Chapter 5: Small Business Issues

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Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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PASS-THROUGH ENTITY TAX

One change made by the Tax Cuts and Jobs Act (TCJA) is the limitation of the itemized deduction for **state and local taxes (SALT).** Starting January 1, 2018, the deduction for SALT on individual income tax returns is limited to $10,000[1] ($5,000 married filing separately (MFS)).[2]

Taxpayers living in states with high income and real estate taxes prompted their state legislatures to pass workarounds to the SALT deduction limitation. One of the most successful efforts is the enactment of **pass-through entity (PTE)** taxes. PTE taxes shift state income tax liabilities from individuals to their PTEs. The PTEs are allowed a deduction against business income equal to the tax.[3] Qualified entities include most entities taxed as partnerships or S corporations according to applicable state law.[4]

Although only some states have passed PTE taxes, residents of any state may have ownership interests in PTEs doing business in the states that have passed a PTE tax. A PTE tax is based on the state's portion of taxable income passed through to the owners of the entity. The entity is allowed a deduction against business income equal to the tax. In addition, each owner's personal income tax liability to the state is decreased by an amount comparable to their share of the PTE tax paid by the entity.[5]

As of July 19, 2022, 29 states have enacted a PTE tax effective for 2022.[6]

Alabama	Louisiana	North Carolina
Arkansas	Maryland	Ohio
Arizona	Massachusetts	Oklahoma
California	Michigan	Oregon
Colorado	Minnesota	Rhode Island
Connecticut[a]	Mississippi	South Carolina
Georgia	Missouri[b]	Utah
Idaho	New Jersey	Virginia
Illinois	New Mexico	Wisconsin
Kansas	New York	

[a] Mandatory.

[b] Passed and expected to be enacted.

As of July 19, 2022, Iowa (HF 2087), Pennsylvania (HB 1709), and Vermont (H0527) have proposed PTE tax bills in committee. New York **City** also has a PTE tax effective in 2023.[7]

1. IRC §164(b)(6), as created by the *Tax Cuts and Jobs Act*, PL 115-97, §11042.
2. IRC §164(b)(6)(B).
3. IRS Notice 2020-75, 2020-49 IRB 1453.
4. Different states may define qualified entity more inclusively. For example, according to IL Pub. 129, *Pass-through Entity Information*, fiduciaries are included in pass-through entities. However, IRS Notice 2020-75 only addresses partnerships and S corporations.
5. *Where individual, corporate, and pass-through entity taxation meet.* Bell-Jacobs, Mo; McCann, Bridget; Wlodychak, Steve. Jun. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/jun/individual-corporate-passthrough-entity-taxation-meet.html] Accessed on May 11, 2022.
6. *States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax.* Jul. 19, 2022. AICPA. [us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-pte-map.pdf] Accessed on Aug. 29, 2022.
7. Ibid.

THE MECHANICS

Individual owners of a PTE report their share of the entity's business income and other separately stated items on their Forms 1040, *U.S. Individual Income Tax Return.* Those PTEs taxed as partnerships issue Schedules K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* to report the pass-through items. PTEs taxed as S corporations issue Schedules K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*

Income, losses, etc. from the entities are included in the Schedule K-1 recipient's adjusted gross income (AGI). As such, the income is subject to individual state income tax. State income taxes paid on that income qualify to be deducted on Schedule A, *Itemized Deductions,* but the SALT deduction cap means that many taxpayers do not benefit from the deduction.

Example 1. JMZ, LLC, a single-member limited liability company (LLC), elected to be taxed as an S corporation. The entity has one member, Joseph Mann. For 2020, the entity had $100,000 of net profit, which was reported to Joseph on his Schedule K-1 (Form 1120-S). Joe's home state imposes a flat individual income tax of 4.95%.

When Joe filed his individual income tax return, he owed $4,950 on JMZ's net profit ($100,000 × 4.95%). He paid this tax in **April 2021**.

Also in 2021, Joe paid $3,000 in state taxes on his wages and $8,000 in real estate taxes on his home. His total itemized deductions for SALT for the year was $15,950 ($4,950 + $3,000 + $8,000). However, his deduction for these taxes was limited to $10,000 on his 2021 return.

For income earned in states that have enacted PTE taxes, a qualified PTE may elect to assume the state tax liability for their owners. States generally permit recipients to claim a credit on their individual income tax returns for the taxes paid by the PTE. However, these provisions vary by state.[8]

Example 2. JMZ, LLC from **Example 1** has $200,000 profit in 2021. On its 2021 state income tax return, it elected to pay the PTE tax on this profit. The entity paid $9,900 ($200,000 × 4.95%) of PTE tax with its 2021 return in March **2022.** The state version of Joe's Schedule K-1 (Form 1120-S) showed $200,000 profit and a PTE credit of $9,900. This $9,900 was added to his withholding and estimated tax payments for the year on his individual state return. Because his LLC is cash basis, this payment did not affect his 2021 federal income tax return.

State PTE taxes paid or accrued reduce the entity's ordinary business income.[9] Thus, the deduction passes through to the Schedule K-1 recipient's AGI. The deduction is **not** included in itemized deductions and is **not** subject to the SALT limitation.

8. *Where individual, corporate, and pass-through entity taxation meet.* Jun. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/jun/individual-corporate-passthrough-entity-taxation-meet.html] Accessed on May 11, 2022.

9. IRS Notice 2020-75, 2020-49 IRB 1453.

Example 3. In 2022, JMZ, LLC from **Example 2** makes **$150,000 profit** before the payment of state taxes. Its total deduction for state taxes on its 2022 return includes the following.

2021 PTE tax paid March 2022	$ 9,900
2021 corporate level franchise tax paid March 2022 ($200,000 profit × 1.5%)	3,000
2022 estimated taxes paid in 2022	10,000
Total state franchise and income taxes	$22,900

After taxes, the LLC's 2022 profit is $127,100 ($150,000 profit – $22,900 total taxes). This amount is reported as ordinary business income on Joe's 2022 Schedule K-1 from JMZ, LLC.

On Joe's 2022 Form 1040, his AGI is reduced because his Schedule K-1 reflects a deduction of $19,900 for PTE taxes paid by the LLC ($9,900 PTE paid March 2022 + $10,000 estimated taxes paid). This results in Joe paying $3,821 less in federal tax, as shown in the following comparison.

	With PTE	Without PTE
Profit	$150,000	$150,000
Replacement tax	(3,000)	(3,000)
PTE tax	(19,900)	
Income per Schedule K-1	$127,100	$147,000
Plus: reduction in QBI deduction (20%)	3,980	0
	$131,080	$147,000
Assumed tax rate	× 24%	× 24%
Income tax from Schedule K-1	$ 31,459	$ 35,280
		(31,459)
Joe's tax savings due to PTE deduction		$ 3,821

Note. In some states, entities that do **not** elect to pay PTE tax are not required to make estimates. However, if the entity made the PTE tax election for the prior year, the entity may be required to make estimates based on both the PTE and franchise taxes.[10] The payments are due on the same schedule as individual estimated state tax payments.

As stated previously, not all state PTE tax laws work the same. Both the method to calculate the tax and the method to elect the tax may vary. Some states allow the election to be made on the "front page" of return, while others have a special form or another means of making the election.

Note. For more information and discussion on the impact of PTE tax on individual partners and shareholders, see the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Individual Taxpayer Issues.

10. Illinois Department of Revenue (IDOR) Pub. 129, *Pass-through Entity Information.*

When PTE taxes lower ordinary business income, they also reduce the qualified business income deduction (QBID).[11] Thus, effectively 20% of the state income taxes previously paid on the PTE's income was already deductible to the extent the taxes did **not** reduce ordinary income. The effect of the PTE tax deduction on qualified business income must be considered when calculating the tax consequences of making a PTE tax election.

Caution. The rules applicable to nonresident partners/shareholders vary by state. In addition, the rules vary if the partners or shareholders are entities.

Practitioner Planning Tip

Entities using **cash basis** tax reporting must pay the estimated PTE taxes by the end of their fiscal year to deduct the taxes on the current year return. For more information about accounting methods and their implications, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

IRS NOTICE 2020-75[12]

Issued in November 2020, IRS Notice 2020-75 announced the IRS **intended** to issue proposed regulations regarding PTE tax payments. As of August 2022, these proposed regulations have not yet been released. Accordingly, tax practitioners may view this notice as a source of direction, even if it is not definitive. Three key issues emerge from analysis of the notice.

1. PTE tax is treated as a liability of the entity, as described in the preamble of the notice.

   State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by a partnership or an S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment.

2. PTE payments are **not** disproportionate distributions, because no partner or shareholder would receive a disproportionate benefit. Further, it seems very unlikely that the IRS would consider payment by an S corporation of the PTE tax as establishing a second class of stock, which could thereby terminate an S corporation election.

3. The notice repeatedly speaks of the deductibility of PTE taxes **paid**. It does not mention taxes accrued in association with the PTE tax, although it does mention that IRC §164(a) allows a deduction for "certain taxes for the taxable year... paid or accrued."[13] It goes to some effort to define a term for paying taxes, "Specified Income Tax Payment," but the term's definition only mentions taxes paid during the "taxable year in which the payment is made." The notice does not distinguish entities using cash method of accounting from those using the accrual method.

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11. IRC §199A. See also *Qualified Business Income Deduction.* Mar. 14, 2022. IRS. [www.irs.gov/newsroom/qualified-business-income-deduction] Accessed on Apr. 7, 2022.
12. IRS Notice 2020-75, 2020-49 IRB 1453.
13. Ibid, §2.01(1).

Practitioner Planning Tip

Having an entity pay PTE tax on behalf of a partner or shareholder may be a way for partners and shareholders to benefit without these payments facing scrutiny as compensation or distributions.

TAX ISSUES OF IN-HOME CARE PROVIDERS

As of 2012, over 1 million providers were being paid to care for young children in their homes.[14] In addition, as of 2018, over 250,000 adults were estimated to be in some type of licensed adult daycare service center.[15]

Practitioner Planning Tip

The daycare industry may represent a growth area for tax professionals.

THE BUSINESS OF PROVIDING DAYCARE

Whether a taxpayer is in business or not is a determination of fact. If the provider is in business, expenses are deductible against business income, and any net profit is subject to self-employment (SE) tax.[16] However, if the provider is **not in business**, their income from the activity is reported under the rules for activities **not engaged in for profit** (i.e., a hobby).[17] Under these rules, deductions are limited, but profit is not subject to SE tax.

Note. For more information on how to report activities that do not rise to the level of business, see the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Schedule C.

To rise to the level of a business, the provider must be involved with the activity with regularity and continuity and have a profit motive.[18] (These tests are covered in depth later.)

Example 4. Mrs. Madrigal has always loved children. She cares for her grandchild in her home and is paid by the state for her efforts. Because she regularly cares for the grandchild, the determination of whether she is in business is made by deciding if she acted like a person who was in the business of providing daycare for profit.

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14. *Characteristics of Home-based Early Care and Education Providers: Initial Findings from the National Survey of Early Care and Education*. Mar. 2016. U.S. Department of Health and Human Services. [www.acf.hhs.gov/sites/default/files/documents/opre/characteristics_of_home_based_early_care_and_education_toopre_032416.pdf] Accessed on Jul. 7, 2022.

15. *2018 National Study of Long-Term Care Providers Survey Methodology for the Residential Care Community and Adult Day Services Center Components*. 2018. Centers for Disease Control (CDC). [www.cdc.gov/nchs/npals/Survey-methodology-document03152021.pdf] Accessed on May 2, 2022.

16. IRC §1402.

17. IRC §183.

18. Rev. Rul. 58-112, 1958-1 CB 323. See also *Comm'r v. Groetzinger,* 480 U.S. 23 (1987) and *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992).

Caution. If the provider performs the care principally in the home of the person being cared for, the provider might be an employee of that person (or their family). If the provider is an employee, their employer must withhold taxes, and the provider's out-of-pocket expenses are not deductible.[19] For more information on household employees, see IRS Pub. 926, *Household Employer's Tax Guide.* Also, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Employment Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

INCOME AND EXPENSES OF AN IN-HOME CARE PROVIDER

Income Sources

Care providers may have multiple sources of revenue. The following are some examples of income a care provider may receive.

- Payments from the individual being provided care
- Payments from family members for the care of loved ones
- State payments to caregivers under programs such as Medicaid
- Payments from insurance companies under long-term care policies
- Reimbursements under the Child and Adult Care Food Program (CACFP)[20]

In most cases, receipt of these payments for services rendered are included in the provider's gross business income. However, as discussed next, there is a potential exception for income received under Medicaid waiver programs.

Medicaid Waiver Payments. Some states have adopted Medicaid waiver programs[21] to encourage home and community-based services for patients who would otherwise require hospitalization or intermediate-level care. Payments received for care **provided in the caregiver's residence** under these programs are excluded from gross income under IRC §131(c) as difficulty of care payments.[22]

Note. A key factor for distinguishing if Medicaid waiver payments are excludable from gross income is whether the caregiving services are provided in the caregiver's residence. Even if the patient is a relative, caregivers who travel to provide assistance may not exclude the Medicaid waiver payments from gross income.[23]

Although Medicaid waiver payments are excludable from gross income, according to a 2019 Tax Court case, these payments **can be included** in earned income for purposes of the earned income credit (EIC) or the additional child tax credit.[24]

Note. This treatment is similar to other forms of compensation that are not included in adjusted AGI on the tax return, but may be treated as earned income for purposes of the EIC, such as combat pay for members of the armed services.

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19. Miscellaneous 2% itemized deductions, including unreimbursed employee expenses, are suspended between 2018 and 2025 under IRC §67(g).

20. The CACFP is a program administered by the Food and Nutrition Service, a division of the USDA. The program provides reimbursements for nutritious meals and snacks to eligible children and adults who are enrolled for care at participating childcare centers, daycare homes, and adult daycare centers. For more information see *Child and Adult Care Food Program.* USDA. [www.fns.usda.gov/cacfp] Accessed on Jul. 5, 2022.

21. Under §1915(c) of the Social Security Act.

22. IRS Notice 2014-7, 2014-4 IRB 445.

23. *Certain Medicaid Waiver Payments May Be Excludable From Income.* Jan. 13, 2022. IRS. [www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income] Accessed on May 3, 2022.

24. *Mary and Edward Feigh v. Comm'r*, 152 TC No. 15 (2019).

Example 5. In 2021, Keith cared for his disabled sister in his own home. He was paid under a state Medicare waiver program. He received a Form W-2, *Wage and Tax Statement,* for $20,000 from the state and a letter that indicated the wages may be excludable from taxable income under IRS Notice 2014-7.

Keith reported the Form W-2 income on his Form 1040 line 1, Wages, salaries, tips, etc. He also reported the wages as a subtraction on Schedule 1, *Additional Income and Adjustments to Income,* on line 8z, Other income. His AGI was $0, as shown on the following form excerpts. Consequently, he did not have any taxable income.

Attach Sch. B if required.	1	Wages, salaries, tips, etc. Attach Form(s) W-2				1	20,000
	2a	Tax-exempt interest	2a		b Taxable interest	2b	
	3a	Qualified dividends	3a		b Ordinary dividends	3b	
	4a	IRA distributions	4a		b Taxable amount	4b	
	5a	Pensions and annuities	5a		b Taxable amount	5b	
Standard Deduction for—	6a	Social security benefits	6a		b Taxable amount	6b	
• Single or Married filing separately, $12,550	7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐				7	
	8	Other income from Schedule 1, line 10				8	(20,000)
	9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶				9	
• Married filing jointly or Qualifying	10	Adjustments to income from Schedule 1, line 26				10	
	11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶				11	0

8	Other income:				
a	Net operating loss	8a	( )		
b	Gambling income	8b			
c	Cancellation of debt	8c			
d	Foreign earned income exclusion from Form 2555	8d	( )		
e	Taxable Health Savings Account distribution	8e			
f	Alaska Permanent Fund dividends	8f			
g	Jury duty pay	8g			
h	Prizes and awards	8h			
i	Activity not engaged in for profit income	8i			
j	Stock options	8j			
k	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8k			
l	Olympic and Paralympic medals and USOC prize money (see instructions)	8l			
m	Section 951(a) inclusion (see instructions)	8m			
n	Section 951A(a) inclusion (see instructions)	8n			
o	Section 461(l) excess business loss adjustment	8o			
p	Taxable distributions from an ABLE account (see instructions)	8p			
z	Other income. List type and amount ▶ IRS Notice 2014-7 adj.	8z	(20,000)		
9	Total other income. Add lines 8a through 8z			9	(20,000)
10	Combine lines 1 through 7 and 9. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			10	(20,000)

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2021**

For EIC purposes, Keith had one qualified child. To calculate his EIC he completed the steps specified in the Form 1040 instructions for lines 27a, 27b, and 27c. In Step 5, where he calculated his earned income, he included the wages on line 1 of the worksheet shown below. However, on line 5, he **chose not** to reduce his earned income by the wages he excluded from taxable income.

Step 5 **Earned Income**

1. Are you filing Schedule SE because you were a member of the clergy or you had church employee income of $108.28 or more?

☐ **Yes.** See *Clergy* or *Church employees,* whichever applies. ☒ **No.** Complete the following worksheet.

1. Enter the amount from Form 1040 or 1040-SR, line 1 . . . . **1.** 20,000

2. Enter any amount included on Form 1040 or 1040-SR, line 1, that is a taxable scholarship or fellowship grant not reported on a Form W-2 . . . . **2.** ______

3. Enter any amount included on Form 1040 or 1040-SR, line 1, that you received for work performed while an inmate in a penal institution. (Enter "PRI" and the same amount on the dotted line next to Form 1040 or 1040-SR, line 1.) . **3.** ______

4. Enter any amount included on Form 1040 or 1040-SR, line 1, that you received as a pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan. (Enter "DFC" and the same amount on the dotted line next to Form 1040 or 1040-SR, line 1.) This amount may be shown in box 11 of Form W-2. If you received such an amount but box 11 is blank, contact your employer for the amount received . . . . **4.** ______

5. Enter any amount included on Form 1040 or 1040-SR, line 1, that is a Medicaid waiver payment you exclude from income (see the instructions for Schedule 1, line 8s), unless you choose to include this amount in earned income, in which case enter -0- **5.** 0

6. Add lines 2, 3, 4, and 5 . . . . **6.** 0

7. Subtract line 6 from line 1 . . . . **7.** 20,000

8. Enter all of your nontaxable combat pay if you elect to include it in earned income. Also enter the amount of your nontaxable combat pay on line 27b of Form 1040 or 1040-SR. See *Combat pay, nontaxable*, later . . . . **8.** ______

CAUTION *Electing to include nontaxable combat pay may increase or decrease your EIC. Figure the credit with and without your nontaxable combat pay before making the election.*

9. Add lines 7 and 8.
This is your earned income* **9.** 20,000

*You may elect to use your 2019 earned income to figure your EIC if your 2019 earned income is more than your 2021 earned income. For details, see Pub. 596. If you make this election, skip question 2 and go to question 3.

Keith's earned income for EIC purposes was $20,000 despite having excluded his wages from AGI and taxable income. His earned income tax credit for 2021 was $3,537.[25]

Expenses

All ordinary and necessary business expenses paid or incurred during the year in the conduct of a trade or business are deductible against the gross income of the business.[26] The following discussion involves several expenses specific to care providers.

Meals and Snacks.[27] Generally, taxpayers use the actual cost of meals and snacks provided for those in their care. However, there is also a **standard rate** for meal and snacks for qualified daycare providers.

> **Caution.** If actual meal costs are used, taxpayers must be prepared to provide the IRS with separate records for food costs of the caregiver's family versus the cost of meals and snacks provided for those being provided care.

25. See EIC Table in IRS Pub. 596, *Earned Income Credit (EIC)*.
26. IRC §162(a).
27. Rev. Proc. 2003-22, 2003-10 IRB 577.

The standard meal and snack rates are **only available** to family daycare providers feeding eligible children, as defined next.[28] The standard rates are not available to commercial daycare centers.

- A **family daycare** provider is a person engaged **in the business** of providing family daycare.
- The care must be provided to eligible children **in the home** of the **family daycare** provider. The care must be non-medical, not involve a transfer of legal custody, and generally last less than 24 hours each day.
- Eligible children are **minor children** receiving care **in the home** of the **family daycare** provider.
- Eligible children do **not** include children who are full-time or part-time residents **in the home** where the childcare is provided or children whose parents or guardians are residents of the same home. Eligible children do **not** include children who receive daycare services for personal reasons of the provider. For example, if a provider provides daycare services for a relative as a favor to that relative, that child is not an eligible child.

The standard meal and snack rates for the 2022 tax year are as follows.[29]

Daycare Provider
Standard Meal Allowance
July 1, 2021 through June 30, 2022

	48 States	Alaska	Hawaii
Breakfast	$1.40	$2.23	$1.63
Lunch or dinner	2.63	4.26	3.08
Snack (limited to 3 per day)	.78	1.27	.91

Daycare Provider
Standard Meal Allowance
July 1, 2022 through June 30, 2023

	48 States	Alaska	Hawaii
Breakfast	$1.66	$2.59	$1.91
Lunch or dinner	3.04	4.87	3.55
Snack (limited to 3 per day)	.97	1.52	1.12

Note. The rates provided are per person, per day. The actual cost of food or the standard meal and snack rates are fully deductible business expenses. Taxpayers may switch annually from the actual cost or standard meal method but must use the same method for all persons provided care during the particular year.[30]

The standard meal and snack rates are adjusted annually based upon the U.S. Department of Agriculture (USDA) reimbursement rates under the CACFP.[31] The standard rates applicable for a particular year are the Tier I rates in effect **on December 31 preceding the beginning of the provider's taxable year.[32]** A taxpayer may deduct the full rate under Tier 1, even if they receive lower-level reimbursements under the same program.

28. IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers).*
29. 127 Fed. Reg. 35733 (Jul. 7, 2021); 142 Fed. Reg. 44328 (Jul. 26, 2022).
30. IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers).*
31. Generally, the CACFP reimbursement rates may be found on the Internet at www.usda.gov under "Child and Adult Care Food Program."
32. Rev. Proc. 2003-22, 2003-10 IRB 577.

Practitioner Planning Tip

Tax professionals are encouraged to advise their clients who provide care to maintain daily logs of the persons in their care, including the time they arrive and leave the caregiver's home each day. These logs should also include the number of meals and snacks provided each day.

Observation. The revenue procedure allowing the use of the standard rates for these deductions applies only to the costs of feeding children. Accordingly, this method of substantiating deductions is **not** available for **adult recipients** in-home care.

Supplies and Equipment. An in-home care provider has the unique challenge of separating the costs of business-use supplies and equipment from the costs of such items purchased for personal use. Taxpayers are required keep proper documentation regarding the business uses of their purchases.[33]

Example 6. Mary provides daycare services for three children in her home. She purchases a $6,500 Viking refrigerator, which she purports is purchased for the sole purpose of holding items used for the children in her care.

Before taking the deduction, Mary's tax preparer should ascertain the actual business use of the refrigerator. They could encourage Mary to provide documentation of her business use, such as photographs.

Converting Personal Use Assets to Business Use. When taxpayers start a business, they often use assets they previously purchased personally in their new enterprise. The deductible cost of assets converted to business use is the **lower** of their **cost** or the **fair market value (FMV)** of the assets when they were put into service.[34] After a taxpayer starts to use an asset for business, if they still use it for personal purposes, the property is mixed-use. As such, any depreciation deduction is subject to additional limitations depending on the type of asset.[35]

For purposes of the IRC §179 deduction, an asset must have been purchased **for** business use. Thus, assets originally purchased for personal use **do not qualify for §179.**[36] However, this restriction does not apply to the deduction for bonus depreciation. Thus, assets may **qualify for the bonus depreciation** deduction even though they were originally purchased for personal use.[37]

Example 7. Use the same facts as **Example 6.** Mary has invested over $10,000 in baby furniture and toys over the years when her children and grandchildren were young. The items are now being used exclusively for the children in her care.

Mary needs to establish and document the FMV of the items in a reasonable manner. She cannot claim a §179 deduction on the baby furniture, but she may be able to take bonus depreciation.

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33. *Deducting Business Supply Expenses.* Dec. 2006. IRS. [www.irs.gov/pub/irs-news/fs-06-28.pdf] Accessed on Jul. 7, 2022.
34. Treas. Reg. §1.167(g)-1.
35. For more information, see IRS Pub. 946, *How to Depreciate Property*.
36. IRC §179(d)(1)(C); Rev. Rul. 77-448, 1977-2 CB 78.
37. IRC §168(k)(2).

BUSINESS USE OF HOME[38]

Typically, for a taxpayer to deduct expenses for the business use of their home, they must use the space exclusively and regularly for business purposes.[39] Taxpayers who provide daycare services in their home frequently have multiple mixed-use areas, like bathrooms and kitchens. Qualifying taxpayers may deduct a portion of these costs even though the home is **not exclusively** used for business.[40] To qualify, a taxpayer must **both:**

- Be in **business** of providing daycare for
  - Children,
  - Persons age 65 or older, **or**
  - Persons who are physically or mentally unable to care for themselves; and
- Have applied for, been granted, **or** be exempt from having a **daycare license** (or equivalent) under state law.

Practitioner Planning Tip

Business use of home deduction is **only** allowed if a taxpayer meets the above criteria.

As used in this material, daycare licenses include any license, certification, registration, or approval as a daycare center or as a family or group daycare home under the provisions of any applicable state law.[41] It only applies to deducting expenses for business use of home. Other direct business expenses are deductible against a provider's income, even if they are providing unlicensed care. A provider who does not have a license because their application was denied does not fall under the exception for providers who have applied for a license. Likewise, a provider whose license has expired or been revoked cannot use prior licensing to meet this test. Providers who are **not required** to be licensed in their state are not required to be licensed to deduct their home office expenses. If a provider is required to be licensed, only the home office expenses incurred **after** they apply for the license are deductible.[42]

Note. For a comprehensive discussion of the home office deduction, including calculating depreciation, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

This material covers business use of a home by **sole proprietorships.** For entities established as **partnerships,** the partner whose home is the location of the business operation may deduct their unreimbursed partnership expenses (UPE) directly against partnership income. This option is only available if the partner was required to pay these expenses according to the partnership agreement. The deduction is claimed by entering the calculation of such expense as "UPE" on part II of Schedule E, *Supplemental Income and Loss,* on their Form 1040.[43]

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38. IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers).*
39. IRC §280A(c).
40. IRC §280A(c)(4).
41. IRC §280A(c)(4)(B)(iii).
42. IRC §280A(c)(4)(B).
43. Instructions for Schedule E. The partnership agreement should contain language which clearly states the partnership will not reimburse the expenses incurred by the partner for partnership activity.

For entities established as **corporations,** the company may reimburse employees for qualified out-of-pocket expenses, including the business use of the home. However, to be deductible by the corporation and not taxable to the employee, the reimbursement must be made as part of an **accountable plan. Employees** using their home to provide services on behalf of their employer[44] may not deduct the related business-use of home expenses.[45]

> **Note.** See the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues for more information on accountable plans. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Hours Used

Areas of a taxpayer's home that might be used regularly, but not exclusively, in their daycare business include bedrooms, playrooms, dining rooms, kitchens, and bathrooms. The business-use portion of the mixed-use areas is determined by the percentage of hours in a year those areas are used for daycare.

A taxpayer does **not** have to keep records to show the specific hours each area was used as part of the daycare business each day. It is enough that they can demonstrate that the room was **available** for use throughout each business day and that it was **regularly used** for business.

Example 8. Use the same facts as **Example 6.** Mary uses her home to provide daycare for an average of 12 hours a day, five days a week, 50 weeks a year, for a total of 3,000 hours. The children in her care have access to nearly all areas of her home. After hours, she uses most of the house for personal purposes. Her business-use percentage is 34.25% as shown on following Form 8829, *Expenses for Business Use of Your Home*.

Form **8829** — Department of the Treasury, Internal Revenue Service (99)

Expenses for Business Use of Your Home

► File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.
► Go to *www.irs.gov/Form8829* for instructions and the latest information.

OMB No. 1545-0074 — **2021** — Attachment Sequence No. **176**

Name(s) of proprietor(s): **Mary P. Oppins** — Your social security number: **111-22-3333**

Part I — Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)			1	1,250
2	Total area of home			2	1,250
3	Divide line 1 by line 2. Enter the result as a percentage			3	100 %
	For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.				
4	Multiply days used for daycare during year by hours used per day	4	3,000 hr.		
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5	8,760 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	. 3425		
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ►			7	34.25 %

Part II — Figure Your Allowable Deduction

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44. Treas. Reg. §1.62-2.

45. Home office expenses incurred by employees are classified as miscellaneous itemized deductions. However, miscellaneous itemized deductions are not deductible for tax years 2018 through 2025 under IRC §67(g).

Square Feet Used[46]

If the entire home is **not** available or used regularly as part of the business, the deduction for business use of home is limited to the percentage of the home's area used by the business as well as the hours used. Thus, for providers who do not use their entire home for daycare, the result on line 7 will be lower than in **Example 8.** Expenses related directly to an area used solely for business are not limited to the percentage of business use as calculated in part I. Other indirect expenses are limited to the business use percentage.

Example 9. Kevin's grandmother comes to visit each day. She stays for 12 hours a day, five days a week, 50 weeks a year. Kevin's father pays him to supervise her because of her dementia. His compensation is underwritten by a local program promoting alternatives to institutionalization for people like his grandmother.

Kevin is not required to be licensed, but he is pursuing a career in elder care. He intends for this venture to be his full-time occupation. He wants to deduct business use of home. Kevin's home has two bedrooms and one bath, with total area of 852 square feet.

The small bedroom (64 square feet) is exclusively used by Kevin's grandmother. This year, he paid $2,000 for repairs and decorations just for her room. He does not use her bedroom, and he does not allow Grandma into his bedroom. His bedroom is 96 square feet.

Kevin calculates the percentage of business use of his home as shown in the following table.

	Never Used for Business		Only Used for Business		Partially Used for Business	
Time						
Number of hours used for daycare	0		3,000		3,000	
Total number of hours available	0		÷ 3,000		÷ 8,760	
Percentage of time used for business	0%	0%	100%	100%	34.25%	34.25%
Square footage						
Square feet of area	96		64		692	
Total square feet in home	÷ 852		÷ 852		÷ 852	
Percentage of total square footage	11.27%	× 11.27%	7.51%	× 7.51%	81.22%	× 81.22%
Business-use percentage		0%		7.51%		27.82%

Kevin's business-use percentage is 35.33% (7.51% + 27.82%). He must attach this computation to his return per IRS instructions.

Form **8829** — **Expenses for Business Use of Your Home**

Department of the Treasury
Internal Revenue Service (99)

► File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.
► Go to *www.irs.gov/Form8829* for instructions and the latest information.

OMB No. 1545-0074
2021
Attachment Sequence No. 176

Name(s) of proprietor(s): KEVIN SMART
Your social security number: 555-66-7777

Part I — Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)			1	
2	Total area of home			2	
3	Divide line 1 by line 2. Enter the result as a percentage			3	%
	For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.				
4	Multiply days used for daycare during year by hours used per day	4	hr.		
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5	8,760 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.		
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ►			7	35.33 %

Figure Your Allowable Deduction

46. Instructions for Form 8829.

In addition to the $2,000 he spent on her room, Kevin spent $800 on homeowner's insurance, $8,000 on rent, and $3,000 on utilities for the year. The $2,000 amount represents **direct** expenses, and the remainder ($11,800) is **indirect** expenses. Excerpts of his Form 8829, shown below, reflect his business-related home office expenses total $6,169 (100% of $2,000 + 35.33% of $11,800).

17	Excess real estate taxes (see instructions) . . .	17				
18	Insurance	18		800		
19	Rent	19		8,000		
20	Repairs and maintenance	20	2,000			
21	Utilities	21		3,000		
22	Other expenses (see instructions)	22				
23	Add lines 16 through 22	23	2,000	11,800		
24	Multiply line 23, column (b), by line 7		24	4,169		
25	Carryover of prior year operating expenses (see instructions)		25			
26	Add line 23, column (a), line 24, and line 25				26	6,169
	Allowable operating expenses. Enter the **smaller** of line 15 or line 26				27	

Calculating the Allowable Deduction

There are two allowable methods to determine the amount of deductible expenses for business use of a home.

1. The simplified method[47]
2. The actual expense method

Simplified Method. The optional simplified method allows taxpayers to deduct $5 per square foot of home office space. No more than 300 square feet may be used in the calculation. Therefore, the deduction is limited to $1,500 per year.

> **Note.** If the actual office in home square footage is less than 300 square feet, the taxpayer must use the actual square footage used. If the actual square footage used is more than 300 square feet, the taxpayer is limited under the safe harbor method to 300 square feet.

The deduction may not exceed the gross income from the business. Any excess deduction **cannot be carried forward** to the following year.

Advantages of the simplified method include the following.

- Itemized deductions for home mortgage interest and real estate taxes are not reduced by the portion of the expenses included in the home office deduction.
- Taxpayers are **not** required to substantiate the expenses incurred for their home.
- There is no depreciation to recapture when the home is sold.

The election to use the simplified method is an annual election that must be made on a timely filed original return. The election is made simply by using this method. However, once made, **the election is irrevocable for that tax year.**

If elected, the Simplified Method Worksheet[48] is used to calculate the amount of expenses deductible for qualified business use of a home. Otherwise, Form 8829 and other worksheets are used to calculate the deduction.

47. Rev. Proc. 2013-13, 2013-6 IRB 478.

48. This worksheet can be found in IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers)* and the instructions for Schedule C.

Most daycare providers must complete the Daycare Facility Worksheet[49] before completing the Simplified Method Worksheet. The facility worksheet is used to limit the deduction to the percentage of time that the space was used for business. Providers who provide at least 300 square feet for daycare regularly **and exclusively** during the year do **not** have to use these worksheets.

Example 10. Kevin from **Example 9** calculates his deduction for business use of home using the following worksheets from IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers)*. His gross income limitation on line 1 of the Simplified Method Worksheet is $45,000. This limitation is discussed later in this material.

Daycare Facility Worksheet (for simplified method)

1. Multiply days used for daycare during the year by hours used per day	1.	**3,000**
2. Total hours available for use during the year. See the Instructions for the Daycare Facility Worksheet	2.	**8,760**
3. Divide line 1 by line 2. Enter the result as a decimal amount here and on line 3b of the Simplified Method Worksheet	3.	**0.3425**

Simplified Method Worksheet

Use this worksheet if you file Schedule F (Form 1040) or you are a partner, and you are using the simplified method to figure your deduction for business use of the home. Use a separate worksheet for each qualified business use of your home.

1. Enter the amount of the gross income limitation. See the Instructions for the Simplified Method Worksheet	1.	**45,000**
2. Allowable square footage for the qualified business use. Do not enter more than 300 square feet. See the Instructions for the Simplified Method Worksheet	2.	**300**
3. Simplified method amount		
a. Maximum allowable amount	3a.	$5
b. For daycare facilities not used exclusively for business, enter the decimal amount from the Daycare Facility Worksheet; otherwise, enter 1.0	3b.	**0.3425**
c. Multiply line 3a by line 3b and enter result to 2 decimal places	3c.	**1.71**
4. Multiply line 2 by line 3c	4.	**513**
5. **Allowable expenses using the simplified method.** Enter the smaller of line 1 or line 4. If zero or less, enter -0-. See *Where To Deduct*, earlier, for where to enter this amount on your return	5.	**513**
6. **Carryover of unallowed expenses from a prior year that are not allowed in 2021.**		
a. Operating expenses. Enter the amount, if any, from your last Worksheet To Figure the Deduction for Business Use of Your Home, line 41 (line 40 if before 2018). See the Instructions for the Simplified Method Worksheet	6a.	
b. Excess casualty losses and depreciation. Enter the amount, if any, from your last Worksheet To Figure the Deduction for Business Use of Your Home, line 42 (line 41 if before 2018). See the Instructions for the Simplified Method Worksheet	6b.	

Note. The instructions for the Simplified Method Worksheet do not address daycare providers specifically with respect to the allowable square footage to enter on line 2. The **limit for daycare providers is calculated on line 3.** See IRS Pub. 587 for atypical situations requiring addition adjustments.

[49] Found in IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers).*

Actual Expense Method. The deduction for home office expenses using the actual expense method is calculated on Form 8829. Part I determining the business-use percentage was explained earlier. Part II is used to report the expenses and apply the business-use percentage to the indirect expenses.

Part II is also used to apply income-related limitations on the deduction. If the home office and other business expenses exceed gross revenue, the deduction for home office expenses is **limited.** When this limitation applies, the taxpayer's business expenses are applied against the business's profits using a set of ordering rules.[50]

Mortgage Interest and Real Estate Taxes. Form 8829 has two lines for mortgage interest and two lines for real estate taxes.

Taxpayers who **itemize deductions** on Schedule A must apply the following limits to determine the amounts to report on Form 8829.

1. Maximum home mortgage deduction (line 10)
2. $10,000 SALT deduction cap (for real estate taxes on line 11)

9	Casualty losses (see instructions) . . .	9			
10	Deductible mortgage interest (see instructions) .	10			
11	Real estate taxes (see instructions)	11			
12	Add lines 9, 10, and 11	12			

Taxpayers who claim **the standard deduction** report mortgage interest and mortgage insurance premiums on line 16 and real estate taxes on line 17.

15	Subtract line 14 from line 8. If zero or less, enter -0-			15	
16	Excess mortgage interest (see instructions) . .	16			
17	Excess real estate taxes (see instructions) . . .	17			
18	Insurance	18			

Unlike the entries on lines 10 and 11, these amounts are not subject to the limitations discussed for taxpayers who itemize.

- **Class 1 Expenses.** The amounts reported on lines 9 through 11 may be deducted fully from the business's net income, **even if this results in a loss.**
- **Class 2 Expenses.** The deduction for this class of expenses is limited to net income remaining after deducting class 1 expenses. Deduction of class 2 expenses **cannot create a loss.** However, any amount not deducted is **carried forward** to the following year. The same limitation applies in the following year for class 2 expenses.

  Expenses in class 2 are reported on lines 16 through 22 of the form. The carryover is reported on line 25.
- **Class 3 Expenses.** Class 3 includes excess casualty losses and depreciation of the home. Part III of the form should be completed each year that the actual method is used for a qualifying home. Taxpayers who switch between the simplified method and actual method must use the optional depreciation table to calculate current depreciation.[51] Class 3 expenses may only be deducted up to the amount of any remaining net income. Any casualty losses and depreciation that cannot be deducted are **carried forward** to the following year. The following year, the expenses are subject to the same limitation.

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50. IRC §280A(c)(5).

51. IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers).*

Example 11. Mary from **Example 8** pays $18,000 in rent. She also pays $3,500 each year for utilities and $300 for renter's insurance. These expenses are reported in part II of her following Form 8829. Her profit before these expenses is $45,000 as reported on line 8. After applying her business-use percentage, Mary's total deduction for business use of her home is $7,467 for 2021.

Form **8829** — Department of the Treasury, Internal Revenue Service (99)

Expenses for Business Use of Your Home

▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.
▶ Go to *www.irs.gov/Form8829* for instructions and the latest information.

OMB No. 1545-0074 — **2021** — Attachment Sequence No. **176**

Name(s) of proprietor(s): **Mary Quitecontrary** — Your social security number: **123-45-6789**

			(a) Direct expenses	(b) Indirect expenses		
Part I	**Part of Your Home Used for Business**					
1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)				1	1,250
2	Total area of home				2	1,250
3	Divide line 1 by line 2. Enter the result as a percentage				3	%
	For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.					
4	Multiply days used for daycare during year by hours used per day	4		3,000 hr.		
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,760	5		8,760 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6		. 3425		
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶				7	34.25 %
Part II	**Figure Your Allowable Deduction**					
8	Enter the amount from Schedule C, line 29, **plus** any gain derived from the business use of your home, **minus** any loss from the trade or business not derived from the business use of your home. See instructions.				8	45,000
	See instructions for columns (a) and (b) before completing lines 9–22.					
9	Casualty losses (see instructions)	9				**Class 1**
10	Deductible mortgage interest (see instructions)	10				
11	Real estate taxes (see instructions)	11				
12	Add lines 9, 10, and 11	12				
13	Multiply line 12, column (b), by line 7	13		0		
14	Add line 12, column (a), and line 13				14	0
15	Subtract line 14 from line 8. If zero or less, enter -0-				15	45,000
16	Excess mortgage interest (see instructions)	16				**Class 2**
17	Excess real estate taxes (see instructions)	17				
18	Insurance	18		300		
19	Rent	19		18,000		
20	Repairs and maintenance	20				
21	Utilities	21		3,500		
22	Other expenses (see instructions)	22				
23	Add lines 16 through 22	23		21,800		
24	Multiply line 23, column (b), by line 7	24		7,467		
25	Carryover of prior year operating expenses (see instructions)	25		0		
26	Add line 23, column (a), line 24, and line 25				26	7,467
27	Allowable operating expenses. Enter the **smaller** of line 15 or line 26				27	7,467
28	Limit on excess casualty losses and depreciation. Subtract line 27 from line 15				28	37,533
29	Excess casualty losses (see instructions)	29		0		**Class 3**
30	Depreciation of your home from line 42 below	30		0		
31	Carryover of prior year excess casualty losses and depreciation (see instructions)	31		0		
32	Add lines 29 through 31				32	0
33	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 28 or line 32				33	0
34	Add lines 14, 27, and 33				34	7,467
35	Casualty loss portion, if any, from lines 14 and 33. Carry amount to **Form 4684.** See instructions				35	0
36	**Allowable expenses for business use of your home.** Subtract line 35 from line 34. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions. ▶				36	7,467
	Depreciation of Your Home					

Note. Because Mary rents the home she uses for her daycare, she has not deducted any depreciation of her primary residence.

SALE OF PERSONAL RESIDENCE WITH HOME OFFICE[52]

> **Note.** The phrase **home office** evokes the image of a small spare bedroom with a desk and computer. However, the phrase as used for an in-home daycare provider encompasses all the portions of the home used for business, even the areas used part-time.

Typically, the gain from the sale of a personal residence is excluded from income under IRC §121 because the taxpayer meets **"two out of five years" ownership and use tests.**[53] The maximum exclusion is $500,000 for married couples filing jointly and $250,000 for all other filing statuses. If an unexpected event kept a taxpayer from satisfying the ownership and use tests, they may qualify for a partial exclusion.

Taxpayers who use the home they own for business purposes may have unexpected tax consequences when they sell the property. Although gains from the sale of a personal residence are usually excluded from tax, using the property in part for business may cause some of the gain to be taxable. In addition, a portion of the gain attributable to depreciation **allowed or allowable** may be subject to recapture on Form 4797, *Sales of Business Property*.

> **Note.** See the Form 4797 Basics section in this chapter for more information on depreciation recapture.

If the home office was **within** the home's living area, the taxable portion of the gain is determined differently than if the home office was in a structure **detached** from the home.

Home Office Within the Living Area

If the home office is located within the taxpayer's living areas, **none of the gain** from the sale needs to be allocated to the areas used for business. Spaces within the living area used for the home office include those areas used exclusively for the daycare business and those with mixed use.

Example 12. Willie, a single taxpayer, lived in his home for eight years and used a spare bedroom (15% of the home space) as a daycare facility. Upon the sale of his house, Willie had a profit of $50,000. Because the daycare was within the living area of his home, he is not required to allocate any portion of the gain to profit from the sale of a business asset. Thus, **the entire gain qualifies for the §121 exclusion.**

Even though none of the gain must be **allocated** to business use, any gain **attributable to depreciation,** allowed or allowable after May 6, 1997, is **not** excludable. Thus, the depreciation allowed or allowable after that date is subject to recapture under IRC §1250.

Example 13. Use the same facts as **Example 12,** except that Willie's gain included $2,000 from depreciation of his home office. This portion of the gain is unrecaptured §1250 gain subject to ordinary income tax rates up to 25%.

> **Note.** See the Form 4797 Basics section in this chapter for more information.

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52. IRS Pub. 523, *Selling Your Home*.

53. IRC §121.

Home Office in a Separate (Appurtenant) Structure

Spaces in a home **outside** of the taxpayer's living area that could be used for daycare include the following.

- A first-floor group center with an attached residence
- An apartment in a duplex
- A recreational area in a detached garage

If the home office is **not** located inside the living areas of the home, profit from the sale must be allocated between the living and office portions of the home. Depreciation allowed or allowable is still subject to recapture.

> **Example 14.** Use the same facts as in **Example 13,** except Willie's home office is an unattached garage that he converted to a daycare center. The garage represents 15% of his total home. Because the daycare is not within the home's living space, the $50,000 of profit must be allocated between the main home and the separate office. Thus, 15% of the gain ($7,500) is from the sale of a business asset. Of the gain, $2,000 is taxed as unrecaptured §1250 gain, and the rest qualifies as a long-term gain from the sale of business assets.

> **Observation.** Had Willie ceased the daycare business' use of the garage for at least two years prior to the sale, the garage would meet the personal-use test, and the gain attributable to the garage would be eligible for exclusion. Only the unrecaptured §1250 gain would be included in income.

Sale of the Separate Structure Eligible for a Like-Kind Exchange.[54] An unattached structure used for business is considered a property held for business purposes and not a personal residence. If a taxpayer finds another property which has both a principal residence and another structure appropriate for business use, it may be possible to defer the gain allocated to the business structure.[55] Properly handled, the taxpayer could dispose of the original structure and acquire the new building in a like-kind exchange (LKE).

> **Observation.** If the taxpayer continues their business activity in a new location, any carryover of disallowed expenses on Form 8829 continued to be carried forward because the same activity is being conducted.[56] Had the business activity ended with the sale of the previous property, the carryover expenses would have been lost.

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54. IRC §1031.
55. *Like-Kind Exchanges — Real Estate Tax Tips***.** Jan. 18, 2022. IRS**.** **[**www.irs.gov/businesses/small-businesses-self-employed/like-kind-exchanges-real-estate-tax-tips**]** Accessed on May 4, 2022.
56. Instructions for Form 8829.

HOUSE FLIPPING: INVESTMENT OR BUSINESS ACTIVITY?

House **flipping** is the process of:

- Buying residential real estate,
- Renovating or rehabilitating the property (fixing), and
- Selling the property (flipping).

This is normally done within a **relative short period** of time with the **intent to earn a profit.** The issue for tax practitioners is determining if the house flipping activity:

- Rises to the level of selling **inventory** in a **business** activity, **or**
- Is an **investment** activity involving **capital assets.**

If the activity of fixing and flipping qualifies as a business, the real estate purchased to flip is treated as **inventory.** If the taxpayer is an individual, the sale is reported on Schedule C, *Profit and Loss From Business*, and any profit is subject to SE tax.[57] Any loss is deductible without considering the deduction limits for net capital losses.

However, if the activity does **not** qualify as a business, the property is treated as an **investment.** The sale of the property is reported on Form 8949, *Sales and Other Dispositions of Capital Assets.* Profit reported on Form 8949 is **not** subject to SE tax, and long-term profits qualify for capital gain tax rates.[58] However, net deductible losses are capped at $3,000.[59]

> **Caution.** The differences between capital gain treatment versus ordinary income tax treatment are discussed more in depth later in this section. Practitioners must determine the proper treatment based on the facts and circumstances of each situation. The desired tax outcome should not be the determining factor.

INVENTORY OR INVESTMENT IN A CAPITAL ASSET

By definition, inventory and capital investments are mutually exclusive. A capital asset is defined as **not** being inventory **and not** being part of the taxpayer's regular business activities. Thus, there are two questions that must be answered when a taxpayer flips houses.[60]

1. Was the property **held** principally as inventory?
2. Was the taxpayer **engaged in a business** of selling that type of property?

The typical individual who flips houses is **not otherwise** engaged in the business of selling real estate. A taxpayer purchasing real estate with the intent to resell may not consciously think of the property as being either inventory or investment. Proper categorization depends on the facts and circumstances surrounding the purchase and sale.

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57. See instructions for Schedule C.
58. IRC §1221(a).
59. IRC §1211(b).
60. IRC §1221(a)(1).

Courts historically consider five factors to determine if property was held as inventory or investment.[61] For taxpayers who are **not** engaged in other real estate-related businesses, the two most important factors are probably the **frequency of sales** and the **types of things the taxpayer did** with respect to the property (i.e., **activity of the seller about the property**).

Note. The frequency and continuity of sales test (#2) is effectively the same factor as the **continuity** portion of the test used to evaluate if an activity rises to the level of a business. Likewise, the activity test (#4) is comparable to the **regularity** portion of the business test. The **continuity and regularity test** is discussed later in this section.

1. **Nature of Property Acquisition.** Although the taxpayer's intent with respect to the property may change, the taxpayer's initial intent regarding the purchase is an important element. Initial intent is particularly important for taxpayers who are engaged in multiple real estate ventures and types of real estate activities. For example, it may be unclear if unimproved land was purchased for investment or development by a taxpayer who frequently builds new infrastructure on such land.

2. **Frequency and Continuity of Sales.** Frequent and substantial similar sales activity indicates that the taxpayer was in the business of selling houses. Taxpayers have the burden of showing that their sales were **not** frequent and substantial **if they treat the property as held for investment** instead of inventory.[62]

3. **Nature and Extent of Business.** If the taxpayer operated a business and the property is similar to property ordinarily sold in that type of business, the property should most likely be included in inventory. However, this assumption may be rebutted by other factors, especially if the distinction is well documented.

4. **Activity of Seller About the Property.** This factor considers the actions of the taxpayer regarding the property. If the taxpayer was **significantly involved** in developing, improving, and/or selling the property, the property might have been held as inventory in a business venture. If the taxpayer is employed in another profession, the amount of time spent on the flipped house may be **insignificant** in comparison, and the property might have been held as an investment.

5. **Extent and Substantiality of the Transaction.** This factor looks to the transaction details for clues about the nature of the sale. For example, a series of related party transactions may be intended to shift profit into transactions subject to capital gains rates from transactions subject to ordinary tax rates.

Business Activity

A taxpayer is treated as being in business for various tax purposes if they meet a 2-pronged test.[63]

1. They engage in the activity with **continuity and regularity,** and

2. They have a **profit motive.**

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61. *Robert E. Austin and Marian H. Austin v. Comm'r,* 263 F.2d 460 (9th Cir. 1959). See also *Cordell D. Pool, et al. v. Comm'r,* TC Memo 2014-3 (Jan. 8, 2014).

62. *Cordell D Pool, et al. v. Comm'r,* TC Memo 2014-3 (Jan. 8, 2014).

63. Rev. Rul. 58-112, 1958-1 CB 323. See also *Comm'r v. Groetzinger,* 480 U.S. 23 (1987) and *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992).

Continuity and Regularity. This test is not a bright-line test but another factor to be considered based on facts and circumstances. In the following cases, the courts considered the frequency of real estate sales as part of their rulings.

- ***Phelan v. Comm'r.***[64] **Two sales in four years** were infrequent enough for the activity **not** to be considered business-related.
- ***Paullus v. Comm'r.***[65] **Eight parcels of land sold over a 12-year period** was considered a pattern of infrequent sales consistent with property held for investment. The court also made this observation, which considers the extent of profits as well as the frequency of the sales (emphasis added).

  > *Courts have generally viewed* ***frequent sales that generate substantial income as tending to show that property was held for sale*** *rather than investment…* ***Conversely, infrequent sales resulting in large profits tend to show that property was held for investment.***

- ***Medlin v. Comm'r.***[66] The IRS determined that the taxpayer was engaged in the business of buying and selling real estate. The court agreed that the profits from the **nine** real estate sales made during the **four years** at issue were subject to SE tax.
- ***Hancock v. Comm'r.***[67] **Eight sales in two years** was considered frequent enough for the activity to be treated as a business.

5

Based on the cases cited previously, the less frequently the taxpayer sold properties, the more likely the court determined the property was held as investment. Frustratingly, many individual taxpayers who flip houses fall clearly into the inconclusive once-a-year period with respect to the frequency factor.

Frequency of Sales	Court Conclusion
Every other year	Investment
Once a year	No conclusive cases
Twice a year	Inventory
Four times a year	Inventory

Example 15. Ted and Gary, who are high-school teachers, routinely buy one older single-family residence each spring. They fix up the property during their summer vacation and sell it for a profit before the end of the year.

Because Ted and Gary have engaged in this activity continuously and regularly for several years, they might be in business. If so, they should report the gain as business income on a partnership return subject to SE tax.

Ultimately, not much has changed since 1947 when, in *Fahs v. Crawford,*[68] the 5th Circuit summarized its 1938 opinion[69] on the same basic issue.

> *Carrying on a business, however, implies an occupational undertaking to which one habitually devotes time, attention, or effort with substantial regularity. Merely disposing of investment assets at intermittent intervals, without more, is not engaging in business, even though some preliminary effort is necessary to render the asset saleable.*

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64. *Timothy J. Phelan and Deborah A. Phelan v. Comm'r,* TC Memo 2004-206 (Sep. 15, 2004).
65. *Loren F. Paullus and Donna Paullus v. Comm'r,* TC Memo 1996-419 (Sep. 17, 1996).
66. *Walter L. Medlin v. Comm'r*, TC Memo 2003-224 (Jul. 29, 2003).
67. *Margaret Hancock v. Comm'r*, TC Memo 1999-336 (Oct. 7, 1999).
68. *Fahs v. Crawford,* 161 F.2d 315 (5th Cir. 1947).
69. *Snell v. Commissioner*, 97 F.2d 891 (5th Cir. 1938).

Profit Motive (Business Intent).[70] Nearly all taxpayers flipping real estate intend to make money on the venture. But for the purpose of determining if the real estate was held as inventory or investment, the relevant issue is whether the taxpayer acted like a person who intended to be **in business** or like an investor.

Specifically, the question is: did they act like a person who intended to be in the business **of selling this type of property?** In *Boree v. Comm'r,*[71] the taxpayer's gain from a land sale was determined to be ordinary income **because** the taxpayer acted like the property was part of his real estate business.

A taxpayer is in business for SE tax purposes if they meet the 2-prong test[72] of **continuity and regularity** (discussed previously) and **profit motive.** For the purpose of deducting losses, a taxpayer is in business if the facts and circumstances show that the taxpayer operated the venture like a business instead of like an activity **not engaged in for profit.** The IRS looks to nine primary factors, which when viewed together paint a picture of the taxpayer's intent.[73] In looking at these factors, courts evaluate the taxpayer's intent for the real estate to be part of the business activity rather than the taxpayer's intent to earn a profit.

1. The **manner** in which the taxpayer carried on the activity
2. The **expertise** of the taxpayer or their advisors
3. The **time and effort** expended by the taxpayer in carrying on the activity
4. The taxpayer's **expectation** that the **value** of the assets used in the business will increase
5. The **previous success** of the taxpayer in carrying on similar or dissimilar activities
6. The **history of income and losses** with respect to the activity
7. The amount of **occasional profits**, if any, which are earned
8. The **financial status** of the taxpayer
9. Any elements of **personal pleasure** or recreation in the activity

No one factor is determinative and other factors may also be considered. The IRS and the courts place greater weight on objective facts than on taxpayers' assertions of intent. Accordingly, taxpayers who maintain proper contemporaneous documentation are more likely to be able to prove their intent.

Note. For an in-depth discussion of these factors, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Schedule C.

Practitioner Planning Tip

Clients should be thoroughly interviewed **annually** to assess whether the taxpayer's level of involvement or intent has evolved. What was once an occasional activity may have become a regular activity. Likewise, what was once engaged in with a profit motive might now be done just for fun.

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70. Treas. Reg. §1.183-2.

71. *Boree v. Comm'r,* 837 F.3d 1093 (11th Cir. 2016), *aff'g in part and rev'g, in part,* TC Memo 2014-85. (The appellate court affirmed the decision, but reversed the Tax Court's holding that the petitioner was subject to an IRC §6662 penalty.)

72. Rev. Rul. 58-112, 1958-1 CB 323. See also *Comm'r v. Groetzinger,* 480 U.S. 23 (1987) and *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992).

73. Treas. Reg. §1.183-2; IRC §183.

TAX CONSEQUENCES

The following chart compares tax consequences of selling inventory in the course of a business and selling capital assets held for investment.

	Inventory of a Business	Investment in Capital Asset
Gain	• Included in ordinary income [74] • Does not qualify for deferral under the LKE provisions [75] • Increases SE income [76] • Subject to additional Medicare tax [77]	• Eligible for capital gains tax rates [78] • Subject to the net investment income tax [79]
Loss	• Ordinary loss [80] • Reduces SE income [81]	• Limited as a capital loss [82]

Additional Information

Some tax provisions apply to both inventory[83] and capital investments,[84] such as the requirement to capitalize certain costs. Which costs of holding and improving property must be included in basis and which must be treated differently depends, in part, on the nature of the property as inventory or investment.

Likewise, various tax provisions may be affected by how a fix-and-flip activity is classified. Some of these implications are illustrated in the following scenarios. Practitioners may wish to explore the following topics further.

- **PTE tax.** See previous discussion in this chapter.
- **Capitalization of costs.** See the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
- **Profit motive.** See the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
- **Retirement plan options for small businesses.** See the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Retirement Plans for Small Businesses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

74. IRS Pub. 544, *Sales and Other Dispositions of Assets*.
75. IRC §1031(a)(2).
76. IRS Pub. 334, *Tax Guide for Small Business.*
77. IRC §1401(b)(2).
78. Under IRC §1(h).
79. IRC §1411(c)(1)(A)(iii).
80. IRC §65.
81. IRS Pub. 334, *Tax Guide for Small Business.*
82. IRC §1211(b).
83. IRC §263A.
84. IRC §263(a).

- **Calculating the QBID.** See the section on Qualified Business Income Issues in the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation. See also the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
- **Capital gains tax brackets.** See the 2014 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 3: Capital Gains and Losses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
- **SE taxes.** See IRS Pub. 334, *Tax Guide for Small Business*.
- **Net investment income tax (NIIT).** See the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Selected Real Estate Topics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
- **Additional Medicare tax.** See IRS Tax Topic No. 560 Additional Medicare Tax. This can be found at **uofi.tax/22b5x1** [www.irs.gov/taxtopics/tc560].
- **Exemption for certain small businesses.**[85] See the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Scenario 1: Bill Carpenter

Background. Bill is a self-employed carpenter. Most of his income typically comes from providing maintenance and improvement services to homeowners. He does not have any employees.

In the spring of 2020, he purchased a burned-out home for $20,000. His plan was to refurbish it and sell it as soon as possible. He spent $50,000 in materials fixing up the property that year. He tracked those expenses separately and added them to his basis tracking spreadsheet for the property. Bill understood that these costs were not currently deductible. (This treatment is correct regardless of whether the house is held as inventory or as an investment.)

Bill put another $30,000 of materials into the house before he sold the place for $400,000 on December 22, 2021. He paid $25,000 in selling expenses from the proceeds of the sale. He did not pay anyone for help with labor on the project.

Bill purchased some specific tools he wanted for the fix-and-flip project. He also used those tools in his carpentry business after he bought them. He deducted the cost of those tools using the de minimis safe harbor election on his 2020 and 2021 returns as business expenses.

> **Note.** For more information on the effect of the **de minimis safe harbor election** on capitalization, see the IRS Frequently Asked Questions regarding tangible property regulations found at **uofi.tax/22b5x2** [irs.gov/businesses/small-businesses-self-employed/tangible-property-final-regulations].

[85] IRC §471(c).

Bill's **profit from the sale** is calculated as shown.

Sales price		$400,000
Less costs:		
Purchase price	$ 20,000	
2020 materials	50,000	
2021 materials	30,000	
Selling expenses	25,000	
Total costs	$125,000	(125,000)
Total gain		$275,000

Tax Issue. Should the sale of the fix-and-flip project house be reported as part of Bill's SE income or as a long-term capital gain? If Bill held the house as inventory in the course of his business, the sale is properly included in SE income. Otherwise, the gain is reported as a long-term capital gain.

Analysis A. Inventory or Investment? To make this determination, Bill's preparer asks the following questions.

- When Bill purchased the property, what was his intent?
- Has he done this kind of project regularly?
- Does he plan to do this type of project regularly in the future?
- How much of his time and efforts were devoted to the project?

Bill answers his preparer's queries that he intended to hold the property until the remodeling was complete. As soon as it was ready, he put it up for sale. He has not done this type of project in the past, but he is now considering doing this every few years. He has not yet purchased another house to flip, but he is on the lookout for the right opportunity. He devoted a great deal of time and effort into remodeling this house over the past few years.

Outcome A. ***Inconclusive.*** None of the answers establish conclusively that the property was held as inventory or prove that it was not. A person getting into the business of flipping houses might answer questions the same way as a person who occasionally invests in real estate for profit.

Analysis B. Ordinarily sold in the course of the taxpayer's business? Bill told his preparer that he had **not** done any of the following.

- Sought a license to sell real estate
- Been in the business of flipping houses before
- Registered a business name for the activity of flipping properties
- Explored resources for people in the business, such as attending seminars on the practice
- Created an LLC or corporation to operate future projects
- Hired any employees to assist with future projects
- Advertised to purchase properties
- Established a separate office space
- Engaged in any business-related activities other than improving the house

Outcome B. ***Not Inventory.*** Bill did **not** act like a person in the business of fixing and flipping houses in 2021. Although he may in the future start to engage in this type of activity as part of a business, based on the facts in 2021, he was not in the business of selling refurbished real estate at the time he sold this house. Therefore, the sale of the flipped house qualified for long-term capital gain treatment.

Scenario 1 Tax Result. Bill realized $100,000 in business profits on his carpentry business in 2021. He had no other income or deductions, except the $275,000 profit from the sale of the flipped house.

Observations from excerpts of his return follow.

1. **Bill's taxable ordinary income was $80,385.** On his 2021 Form 1040, his ordinary income and deductions appear on the following lines.

Schedule C net income	$100,000	Line 8
Less: ½ SE tax	(7,065)	Line 10
Less: standard deduction	(12,550)	Line 12c
Taxable ordinary income	$ 80,385	

The following section of Form 1040 shows placement of these amounts.

Standard Deduction for— • Single or Married filing separately, $12,550 • Married filing jointly or Qualifying widow(er), $25,100 • Head of household, $18,800 • If you checked any box under *Standard Deduction,* see instructions.	6a				6b	
	7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			7	275,000
	8	Other income from Schedule 1, line 10			8	100,000
	9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶			9	375,000
	10	Adjustments to income from Schedule 1, line 26			10	7,065
	11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶			11	367,935
	12a	**Standard deduction or itemized deductions** (from Schedule A)	12a	12,550		
	b	Charitable contributions if you take the standard deduction (see instructions)	12b			
	c	Add lines 12a and 12b			12c	12,550
	13	Qualified business income deduction from Form 8995 or Form 8995-A			13	0
	14	Add lines 12c and 13			14	12,550
	15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-			15	355,385

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2021)

Taxable ordinary income can also be calculated by subtracting net long-term capital gains ($275,000) from net taxable income ($355,385).

2. **Bill did not get any QBID** on line 13 of his Form 1040 because the deduction was phased out at his income level. If he had paid wages or had significant levels of investment in qualified business property, he might have qualified for the deduction. Form 8995-A, *Qualified Business Income Deduction,* shows that Bill's business did not generate any QBID from wages paid or property with an unadjusted basis. This form appears next.

Form **8995-A** — Department of the Treasury, Internal Revenue Service

Qualified Business Income Deduction

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form8995A* for instructions and the latest information.

OMB No. 1545-2294 — 2021 — Attachment Sequence No. 55A

Name(s) shown on return: **BILL CARPENTER** — Your taxpayer identification number: **458-24-9856**

Note: *You can claim the qualified business income deduction **only** if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.*

Use this form if your taxable income, before your qualified business income deduction, is above $164,900 ($164,925 if married filing separately; $329,800 if married filing jointly), or you're a patron of an agricultural or horticultural cooperative.

Part I — Trade, Business, or Aggregation Information

Complete Schedules A, B, and/or C (Form 8995-A), as applicable, before starting Part I. Attach additional worksheets when needed. See instructions.

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	BILL CARPENTER	☐	☐	458-24-9856	☐
B		☐	☐		☐
C		☐	☐		☐

Part II — Determine Your Adjusted Qualified Business Income

			A	B	C
2	Qualified business income from the trade, business, or aggregation. See instructions	2	92,935		
3	Multiply line 2 by 20% (0.20). If your taxable income is $164,900 or less ($164,925 if married filing separately; $329,800 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	18,587		
4	Allocable share of W-2 wages from the trade, business, or aggregation	4	0		
5	Multiply line 4 by 50% (0.50)	5	0		
6	Multiply line 4 by 25% (0.25)	6	0		
7	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7	0		
8	Multiply line 7 by 2.5% (0.025)	8	0		
9	Add lines 6 and 8	9	0		
10	Enter the greater of line 5 or line 9	10	0		
11	W-2 wage and UBIA of qualified property limitation. Enter the smaller of line 3 or line 10	11	0		
12	Phased-in reduction. Enter the amount from line 26, if any	12	0		

3. **Bill's total federal tax liability for 2021, as shown on his Form 1040, was $75,192.**

Form 1040 (2021) — Page **2**

16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16	54,681
17	Amount from Schedule 2, line 3	17	
18	Add lines 16 and 17	18	54,681
19	Nonrefundable child tax credit or credit for other dependents from Schedule 8812	19	
20	Amount from Schedule 3, line 8	20	
21	Add lines 19 and 20	21	
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	54,681
23	Other taxes, including self-employment tax, from Schedule 2, line 21	23	20,511
24	Add lines 22 and 23. This is your **total tax** ▶	24	75,192

4. **Bill paid $41,250 (15%) in capital gains taxes on his $275,000 profit from the sale of the flipped house.** If he had earned less SE income during the year he sold the property, some of the gain might have been taxed at the 0% rate. His Qualified Dividends and Capital Gain Tax Worksheet shows the calculation of capital gains tax on line 18, as shown next.

Qualified Dividends and Capital Gain Tax Worksheet—Line 16

Keep for Your Records

Before you begin:
- √ See the earlier instructions for line 16 to see if you can use this worksheet to figure your tax.
- √ Before completing this worksheet, complete Form 1040 or 1040-SR through line 15.
- √ If you don't have to file Schedule D and you received capital gain distributions, be sure you checked the box on Form 1040 or 1040-SR, line 7.

1.	Enter the amount from Form 1040 or 1040-SR, line 15. However, if you are filing Form 2555 (relating to foreign earned income), enter the amount from line 3 of the Foreign Earned Income Tax Worksheet		1. 355,385	
2.	Enter the amount from Form 1040 or 1040-SR, line 3a*	2.		
3.	Are you filing Schedule D?* ☒ **Yes.** Enter the **smaller** of line 15 or 16 of Schedule D. If either line 15 or 16 is blank or a loss, enter -0-. ☐ **No.** Enter the amount from Form 1040 or 1040-SR, line 7.	3. 275,000		
4.	Add lines 2 and 3	4. 275,000		
5.	Subtract line 4 from line 1. If zero or less, enter -0-		5. 80,385	
6.	Enter: $40,400 if single or married filing separately, $80,800 if married filing jointly or qualifying widow(er), $54,100 if head of household.		6. 40,400	
7.	Enter the smaller of line 1 or line 6		7. 40,400	
8.	Enter the smaller of line 5 or line 7		8. 40,400	
9.	Subtract line 8 from line 7. This amount is taxed at 0%		9. 0	
10.	Enter the smaller of line 1 or line 4		10. 275,000	
11.	Enter the amount from line 9		11. 0	
12.	Subtract line 11 from line 10		12. 275,000	
13.	Enter: $445,850 if single, $250,800 if married filing separately, $501,600 if married filing jointly or qualifying widow(er), $473,750 if head of household.		13. 445,850	
14.	Enter the smaller of line 1 or line 13		14. 355,385	
15.	Add lines 5 and 9		15. 80,385	
16.	Subtract line 15 from line 14. If zero or less, enter -0-		16. 275,000	
17.	Enter the smaller of line 12 or line 16		17. 275,000	
18.	Multiply line 17 by 15% (0.15)			18. 41,250
19.	Add lines 9 and 17		19. 275,000	
20.	Subtract line 19 from line 10		20. 0	
21.	Multiply line 20 by 20% (0.20)			21. 0
22.	Figure the tax on the amount on line 5. If the amount on line 5 is less than $100,000, use the Tax Table to figure the tax. If the amount on line 5 is $100,000 or more, use the Tax Computation Worksheet			22. 13,431
23.	Add lines 18, 21, and 22			23. 54,681
24.	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			24. 98,929
25.	**Tax on all taxable income.** Enter the **smaller** of line 23 or 24. Also include this amount on the entry space on Form 1040 or 1040-SR, line 16. If you are filing Form 2555, don't enter this amount on the entry space on Form 1040 or 1040-SR, line 16. Instead, enter it on line 4 of the Foreign Earned Income Tax Worksheet			25. 54,681

** If you are filing Form 2555, see the footnote in the Foreign Earned Income Tax Worksheet before completing this line.*

5. **Bill paid $14,129 in SE tax on his carpentry business,** computed on his Schedule SE, *Self-Employed Tax,* which is shown next.

SCHEDULE SE (Form 1040) — **Self-Employment Tax** — OMB No. 1545-0074 — **2021**

Department of the Treasury Internal Revenue Service (99)

► Go to *www.irs.gov/ScheduleSE* for instructions and the latest information.
► Attach to Form 1040, 1040-SR, or 1040-NR.

Attachment Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040, 1040-SR, or 1040-NR): **BILL CARPENTER**

Social security number of person with **self-employment** income ►: **458-24-9856**

Part I Self-Employment Tax

Note: If your only income subject to self-employment tax is **church employee income,** see instructions for how to report your income and the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I ► ☐

Skip lines 1a and 1b if you use the farm optional method in Part II. See instructions.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	( )
	Skip line 2 if you use the nonfarm optional method in Part II. See instructions.		
2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order	2	**100,000**
3	Combine lines 1a, 1b, and 2	3	**100,000**
4a	If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3	4a	**92,350**
	Note: If line 4a is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.		
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here	4b	
c	Combine lines 4a and 4b. If less than $400, **stop;** you don't owe self-employment tax. **Exception:** If less than $400 and you had **church employee income,** enter -0- and continue ►	4c	**92,350**
5a	Enter your **church employee income** from Form W-2. See instructions for definition of church employee income — 5a:		
b	Multiply line 5a by 92.35% (0.9235). If less than $100, enter -0-	5b	**0**
6	Add lines 4c and 5b	6	**92,350**
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2021	7	142,800
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $142,800 or more, skip lines 8b through 10, and go to line 11 — 8a:		
b	Unreported tips subject to social security tax from Form 4137, line 10 — 8b:		
c	Wages subject to social security tax from Form 8919, line 10 — 8c:		
d	Add lines 8a, 8b, and 8c	8d	
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 ►	9	**142,800**
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (0.124)	10	**11,451**
11	Multiply line 6 by 2.9% (0.029)	11	**2,678**
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Schedule 2 (Form 1040), line 4**	12	**14,129**
13	**Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (0.50). Enter here and on **Schedule 1 (Form 1040), line 15** — 13: **7,065**		

Part II Optional Methods To Figure Net Earnings (see instructions)

6. **Bill paid $6,382 in NIIT on the sale.** Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts,* shows how this amount is computed and is shown below.

Form **8960**

Department of the Treasury
Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

► Attach to your tax return.

► Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227

2021

Attachment Sequence No. 72

Name(s) shown on your tax return: **BILL CARPENTER**

Your social security number or EIN: **458-24-9856**

Part I Investment Income

☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property (see instructions)	5a	275,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	275,000
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	275,000
Part II	**Investment Expenses Allocable to Investment Income and Modifications**				
9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	
Part III	**Tax Computation**				
12	Net investment income. Subtract Part II, line 11, from Part I, line 8. Individuals, complete lines 13–17. Estates and trusts, complete lines 18a–21. If zero or less, enter -0-			12	275,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	367,935		
14	Threshold based on filing status (see instructions)	14	200,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	167,935		
16	Enter the smaller of line 12 or line 15			16	167,935
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			17	6,382
	Estates and Trusts:				

Scenario 2: Kim Flipper

Background. Kim took the exact same course of action as Bill from Scenario 1, **except** she **also** took the following actions in 2021.

- Registered for courses needed to become licensed to sell real estate in her locale
- Created an LLC to hold future real estate purchases to fix and flip
- Announced her interest in buying distressed homes on her social network page
- Established a line-of-credit with her local bank for future purchases
- Established a simplified employee pension (SEP) plan and deposited $58,000 into a SEP individual retirement arrangement (IRA)

Tax Issue. Should the sale of the fix-and-flip project house be reported as part of Kim's SE income or as a long-term capital gain?

Analysis A. Inventory or Investment? Kim's and Bill's situations are the same so this analysis is **inconclusive** in both scenarios.

Analysis B. Ordinarily sold in the course of the taxpayer's business? When Kim's tax preparer considered her actions, he determined that she **had acted** like a person who had started a business of fixing and flipping houses.

Scenario 2 Tax Result. Kim realized $100,000 in business profits from her carpentry business in 2021. She had no other income or deductions except the $58,000 SEP IRA contribution and the profit of $275,000 from the sale of the flipped house.

Excerpts from her return follow.

1. **Kim's taxable income was $290,575.** Her ordinary income and deductions from her Form 1040 are as follows.

Standard Deduction for—
- Single or Married filing separately, $12,550
- Married filing jointly or Qualifying widow(er), $25,100
- Head of household, $18,800
- If you checked any box under *Standard Deduction,* see instructions.

7	... or (loss). ... required. If not req... ▶ ☐			7	
8	Other income from Schedule 1, line 10			8	375,000
9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶			9	375,000
10	Adjustments to income from Schedule 1, line 26			10	71,875
11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶			11	303,125
12a	**Standard deduction or itemized deductions** (from Schedule A)	12a	12,550		
b	Charitable contributions if you take the standard deduction (see instructions)	12b			
c	Add lines 12a and 12b			12c	12,550
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	0
14	Add lines 12c and 13			14	12,550
15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-			15	290,575

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2021)

2. **Line 10 of Kim's Form 1040 is the total of these entries on page 2 of her Schedule 1.**

Schedule 1 (Form 1040) 2021 Page **2**

Part II Adjustments to Income

11	Educator expenses	11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	12	
13	Health savings account deduction. Attach Form 8889	13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903	14	
15	Deductible part of self-employment tax. Attach Schedule SE	15	13,875
16	Self-employed SEP, SIMPLE, and qualified plans	16	58,000
	...f-employed health insurance deduction		

3. **Line 16** of Form 1040 is calculated using ordinary income tax rates.
4. **Line 23** of her Form 1040 is the total of her SE taxes and additional Medicare tax from Schedule 2, *Additional Taxes*.
5. **Kim did not receive any QBID** because the deduction was phased out at her income level.
6. **Kim's total federal tax liability for 2021 was $105,313.**

Relevant portions of her Form 1040 and Schedule 2 follow.

SCHEDULE 2 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Taxes

► Attach to Form 1040, 1040-SR, or 1040-NR.
► Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2021
Attachment Sequence No. 02

Name(s) shown on Form 1040, 1040-SR, or 1040-NR	Your social security number
KIM FLIPPER	458-24-2222

Part I Tax

1	Alternative minimum tax. Attach Form 6251			1	
2	Excess advance premium tax credit repayment. Attach Form 8962			2	
3	Add lines 1 and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17			3	

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE			4	27,750
5	Social security and Medicare tax on unreported tip income. Attach Form 4137	5			
6	Uncollected social security and Medicare tax on wages. Attach Form 8919	6			
7	Total additional social security and Medicare tax. Add lines 5 and 6			7	
8	Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required			8	
9	Household employment taxes. Attach Schedule H			9	
10	Repayment of first-time homebuyer credit. Attach Form 5405 if required			10	
11	Additional Medicare Tax. Attach Form 8959			11	1,317

Form 1040 (2021) Page 2

16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16	76,246
17	Amount from Schedule 2, line 3	17	
18	Add lines 16 and 17	18	76,246
19	Nonrefundable child tax credit or credit for other dependents from Schedule 8812	19	
20	Amount from Schedule 3, line 8	20	
21	Add lines 19 and 20	21	
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	76,246
23	Other taxes, including self-employment tax, from Schedule 2, line 21	23	29,067
24	Add lines 22 and 23. This is your **total tax** ►	24	105,313

Federal income tax withheld from:

Comparing Scenario 1 and 2 Results

The taxpayers in the previous scenarios paid significantly different amounts of taxes on the same economic outcomes from their ventures:

- Bill in **Scenario 1** is considered **not in the business** of flipping houses.
- Kim in **Scenario 2** is considered **in the business** of flipping houses.

Bill's gain from the fix-and-flip activity was treated as an investment and taxed at capital gains rate. Kim's gain was treated as part of her gross profit from SE activities. The following table summarizes select portions of their returns shown previously.

	Bill Carpenter	Kim Flipper
Taxable income:		
Net capital gains	$275,000	$ 0
Net business profit	100,000	375,000
½ SE tax deduction	(7,065)	(13,875)
Retirement contributions	0	(58,000)
Standard deduction	(12,550)	(12,550)
Taxable income	$355,385	$290,575
Total tax:		
Income tax	$ 54,681	$ 76,246
SE tax	14,129	27,750
NIIT	6,382	0
Additional Medicare tax	0	1,317
Total tax	$ 75,192	$105,313

Note. Bill could have contributed to a SEP IRA plan based on his construction business. His maximum contribution based on $100,000 profit would be $**18,587.** This would have reduced Bill's taxable ordinary income in his marginal 22% bracket and saved him another $4,092 in federal income taxes.

ADDITIONAL DISCUSSION SCENARIOS

Consider the following scenarios to determine if the activities are investment activities or involve inventory sold in the course of the taxpayer's business.

Discussion Scenario 1

Larry is a full-time employee of a phone company. After watching a program about flipping houses on television, Larry decides to buy a distressed property. He does rehab work to the property himself in his spare time and sells it after spending more than a year getting it in shape for sale. He is pleased with his gain of $15,000 on the sale. His employer complains that Larry seems lethargic at work, so he doubts he will undertake such an exhaustive use of his free time again.

Dealer or Investor? ______________________________

Discussion ______________________________

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Discussion Scenario 2

Use the same facts as **Discussion Scenario 1**, except instead of a $15,000 profit, Larry loses $15,000. A friend of his tells him he read that house flipping is a business activity, and therefore Larry can deduct the entire loss in the year of sale.

Dealer or Investor? ______________________________

Discussion ______________________________

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Discussion Scenario 3

Joannie hates her job. Looking for new opportunities, she purchases an online course on house flipping. Passionate about her prospects, she quits her job, takes an early distribution from her 401(k) plan, and uses the funds to buy three distressed properties. She has been working night and day but has not completed renovations to the properties. She has not sold the properties or lined up any potential buyers.

Dealer or Investor? ______________________________

Discussion ______________________________

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Discussion Scenario 4

Gwen owns a construction company. She purchases 100 acres of undeveloped land, which she intends to develop into a subdivision. To manage costs, she divides the property into two 50-acre parcels and begins work on Parcel 1.

- **Parcel 1.** Gwen makes the following progress.
    - Contracts with engineers and surveyors
    - Adds infrastructure to connect the subdivision to city services
    - Creates 100 lots available for sale
- **Parcel 2.** No development is done on the second 50-acre parcel.

Due to the economy, lot sales on the first parcel are sluggish. Gwen reduces prices to the point where she is losing money on each lot sold.

Her lender, threatening foreclosure, demands that Gwen sell the second 50-acre parcel before being forced into bankruptcy. She sells the second parcel for one-third of her original cost.

Dealer or Investor? ______________________________

Discussion______________________________

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Observation. The facts illustrated in **Discussion Scenario 4** were loosely based on the case of *Richwood Land Company, Inc. v. Comm'r.*[86] In this 1973 decision, the court held the sale of the undeveloped land to be investment property. Therefore, the loss was a capital loss, subject to the $3,000 annual limit. If it had been an ordinary loss, it would have been fully deductible.

86. *Ridgewood Land Company, Inc. v. Comm'r,* 477 F.2d 135 (5th Cir. 1973).

FORM 4797 BASICS

Form 4797, *Sales of Business Property*, was first introduced for use in preparing 1971 income tax returns. For a form that has not substantially changed in over 50 years, it can be a significant source of frustration for many tax practitioners. The form and instructions rely upon Code sections in lieu of repeating lengthy definitions and sets of rules. While succinct, this leaves the reader who does not think in Code at a disadvantage when confronting this form.

Essentially, Form 4797 is a sorting form. Its purpose is to gather all the sales of business assets (and other special types of assets) and sort the results into **gains that qualify for capital gain rates**[87] (IRC §1231 gains) and gains/losses that do not.

The **net gains** that do **not** qualify for capital gains rates are taxed as **ordinary income.** The **net losses reduce ordinary income**[88] without the $3,000 a year limit that is imposed on capital losses.[89] These allowed losses are commonly called "§1231 losses" because that is the Code section that establishes the special rules for gains and losses from sales of business assets.

> **Note.** The following discussion of Form 4797 only covers simple sales of business properties. Other transactions, such as involuntary conversions, installment sales, and like-kind exchanges which are also reported on Form 4797 are beyond the scope of this material. For comprehensive coverage of the topic, see the 2013 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 1: Form 4797. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

FORM 4797 STRUCTURE[90]

Form 4797 begins with line 1, which is followed by four parts. Line 1 previously only matched tax reporting documents to the form. The line was revised on the 2021 version to add lines 1b and 1c. These new lines ask taxpayers to separately identify the total gains and the total losses included in the net gains/losses from **partial dispositions** of modified accelerated cost recovery system (MACRS) assets reported on the form. The entries on line 1 are for IRS purposes and do not affect the form calculations.

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2021
Attachment Sequence No. **27**

Name(s) shown on return	Identifying number

1a	Enter the gross proceeds from sales or exchanges reported to you for 2021 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	**1a**	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	**1b**	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	**1c**	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other**

87. IRC §1231(a)(1).
88. IRC §1231(a)(2).
89. IRC §1211(b).
90. Instructions for Form 4797.

Each subsequent part of the form has a unique purpose.

- **Part I** establishes the net gains qualified for long-term capital gain treatment.
- **Part II** determines the net gain or loss subject to ordinary rates.
- **Part III** allocates long-term **gains from depreciable assets** into the portions qualifying for the special rates and those that do not. Part III results generally flow to parts I and II, as applicable.
- **Part IV** recaptures certain depreciation deductions when business use of an asset drops to 50% or less and the taxpayer has not disposed of the affected asset.

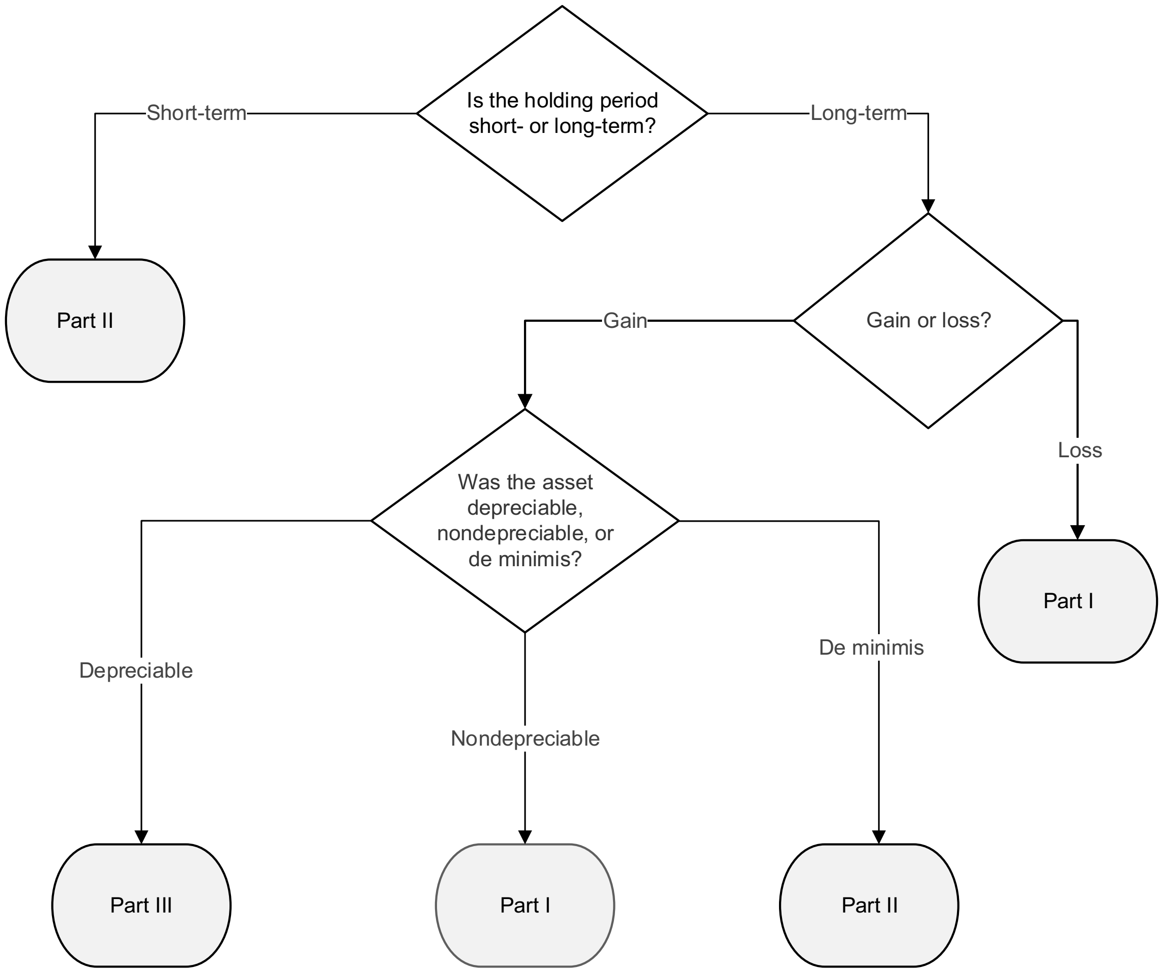
The IRS provides the following table in the instructions for Form 4797 to direct the taxpayer on where to make their first entry on the form. Note that all dispositions of assets held less than 12 months are reported in part II, as well as dispositions of certain farm animals held less than 24 months. These transactions are all considered short-term.

Where To Make First Entry for Certain Items Reported on This Form

	(a) Type of property	(b) Held 1 year or less	(c) Held more than 1 year
1	**Depreciable tangible trade or business property:**		
	a Sold or exchanged at a gain	Part II	Part III (1245)
	b Sold or exchanged at a loss	Part II	Part I
2	**Depreciable real trade or business property:**		
	a Sold or exchanged at a gain	Part II	Part III (1250)
	b Sold or exchanged at a loss	Part II	Part I
3	**Farmland held less than 10 years upon which soil or water expenses were deducted:**		
	a Sold at a gain	Part II	Part III (1252)
	b Sold at a loss	Part II	Part I
4	**Real or tangible trade or business property which was deducted under the de minimis safe harbor**	Part II	Part II
5	**All other farmland used in a trade or business**	Part II	Part I
6	**Disposition of cost-sharing payment property described in section 126**	Part II	Part III (1255)
7	**Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:**	**Held less than 24 months**	**Held 24 months or more**
	a Sold at a gain	Part II	Part III (1245)
	b Sold at a loss	Part II	Part I
	c Raised cattle and horses sold at a gain	Part II	Part I
8	**Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:**	**Held less than 12 months**	**Held 12 months or more**
	a Sold at a gain	Part II	Part III (1245)
	b Sold at a loss	Part II	Part I
	c Raised livestock sold at a gain	Part II	Part I

The following flowchart may also be helpful in determining which part to use to report dispositions of business assets.

Flowchart to Determine Which Part of Form 4797 to Use to Report Dispositions of Business Assets



Part I: Sales or Exchanges of Business Property Held More Than One Year

Part I of the form totals the long-term gains and losses from various business-related sources. As mentioned previously, a net long-term gain qualifies for the lower capital gains tax rates applicable to the taxpayer, generally 0%, 15%, or 20%.[91]

assets 1c

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

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

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824.	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, 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 didn't 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)

Line 2 is used to report those sales of business assets that were **held longer than one year** which have not been reported in other sections or on other forms. Those long-term business-related gains or losses reported on other forms flow into this section via lines 3 through 5.

Line 6 flows from part III, which determines the portions of the long-term gains from depreciable assets that qualify for the best rates and the portions that are subject to less favorable rates. The most favorably taxed portions from part III flow to line 6.

Line 7 subtotals all the qualified long-term gains and losses from sales of business properties. **If the subtotal is a loss, the loss is carried to part II of Form 4797.** However, if the subtotal is a gain, another step may be required.

91. Rev. Proc. 2021-45, 2021-48 IRB 764; IRC §1(h).

Taxpayers who have **nonrecaptured net §1231 losses from prior years** must complete line 8. If the taxpayer does **not** have nonrecaptured losses, the gain on line 7 flows to Schedule D, *Capital Gains and Losses,* to be combined with other long-term capital gains and losses.

> **Caution.** Nonrecaptured net §1231 losses are discussed in detail later. In brief, a taxpayer may not take advantage of long-term capital gains rates on the sales of business assets if that same taxpayer has benefited from the special rules for losses from the sales of business assets in the last five years. The purpose of the entry on line 8 is to **reclassify current-year long-term gains** into **ordinary gains** that do not qualify for special rates. Thus, line 8 is a trap for unwary taxpayers.

Line 9 is the remaining gain taxed as long-term capital gains after the reclassification. This amount flows to Schedule D to be netted with other long-term capital gains and losses.

> **Note.** Gains from real estate (§1250 assets) included in part III transfer to part I **without** allocating any portion of the gains to **unrecaptured** depreciation. However, the portion of the gains attributable to unrecaptured depreciation does **not** qualify for the lowest capital gains rates. Instead, the rate on this component is capped at 25%. The rules for **unrecaptured §1250 gains** are discussed in more detail later.

Part II: Ordinary Gains and Losses

Part II nets the following types of income.

- Short-term gains and losses
- Long-term losses
- The portion of gains taxed as ordinary income due to depreciation recapture
- Gains reclassed under the rules for nonrecaptured net §1231 losses

Except for casualty losses, the result transfers to Form 1040, Schedule 1.

	capital gain on the Schedule D filed with your return. See instructions . . .	9

Part II Ordinary Gains and Losses (see instructions)

10	Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):	
11	Loss, if any, from line 7 . . .	11 ( )
12	Gain, if any, from line 7 or amount from line 8, if applicable . . .	12
13	Gain, if any, from line 31 . . .	13
14	Net gain or (loss) from Form 4684, lines 31 and 38a . . .	14
15	Ordinary gain from installment sales from Form 6252, line 25 or 36 . . .	15
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . .	16
17	Combine lines 10 through 16. . . .	17
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 loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions . . .	18a
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4 . . .	18b

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2021)

Line 10 is used to report the sales of business assets held less than one year that are not reported elsewhere on the return. **This line is also used to report the disposition of property if the cost was deducted under the de minimis safe harbor rules of Treas. Reg. §1.263(a)-1(f).** Other dispositions which qualify for special treatment, such as the sale of IRC §1244 stock, are also reported here.

The amounts to report on Lines 11 and 12 come from part I. If the transactions in part I net to a loss, the loss transfers to Line 11. If the taxpayer has nonrecaptured §1231 gains, the amount on Line 12 is the **lesser of** the net gains reported on line 7 in part I or the amount of nonrecaptured §1231 gains on line 8.

Line 13 flows from part III. This is amount of depreciation recapture calculated in part III. (Depreciation recapture is discussed in more detail later in this section.)

Dispositions of business assets involving casualties, installment sales, and LKE are reported on the applicable forms. The ordinary gains and losses calculated on those forms flow into this part of Form 4797 on lines 14 through 16.

Line 17 totals the ordinary gains and losses reported on the previous lines. Line 18 divides the result into casualty losses from income-producing property that is deductible on Schedule A, and all other losses deducted on Schedule 1.

Part III: Gain from Disposition of Property Under IRC §§1245, 1250, 1252, 1254, and 1255

Gains from sales of business assets are reported in part III if the assets' adjusted bases include depreciation allowed or allowable under §§1245 or 1250. Additionally, if the taxpayer deducted specific expenses under certain specialized Code provisions, gains from sales of the related assets are reported in part III. The Code sections referenced in the title refer to the following categories of business assets. The most common types of property in each category include the following.

- **§1245** — Personal property
- **§1250** — Real estate
- **§1252** — Certain farmland held less than 10 years
- **§1254** — Interests in oil, gas, geothermal, or other mineral properties
- **§1255** — Property for which income was excluded under IRC §126

Part III identifies which portions of the gains are subject to ordinary rates and which qualify for the capital gain rates. Lines 19 through 24 identify the property and calculate the gain.

Lines 25 through 29 calculate the portion of the gain for each disposition that is subject to ordinary rates based on the rules applicable to each category of asset. Thus, line 25 is only applicable to §1245 property, line 26 is only applicable to §1250 property, line 27 is only applicable to §1252 property, line 28 is only applicable to §1254 property, and line 29 is only applicable to §1255 property.

In the **summary section,** line 30 totals all the gains reported in this part of the form. Line 31 totals all the ordinary income components from each category. This amount transfers to part II where it is combined with the other gains and losses subject to the taxpayer's ordinary income tax rates.

The remainder on line 32 is the amount eligible for capital gains rates. This amount generally transfers to part I and is combined with other eligible gains and long-term losses as discussed previously. Gains from casualties and thefts, however, transfer to Form 4684, *Casualties and Thefts.*

Part III of Form 4797 follows.

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			
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 1a before completing.*) .	20				
21	Cost or other basis plus expense of sale	21				
22	Depreciation (or depletion) allowed or allowable . . .	22				
23	Adjusted basis. Subtract line 22 from line 21	23				
24	Total gain. Subtract line 23 from line 20	24				
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22 . . .	25a				
b	Enter the **smaller** of line 24 or 25a.	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975. See instructions .	26a				
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions.	26b				
c	Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d	Additional depreciation after 1969 and before 1976. .	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f	26g				
27	**If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a 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	
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

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

Part IV: Recapture Amounts under IRC §§179 and 280F(b)(2) When Business Use Drops to 50% or Less

Two types of depreciation deductions must be recaptured when the business use of the asset is no longer greater than 50%.

1. Elections under §179
2. Depreciation of listed property as defined by §280F

The recapture amount is reported on the form or schedule (e.g., Schedule C or Schedule F, *Profit or Loss From Farming*) where the depreciation was originally deducted. If the business activity is subject to SE tax, then the recapture amount is included in SE income. Recaptured amounts are added back into the basis of the asset.

32 Sub... other than casualty or theft on Form 4797, line ... 32

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

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

Form **4797** (2021)

If the asset was sold and the sale is subject to depreciation recapture under §1245, the rules for §179 recapture do not apply.[92] Likewise, if business use of listed property did **not** decrease to 50% or less **prior** to the property being sold, no recapture under §280F(b)(2) is required. Thus, taxpayers are generally not required to complete this section for dispositions already reported in parts I, II, or III. As described previously, gains and losses from dispositions reported in those parts **do not flow** to the schedule where the original deduction was taken. Accordingly, they also do **not** affect SE income.

> **Note.** See IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses,* and IRS Pub. 946, *How To Depreciate Property,* for more details on calculating recapture of excess depreciation.

92. Treas. Reg. §1.179-1(e)(3).

IRC §1245 DEPRECIATION RECAPTURE (PERSONAL PROPERTY)

IRC §1245 requires **the lesser of the gain realized or the depreciation allowed or allowable to be recaptured as ordinary income** upon the sale of covered property. Thus, the first portion of the gain on §1245 property is treated as ordinary gain. **Any portion of the sales price that exceeds the original cost basis may qualify for capital gains rates.**

Type of Gain	Description of Portion of Gain Being Taxed	Applicable Rates
Recaptured §1245 gain	Depreciation component of gain	Ordinary
§1231 gain	Proceeds above original cost	Capital gains rates

Example 16. In 2021, Sorrenta sold a 1-ton truck for $4,000 that she used in her construction business. In 2018, she wrote off the entire $15,000 cost of the truck by making a §179 election. Thus, she has a $4,000 gain from the sale. By following the flow chart shown previously, Sorrenta reported this long-term transaction as a gain attributable to depreciation in part III of Form 4797. Sorrenta's $4,000 of depreciation recapture was taxed as ordinary income.

Form 4797 (2021) 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	1 Ton Truck	06/01/2018	06/01/2021
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 1a before completing.*)	20	4,000			
21	Cost or other basis plus expense of sale	21	15,000			
22	Depreciation (or depletion) allowed or allowable	22	15,000			
23	Adjusted basis. Subtract line 22 from line 21	23	0			
24	Total gain. Subtract line 23 from line 20	24	4,000			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	15,000			
b	Enter the **smaller** of line 24 or 25a	25b	4,000			

Observation. The §179 deduction that Sorrenta claimed in 2018 reduced her Schedule C income and therefore reduced her SE tax. The §1245 recapture reported in 2021 did not transfer to Schedule C and did not increase her SE tax.

Example 17. Sorrenta from **Example 16** also sold a custom-made office desk for $1,500 in 2021. She purchased the desk two years previously for $1,000. Therefore, she realized a gain of $500 before depreciation recapture. This portion of the gain is eligible for capital gains rates.

The desk is depreciated using the MACRS half-year convention. Sorrenta does not elect the §179 deduction, and she elects out of bonus depreciation. The accumulated allowed or allowable depreciation is $475. This portion of her gain is recaptured as ordinary income.

Sorrenta reports these transactions as shown on the following Form 4797. The total of the line 25b entries in the columns for Property A and Property B is the §1245 recapture. The total recapture of $4,475 is shown on line 31. This amount transfers to line 13 of part II.

The $500 portion of the gain eligible for capital gain rates is calculated on line 32, and transfers to line 6 of part I.

Form 4797 (2021) 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	1 Ton Truck	06/01/2018	06/01/2021
B	Office Desk	02/01/2019	08/25/2021
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 1a before completing.*)	20	4,000	1,500		
21	Cost or other basis plus expense of sale	21	15,000	1,000		
22	Depreciation (or depletion) allowed or allowable	22	15,000	475		
23	Adjusted basis. Subtract line 22 from line 21	23	0	525		
24	Total gain. Subtract line 23 from line 20	24	4,000	975		
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a	15,000	475		
b	Enter the **smaller** of line 24 or 25a	25b	4,000	475		
	...roperty: If straight line depreciation was used					
b	Enter the smalle... or 29a. See ins...	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	4,975
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	4,475
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	500

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

IRC §1245 LOSSES

For §1245 property sold at a loss, the **recapture rules do not apply.** The loss reduces ordinary income.

Example 18. Sorrenta, from **Example 17,** also sold an office trailer in 2021. She originally purchased the trailer for $20,000 in 2017. Her remaining basis after depreciation was $5,355. Unfortunately, she was only able to sell it for $3,500. Accordingly, she has a deductible loss of $1,855. By following the flow chart shown previously, Sorrenta reported this long-term transaction with a loss on part I of the following Form 4797. (See **Example 17** for the calculation of the amounts on lines 6 and 13 that transferred from part III.)

For Example 18

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

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

► Attach to your tax return.

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

OMB No. 1545-0184

2021

Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Sorrenta Jones	423-45-6789

1a	Enter the gross proceeds from sales or exchanges reported to you for 2021 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

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)
Office Trailer	01/01/2017	07/25/2021	3,500	14,645	20,000	(1,855)

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	500
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	(1,355)
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, 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 didn't 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	(1,355)
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	4,475
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	3,120
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 loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	3,120

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2021)

Observation. Sorrenta's $500 gain from the sale of the desk in **Example 17** was not taxed at the long-term capital gains rates. Instead, the $500 gain was netted against her $1,855 loss on the trailer. The $1,355 net loss transferred to part II, where it was netted against the depreciation recapture from part III.

RECAPTURED AND UNRECAPTURED REAL PROPERTY GAINS

IRC §1250 property generally includes all depreciable **real property**. However, if the property was ever subject to §1245, the "personal property taint" remains. To that extent, the harsher recapture rules of §1245 apply instead of the §1250 recapture rules discussed later. Real property subject to §1245 includes real property **improvements for which a §179 election was made**[93] as well as other industry-specific facilities.[94]

Example 19. JoJo placed his office building in service in 1997. In 2019, he added a heating and air conditioning system. The system cost $20,000. On his 2019 return, JoJo elected to deduct $15,000 of the cost under §179. If JoJo sells the property, up to $15,000 of gain may be subject to recapture as ordinary income.

Note. IRS Pub. 946 refers readers to IRS Notice 2013-59[95] for how to determine the portion of the gain attributable to §1245 property upon the sale of qualified real property. Although this notice specifically addresses §179(f), which has been repealed, the methods for allocating the gain are still applicable for §179(e) property. Subsection (3) of the notice contains examples exhibiting reasonable methods to calculate the allocation.

For most real estate, §1250 requires **the lesser of the gain realized,** or the **depreciation** claimed **in excess of straight-line depreciation,** to be **recaptured as ordinary income** upon the sale or transfer of §1250 property. This excess depreciation component is the **recaptured** §1250 gain. The portion of the gain attributable to straight-line depreciation is the **unrecaptured** §1250 gain. The remaining portion of the gain is the §1231 gain, which qualifies for capital gains rates.

Portion of Gain	Description	Applicable Rates
Recaptured gain	Accelerated depreciation in excess of straight line	Ordinary income
Unrecaptured gain	Straight line depreciation	Ordinary capped at 25%
§1231 gain	Above original cost and sales expenses	Capital gains rates

Example 20. In 2016, Ginger bought three acres of land and built an equipment shed for use in her landscaping and nursery business (considered a farming activity under 29 CFR §780.206). The building is 20-year property[96] and qualifies for bonus depreciation.[97] Ginger did not elect out of the 50% bonus depreciation applicable to the property on her 2016 return. Therefore, of her $80,000 purchase cost, she was able to deduct $40,000 of bonus depreciation. The remaining basis she depreciated using the half-year convention and 150% declining balance method.

In 2021, Ginger sold the building and three acres of land to a neighbor for $150,000. She and the buyer agreed that the price allocated to the land was $15,000. Her cost basis in the acreage was $6,000, and she paid $1,000 in closing costs.

93. IRC §1245(a)(3)(C). See also IRC §179(e) referencing IRC §168(e)(6).

94. IRC §§1245(a)(3)(D) – (F).

95. IRS Notice 2013-59, 2013-40 IRB 297.

96. IRS Pub. 946, *How to Depreciate Property*.

97. IRC §168(k)(2)(A)(i)(I).

Ginger reported the following two transactions on her 2021 return.

- The sale of the land
- The sale of the depreciable building

Both transactions resulted in gains.

	Sales Price	Allocation	Cost	Selling Expenses	Depreciation	Gain [a]
Land	$ 15,000	10%	$ 6,000	$ 100	$ 0	$ 8,900
Building	135,000	90%	80,000	900	52,872	106,972
Total	$150,000	100%	$86,000	$1,000	$52,872	$115,872

[a] Gain = sales price − cost − selling expenses + depreciation.

Using lines 20 through 24 of part III, Ginger determined her total gain from the sale of the building. Because the building was §1250 property, she also completed line 26.

On line 26a, Ginger reported the portion of the gain on the sale of the building that was in excess of straight-line depreciation and therefore subject to recapture. She determined how much excess depreciation to claim as follows.

Total depreciation allowed or allowable	$52,872
Depreciation allowable using straight-line method	(20,000)
Excess depreciation	$32,872

On Line 26b, she entered the **lesser** of excess depreciation ($32,872) or gain from the sale ($106,972), multiplied by the **applicable rate** (which in most cases is 100%[98]), thus $32,872.

Line 26b shows the amount of her gain that was **recaptured** as ordinary income. The remaining portion of the gain is reported on line 26c.

> **Note.** The remaining gain on line 26c contains both unrecaptured and capital gain components. This is important, as shown later in **Example 21.**

Ginger's gain from the sale of the building included the following types of gains. Her completed Form 4797 follows.

	Amount	Form Line	Description	Tax Rates
Total gain	$106,972	Line 24		To be allocated
Recaptured gain	32,872	Line 26g	Accelerated depreciation in excess of straight line	Ordinary
Unrecaptured gain	20,000 [a]	Line 22 less line 26g	Straight-line depreciation	Ordinary capped at 25%
§1231 gain	$ 54,100 [b]		Total gain less recaptured and unrecaptured portions	Capital gains rates

[a] $52,872 total depreciation − $32,872 excess depreciation

[b] $135,000 sales price − $80,000 original cost − $900 sales expenses

98. Special rates apply for certain low-income rental housing. See IRC §§1250(a)(1)(B)(i) – (iv).

For Example 20

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

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

► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2021
Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Ginger Jones	543-22-2345

1a	Enter the gross proceeds from sales or exchanges reported to you for 2021 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	150,000
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

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)
Land	2/24/2016	07/01/2021	15,000		6,100	8,900

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	74,100
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	83,000

Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, 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 didn't 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	32,872
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	32,872
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 loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	32,872

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For Example 20

Form 4797 (2021) Page **2**

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

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	Equipment shed	02/24/2016	07/01/2021
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 1a before completing.*)	20	135,000			
21	Cost or other basis plus expense of sale	21	80,900			
22	Depreciation (or depletion) allowed or allowable	22	52,872			
23	Adjusted basis. Subtract line 22 from line 21	23	28,028			
24	Total gain. Subtract line 23 from line 20	24	106,972			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a				
b	Enter the **smaller** of line 24 or 25a	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975. See instructions	26a	32,872			
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b	32,872			
c	Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c	74,100			
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	32,872			
27	**If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a 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	106,972
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	32,872
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	74,100

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** (2021)

How Unrecaptured §1250 Gains Flow to the Tax Calculation

Unrecaptured §1250 gains are the portion of gains attributable to straight-line depreciation, as discussed previously. Although Form 4797 contains the information necessary to know the amount, the form does not explicitly identify any line as unrecaptured §1250 gains. These gains are included in the total long-term gains that flow from part I. As such, it appears that the entire amount of long-term gains qualifies for capital gains rates.

Appearances are misleading. IRC §1(h)(1)(E) provides that the **maximum** tax on unrecaptured §1250 gains is 25%, instead of the 0%, 15%, and 20% rates applicable to other long-term capital gains.

To account for this rate difference, Schedule D has the taxpayer identify the amount of unrecaptured §1250 gains included in net capital gains by completing the *Unrecaptured Section 1250 Gain Worksheet — Line 19* found in the instructions for Schedule D. As shown in **Example 21,** which follows, these amounts come from Form 4797.

The Schedule D Tax Worksheet (found in the instructions for Form 1040) calculates the tax based on each bracket and the categories of income reported. This worksheet pulls the amount of unreported §1250 gains from Schedule D into the sorting function to cap the amount of tax paid on the gains at 25%. Note that based on the tax rates applicable for 2021, the 25% **maximum rate** on unrecaptured §1250 gains does not apply until the taxpayer is in the 32% ordinary income tax bracket.

> **Example 21.** Ginger from **Example 20** has no other income in 2021 because she ceased farming operations in late 2020.. Her tax is calculated using the following worksheets. For reference purposes, select portions of other pages in her 2021 return are shown following the worksheets.

Unrecaptured Section 1250 Gain Worksheet—Line 19

Keep for Your Records

If you aren't reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.

1. If you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252), enter the **smaller** of line 22 or line 24 of Form 4797 for that property. If you didn't have any such property, go to line 4. If you had more than one such property, see instructions			**1.**	52,872
2. Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1			**2.**	32,872
3. Subtract line 2 from line 1			**3.**	20,000
4. Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year. See instructions			**4.**	0
5. Enter the total of any amounts reported to you on a Schedule K-1 from a partnership or an S corporation as "unrecaptured section 1250 gain"			**5.**	0
6. Add lines 3 through 5			**6.**	20,000
7. Enter the **smaller** of line 6 or the gain from Form 4797, line 7	**7.**	20,000		
8. Enter the amount, if any, from Form 4797, line 8	**8.**	0		
9. Subtract line 8 from line 7. If zero or less, enter -0-			**9.**	20,000
10. Enter the amount of any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain. See instructions			**10.**	0
11. Enter the total of any amounts reported to you as "unrecaptured section 1250 gain" on a Schedule K-1, Form 1099-DIV, or Form 2439 from an estate, trust, real estate investment trust, or mutual fund (or other regulated investment company) or in connection with a Form 1099-R			**11.**	0
12. Enter the total of any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you didn't make an entry in Part I of Form 4797 for the year of sale. See instructions			**12.**	0
13. Add lines 9 through 12			**13.**	20,000
14. If you had any section 1202 gain or collectibles gain or (loss), enter the total of lines 1 through 4 of the **28% Rate Gain Worksheet**. Otherwise, enter -0-	**14.**	0		
15. Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	**15.**	(0)		
16. Enter your long-term capital loss carryovers from Schedule D, line 14, and Schedule K-1 (Form 1041), box 11, code D*	**16.**	(0)		
17. Combine lines 14 through 16. If the result is a (loss), enter it as a positive amount. If the result is zero or a gain, enter -0-			**17.**	0
18. Unrecaptured section 1250 gain. Subtract line 17 from line 13. If zero or less, enter -0-. If more than zero, enter the result here and on Schedule D, line 19			**18.**	20,000

* If you are filing Form 2555 (relating to foreign earned income), see the footnote in the Foreign Earned Income Tax Worksheet in the Instructions for Forms 1040 and 1040-SR before completing this line.

For Example 21

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 and lines 15 and 16 of Schedule D are gains or if you file Form 4952 and you have an amount on line 4g, even if you don't need to file Schedule D. Otherwise, complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Forms 1040 and 1040-SR, line 16 (or in the instructions for Form 1040-NR, line 16) to figure your tax. Before completing this worksheet, complete Form 1040, 1040-SR, or 1040-NR through line 15.

Exception: Don't 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, 1040-SR, or 1040-NR, line 3a;

or
- Form 1040, 1040-SR, or 1040-NR, line 15, is zero or less.

Instead, see the instructions for Forms 1040 and 1040-SR, line 16 (or Form 1040-NR, line 16).

1.	Enter your taxable income from Form 1040, 1040-SR, or 1040-NR, line 15. (However, if you are filing Form 2555 (relating to foreign earned income), enter instead the amount from line 3 of the Foreign Earned Income Tax Worksheet in the instructions for Forms 1040 and 1040-SR, line 16)					1. 99,258
2.	Enter your qualified dividends from Form 1040, 1040-SR, or 1040-NR, line 3a		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. 83,000			
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. 83,000		
10.	Add lines 6 and 9				10. 83,000	
11.	Add lines 18 and 19 of Schedule D**			11. 20,000		
12.	Enter the **smaller** of line 9 or line 11				12. 20,000	
13.	Subtract line 12 from line 10					13. 63,000
14.	Subtract line 13 from line 1. If zero or less, enter -0-					14. 36,258
15.	Enter: • \$40,400 if single or married filing separately; • \$80,800 if married filing jointly or qualifying widow(er); or • \$54,100 if head of household.			15. 40,400		
16.	Enter the **smaller** of line 1 or line 15				16. 40,400	
17.	Enter the **smaller** of line 14 or line 16			17. 36,258		
18.	Subtract line 10 from line 1. If zero or less, enter -0-		18. 16,258			
19.	Enter the **smaller** of line 1 or: • \$164,925 if single or married filing separately; • \$329,850 if married filing jointly or qualifying widow(er); or • \$164,900 if head of household.		19. 99,258			
20.	Enter the **smaller** of line 14 or line 19		20. 36,258			
21.	Enter the **larger** of line 18 or line 20				21. 36,258	
22.	Subtract line 17 from line 16. This amount is taxed at 0%.				22. 4,142	
	If lines 1 and 16 are the same, skip lines 23 through 43 and go to line 44. Otherwise, go to line 23.					
23.	Enter the **smaller** of line 1 or line 13			23. 63,000		
24.	Enter the amount from line 22. (If line 22 is blank, enter -0-.)			24. 4,142		
25.	Subtract line 24 from line 23. If zero or less, enter -0-			25. 58,858		
26.	Enter: • \$445,850 if single; • \$250,800 if married filing separately; • \$501,600 if married filing jointly or qualifying widow(er); or • \$473,750 if head of household.			26. 445,850		
27.	Enter the smaller of line 1 or line 26			27. 99,258		
28.	Add lines 21 and 22			28. 40,400		
29.	Subtract line 28 from line 27. If zero or less, enter -0-			29. 58,858		
30.	Enter the **smaller** of line 25 or line 29				30. 58,858	

For Example 21

Schedule D Tax Worksheet—*Continued* *Keep for Your Records*

31.	Multiply line 30 by 15% (0.15)		31.	8,829
32.	Add lines 24 and 30	32. 63,000		
	If lines 1 and 32 are the same, skip lines 33 through 43 and go to line 44. Otherwise, go to line 33.			
33.	Subtract line 32 from line 23	33. 0		
34.	Multiply line 33 by 20% (0.20)		34.	0
	If Schedule D, line 19, is zero or blank, skip lines 35 through 40 and go to line 41. Otherwise, go to line 35.			
35.	Enter the **smaller** of line 9 above or Schedule D, line 19	35. 20,000		
36.	Add lines 10 and 21	36. 119,258		
37.	Enter the amount from line 1 above	37. 99,258		
38.	Subtract line 37 from line 36. If zero or less, enter -0-	38. 20,000		
39.	Subtract line 38 from line 35. If zero or less, enter -0-	39. 0		
40.	Multiply line 39 by 25% (0.25)		40.	0
	If Schedule D, line 18, is zero or blank, skip lines 41 through 43 and go to line 44. Otherwise, go to line 41.			
41.	Add lines 21, 22, 30, 33, and 39	41.		
42.	Subtract line 41 from line 1	42.		
43.	Multiply line 42 by 28% (0.28)		43.	
44.	Figure the tax on the amount on **line 21.** If the amount on line 21 is less than $100,000, use the Tax Table to figure the tax. If the amount on line 21 is $100,000 or more, use the Tax Computation Worksheet		44.	4,154
45.	Add lines 31, 34, 40, 43, and 44		45.	12,983
46.	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		46.	17,847
47.	**Tax on all taxable income (including capital gains and qualified dividends).** Enter the **smaller** of line 45 or line 46. Also, include this amount on Form 1040, 1040-SR, or 1040-NR, line 16. (If you are filing Form 2555, don't enter this amount on Form 1040 or 1040-SR, line 16. Instead, enter it on line 4 of the Foreign Earned Income Tax Worksheet in the Instructions for Forms 1040 and 1040-SR)		47.	12,983

* 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, see the footnote in the Foreign Earned Income Tax Worksheet in the instructions for Forms 1040 and 1040-SR, line 16, before completing this line.

Form **1040** Department of the Treasury—Internal Revenue Service (99) **U.S. Individual Income Tax Return** **2021** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status Check only one box. ☒ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial	Last name	Your social security number
Ginger	Jones	543 22 2345

Standard Deduction for—
- Single or Married filing separately, $12,550
- Married filing jointly or Qualifying widow(er), $25,100
- Head of household, $18,800
- If you checked any box under *Standard Deduction,* see instructions.

7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			7	83,000
8	Other income from Schedule 1, line 10			8	32,872
9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶			9	115,872
10	Adjustments to income from Schedule 1, line 26			10	
11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶			11	115,872
12a	**Standard deduction or itemized deductions** (from Schedule A)	12a	12,550		
b	Charitable contributions if you take the standard deduction (see instructions)	12b			
c	Add lines 12a and 12b			12c	12,550
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	4,064
14	Add lines 12c and 13			14	16,614
15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-			15	99,258

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2021)

For Example 21

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2021
Attachment Sequence No. 01

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: Ginger Jones
Your social security number: 543-22-2345

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1	
2a	Alimony received	2a	
b	Date of original divorce or separation agreement (see instructions) ▶		
3	Business income or (loss). Attach Schedule C	3	
4	Other gains or (losses). Attach Form 4797	4	32,872

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to *www.irs.gov/ScheduleD* for instructions and the latest information.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074
2021
Attachment Sequence No. 12

Name(s) shown on return: Ginger Jones
Your social security number: 543-22-2345

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ Yes ☒ No

Part II Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

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	83,000
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 8a through 14 in column (h). Then, go to Part III on the back	15	83,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2021**

For Example 21

Schedule D (Form 1040) 2021 Page **2**

Part III **Summary**

16	Combine lines 7 and 15 and enter the result	16	83,000
	• If line 16 is a **gain,** enter the amount from line 16 on Form 1040, 1040-SR, or 1040-NR, line 7. 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, 1040-SR, or 1040-NR, line 7. Then, go to line 22.		
17	Are lines 15 and 16 **both** gains? ☐ **Yes.** Go to line 18. ☐ **No.** Skip lines 18 through 21, and go to line 22.		
18	If you are required to complete the **28% Rate Gain Worksheet** (see instructions), enter the amount, if any, from line 7 of that worksheet . . . . ▶	18	
19	If you are required to complete the **Unrecaptured Section 1250 Gain Worksheet** (see instructions), enter the amount, if any, from line 18 of that worksheet . . . . ▶	19	20,000

5

For Example 21

Form **8995**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction Simplified Computation

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form8995* for instructions and the latest information.

OMB No. 1545-2294

2021

Attachment Sequence No. 55

Name(s) shown on return	Your taxpayer identification number
Ginger Jones	543-22-2345

Note. *You can claim the qualified business income deduction* ***only*** *if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.*

Use this form if your taxable income, before your qualified business income deduction, is at or below $164,900 ($164,925 if married filing separately; $329,800 if married filing jointly), and you aren't a patron of an agricultural or horticultural cooperative.

1	(a) Trade, business, or aggregation name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
i	Ginger Jones	543-22-2345	32,872
ii			
iii			
iv			
v			

2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2	32,872		
3	Qualified business net (loss) carryforward from the prior year	3	( )		
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4	32,872		
5	Qualified business income component. Multiply line 4 by 20% (0.20)			5	6,574
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6			
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	( )		
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8			
9	REIT and PTP component. Multiply line 8 by 20% (0.20)			9	0
10	Qualified business income deduction before the income limitation. Add lines 5 and 9			10	6,574
11	Taxable income before qualified business income deduction (see instructions)	11	103,322		
12	Net capital gain (see instructions)	12	83,000		
13	Subtract line 12 from line 11. If zero or less, enter -0-	13	20,322		
14	Income limitation. Multiply line 13 by 20% (0.20)			14	4,064
15	Qualified business income deduction. Enter the smaller of line 10 or line 14. Also enter this amount on the applicable line of your return (see instructions) ▶			15	4,064
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-			16	(0)
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-			17	(0)

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37806C Form **8995** (2021)

Note. The depreciation recapture portion of her gains was qualified business income for purposes of the QBID.[99] For more information, see the instructions for Form 8995, *Qualified Business Income Deduction Simplified Computation.*

99. IRC §199A(c)(1).

TAX BRACKETS AND UNRECAPTURED §1250 GAINS

The table below is a comparison of how unrecaptured §1250 gains interact with ordinary income and capital gain tax brackets. Schedule D allocates the income into types according to relative tax burden: heaviest (ordinary) to lightest (capital)

Single Taxpayers

Taxable Income				Taxable Income		
Over	But Not Over	Ordinary Income Tax Rate	§1250 Rate	Over	But Not Over	Capital Gain Rate
$ 0	$ 10,275	10%	10%			
10,275	41,775	12%	12%			
41,775	89,075	22%	22%	$ 0	$ 41,675	0%
89,075	170,050	24%	24%			
170,050	215,950	32%	25%			
215,950	539,900	35%	25%	41,675	459,750	15%
539,900		37%	25%	459,750		20%

- Tax on ordinary income is based on the lowest applicable brackets.
- Tax on unrecaptured §1250 gains is based on the ordinary rates but capped at 25%.
- Taxes on otherwise qualified long-term capital gains and dividends are capped at various rates based on the applicable brackets.

Note. Although Congress intended for the 0% capital gains rate to apply to income that would otherwise fall in the 10–12% brackets, a glitch in the wording of the law caused the top of the 0% capital gains tax bracket to be slightly misaligned with the top of the 12% ordinary income tax bracket. The top of the 15% capital gains bracket falls somewhere in the 35% bracket for ordinary income.

Example 22. Corbin, who uses single filing status, has 2021 taxable income of $75,000, of which $25,000 is qualified long-term capital gains. His remaining $50,000 taxable income is ordinary income. His ordinary income occupies the 10% and 12% brackets, as well as part of the 22% bracket. As ordinary income increases, the capital gains rate will also increase based upon the preceding table.

NONRECAPTURED NET §1231 LOSSES FROM PRIOR YEARS

To the extent that §1231 losses were deducted against ordinary income in the previous **five years** and have **not been recaptured,** gains from sales of business assets must be reported as ordinary income.[100] The term "recapture" for this purpose refers to the recharacterization of §1231 gains as ordinary income rather than long-term capital gains. This rule requires a taxpayer to keep a running balance of recaptured §1231 losses so that the amount of net §1231 gain that must be reported as ordinary income can be calculated. To accomplish this, these losses are reported on line 8 of Form 4797.

Note. Nonrecaptured §1231 losses are the net §1231 losses deducted during the five preceding tax years that have not yet been applied against any net §1231 gain to determine how much net §1231 gain is treated as ordinary income under this rule.[101] A taxpayer has a net §1231 loss if §1231 losses exceeded §1231 gains. Gains are included only to the extent considered in figuring gross income. Losses are included only to the extent considered in figuring taxable income except that the limitation on capital losses does not apply. The net §1231 gain on line 7 is treated as ordinary income to the extent of nonrecaptured §1231 losses. See the instructions for Form 4797 for a completed example.

100. IRC §1231(c).

101. Instructions for Form 4797, line 8.

Example 23. As of the end of 2020, Ranija had the following §1231 gains and losses for the previous five years.

Year	Gain/(Loss)
2016	($10,000)
2017	(10,000)
2018	15,000
2019	10,000
2020	(7,000)

In 2021, Ranija had $10,000 of §1231 gain. She calculated her recapture as follows.

Year	Gain/(Loss)	Loss Recaptured	Unrecaptured Loss Remaining at End of Year	Ordinary Income/(Loss) Recognized	Capital Gain Recognized
2016	($10,000)	$ 0	($10,000)	($10,000)	$ 0
2017	(10,000)	0	(20,000)	(10,000)	0
2018	15,000	15,000	(5,000)	15,000	0
2019	10,000	5,000	0	5,000	5,000
2020	(7,000)	0	(7,000)	(7,000)	0
2021	10,000	7,000	0	7,000	3,000

The 5-year look-back recapture rule is applied by comparing the net §1231 gain with the unrecaptured §1231 losses from the previous five years. Ranija's net gains of $15,000 in 2018 and $10,000 in 2019 caused her to recapture all the $20,000 in net losses from 2016 and 2017. Therefore, her only unrecaptured loss that carried to 2021 was the $7,000 net loss from 2020. Because of this unrecaptured loss, Ranija **recognized $7,000 of 2021's $10,000 gain as ordinary income. The remaining $3,000 was long-term capital gain.** The relevant portion of her Form 4797 follows.

6	Gain, if any, fr... from other tha... or th...	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	10,000
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, 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 didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	7,000
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	3,000

Part II Ordinary Gains and Losses (see instructions)

10	Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):		
11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	7,000
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	7,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	7,000

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