired the farm building in 2003 for \$80,000. Buildings used for farming purposes have a MACRS recovery period of 20 years and qualify for bonus depreciation. In 2003, the applicable bonus depreciation rate was 50%.

The amount of IRC §1250 recapture that must be reported by Oliver for 2011 is calculated as follows.

Bonus depreciation	\$40,000
Plus: straight-line depreciation (rounded for illustration purposes to the nearest \$1,000)	<u>19,000</u>
Total depreciation allowed	\$59,000
Less: allowable depreciation using straight-line only	<u>(38,000)</u>
IRC §1250 depreciation recapture	\$21,000

For purposes of calculating Oliver's gain from the installment sale, his basis is equal to:

Original purchase price	\$80,000
Less: allowed depreciation	(59,000)
Plus: IRC §1250 recapture	<u>21,000</u>
Net basis after adjustments	\$42,000

Even though Oliver only received \$10,000 in 2011, he must report the entire \$21,000 of depreciation recapture as ordinary income. In addition, he must report the unrecaptured §1250 gain of \$7,900, which is subject to the maximum rate of 25%. This \$7,900 is the portion of the \$10,000 he receives that is allocated to gain using the installment method.

The following forms show how the installment sale and gain are reported on Oliver's 2011 return. To understand the flow of the return, the forms are shown in the order that they are completed. Page 2 of Form 4797 is prepared first, followed by Form 6252, page 1 of Form 4797, and Schedule D.

2012 Workbook

For Example 31

Form 4797 (2011)

355-55-5555

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 building	06/30/03	02/24/11
	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.)	200,000			
21	Cost or other basis plus expense of sale	80,000			
22	Depreciation (or depletion) allowed or allowable	59,000			
23	Adjusted basis. Subtract line 22 from line 21.	21,000			
24	Total gain. Subtract line 23 from line 20	179,000			
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)	21,000			
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	21,000			
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	158,000			
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.	21,000			
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, mining exploration costs, and depletion (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	179,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	21,000
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	0

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

Form 4797 (2011)

2012 Workbook

For Example 31

Form **6252**
Department of the Treasury
Internal Revenue Service

Installment Sale Income

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

OMB No. 1545-0228

2011
Attachment
Sequence No. **79**

Name(s) shown on return

Oliver Green

Identifying number

355-55-5555

- 1** Description of property ► **Farm building**
- 2a** Date acquired (mm/dd/yyyy) ► **06/30/2003** **b** Date sold (mm/dd/yyyy) ► **02/24/2011**
- 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	200,000
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	200,000
8	Cost or other basis of property sold	8	80,000
9	Depreciation allowed or allowable	9	59,000
10	Adjusted basis. Subtract line 9 from line 8	10	21,000
11	Commissions and other expenses of sale	11	
12	Income recapture from Form 4797, Part III (see instructions)	12	21,000
13	Add lines 10, 11, and 12	13	42,000
14	Subtract line 13 from line 5. If zero or less, do not complete the rest of this form (see instructions)	14	158,000
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	158,000
17	Subtract line 13 from line 6. If zero or less, enter -0-	17	0
18	Contract price. Add line 7 and line 17	18	200,000

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 (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions	19	0.7900
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-	20	0
21	Payments received during year (see instructions). Do not include interest, whether stated or unstated	21	10,000
22	Add lines 20 and 21	22	10,000
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	7,900
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	7,900

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 (mm/dd/yyyy) ►
- 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 IRS 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 2011 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** (2011)

2012 Workbook

For Example 31

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 <div style="font-size: 2em; font-weight: bold;">2011</div> Attachment Sequence No. 27					
Name(s) shown on return Oliver Green		Identifying number 355-55-5555					
1 Enter the gross proceeds from sales or exchanges reported to you for 2011 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)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
3	Gain, if any, from Form 4684, line 39						3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4 7,900
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 0
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						7 7,900
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 21,000
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 21,000
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 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions . . .							
18a							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 21,000	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 130861

Form **4797** (2011)

2012 Workbook

For Example 31

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on return

Oliver Green

Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).
► Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074

2011

Attachment
Sequence No. **12**

Your social security number

355-55-5555

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

checked in Pa		
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	7,900
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	
13	Capital gain distributions. See the instructions	
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions	()
15	Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back	7,900

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Cat. No. 11338H

Schedule D (Form 1040) 2011

Schedule D (Form 1040) 2011

355-55-5555

Page **2**

Part III Summary

16	Combine lines 7 and 15 and enter the result	7,900
	<ul style="list-style-type: none">• If line 16 is a gain, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.• If line 16 is a loss, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.• If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.	
17	Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.	
18	Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet in the instructions . . . ►	
19	Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet in the instructions . . . ►	7,900
20	Are lines 18 and 19 both zero or blank? <input type="checkbox"/> Yes. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). Do not complete lines 21 and 22 below. <input checked="" type="checkbox"/> No. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Schedule D Tax Worksheet in the instructions. Do not complete lines 21 and 22 below.	

Multiple Assets Sold on Installment as Part of a Sale of Business

To determine whether any of the gain on the sale of the business can be reported on the installment method, the total selling price and the payments received in the year of sale must be allocated between each of the following types of assets.

1. Assets sold at a loss
2. Real and personal property eligible for the installment method
3. Real and personal property not eligible for the installment method, including:
 - a. Inventory,
 - b. Dealer property, and
 - c. Stocks and securities

Inventory. The sale of inventories of personal property **cannot** be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if the payments are received in later years. The amount allocated to inventory is reported as ordinary business income. Any part of the selling expenses allocable to inventory is deductible as an ordinary business expense.

Ideally, the agreement states which payments received are for inventory and which are for the other assets being sold. In addition, because the total price of the inventory items is reported as income in the year of the sale, it is best to specify in the contract that the first payments are applied to the inventory purchased.

If the agreement does not specify how the payments are applied, each payment must be allocated between the inventory and the other assets sold based on their relative sales price.

Residual Method. Except for assets exchanged under the like-kind exchange rules, both the buyer and seller of a business must use the residual method to allocate the sale price to each business asset sold. This method is the same one used to determine the price of assets reported on Form 8594.

2012 Workbook