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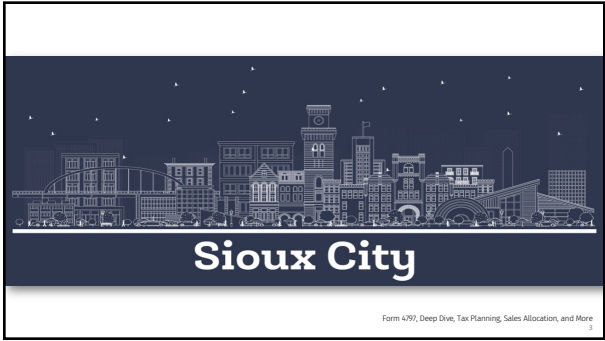
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Speaker

Allan J "A J" Reynolds, EA

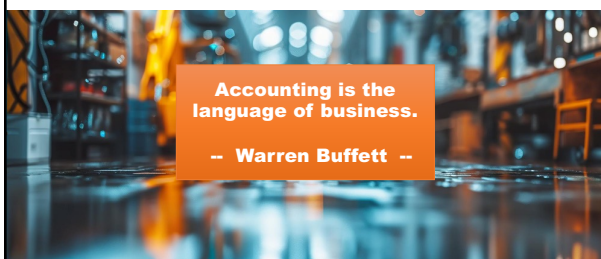
AJ was the recipient of the 2024 Excellence in Education award from NAEA and one of the 2024 Top Educators by M/PE ONE Excellence Awards. AJ has over 35 years of experience in diverse areas of taxation. He brings his every day "in the trenches" experience when assisting attendees with real issues affecting tax professionals. AJ's clientele ranges from average workers to Fortune 500 executives. AJ started his tax career with a National CPA firm in San Diego, CA after proudly serving in the United States Navy onboard the Guided Missile Destroyer USS Callaghan.



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### Quote of the Session



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5

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6

## Objectives

- ✓ Explain rules on how to compute gain or loss and depreciation recapture
- ✓ What is a trade or business
- ✓ What sales go where on Form 4797
- ✓ Eliminate the confusion and solve the mystery of Form 4797

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7

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## Objectives

- ✓ Examine the difference between a 1245 and 1250 property
- ✓ Correctly identify a 1231 property
- ✓ Ascertain the sales price
- ✓ Calculate basis and categorize transactions into their appropriate parts on Form 4797
- ✓ Differentiate between depreciation recapture and capital gain
- ✓ Identify unrecaptured depreciation
- ✓ Calculate 199A in reference to §§ 1231, 1245 and 1250

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8

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## Agenda

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

Form 1040.  
**INCOME TAX.**

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

UNITED STATES INTERNAL REVENUE.

**OF ANNUAL NET INCOME OF INI**  
As provided by Act of Congress, approved October 3, 1913.

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9

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## Agenda

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

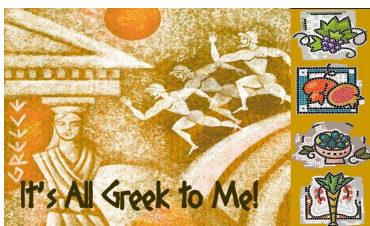


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10

## Form 4797



11

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## Form 4797 Overview

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

12

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### Form 4797 Overview

- ❑ Form 1099-S
- ❑ HUD-1 Settlement Statement

13

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### Settlement Statement - HUD-1

- ✓ **Real Estate Taxes**
- ✓ **Commissions**
- ✓ **Title Fees**
- ✓ **Assessments**
- ✓ **Loan origination fee (points)**
- ✓ **Inspection fees, et al**
- ✓ **Prepaid expenses**

14

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### Trade or Business

- ❑ What is a trade or business expense under IRC §162?
- ❑ Although “trade or business” is a widely used term in the IRC, **neither the code nor the Treasury Regulations provide a definition**
- ❑ The definition of a “trade or business” comes from common law
- ❑ The concepts have been developed and refined by the courts

15

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### Trade or Business

➤ Courts have held that for an activity to rise to the level of constituting a trade or business, "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."

☐ **Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987)**

➤ Regular / Ongoing / Continuous / Rather than Sporadic / Activities must be Substantial / Profitable.

16

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### Form 4797 Overview

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

17

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### Form 4797 Overview

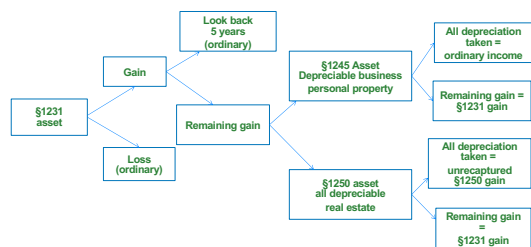
- ☐ §1001 dictates to simply take the difference between the **amount realized** and the **tax basis** to determine gain or loss
- ☐ However, determining the character of the resulting gain or loss – that is what is confusing – Congress has made it a complex process
- ☐ Do we have an ordinary gain or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

18

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## Flowchart §§ 1231, 1245, 1250 Assets



19

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## Form 4797

☐ Sales price

## ❖ Amount realized;

- ✓ **Total of all money received**
- ✓ **Liabilities assumed by the buyer**
- ✓ **Fair market value of services or property received**

20

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## Form 4797

☐ Basis = original cost (**cash, debt obligations, other property or services**) "plus";

## ❖ Increases to basis:

- ✓ **Capital improvements**
- ✓ **Assessments for local improvements**
- ✓ **Restoring damaged property**

21

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## Form 4797

☐ Decreases to basis

- ✓ Regular depreciation and amortization
- ✓ Insurance reimbursements
- ✓ Section 179 and bonus depreciation
- ✓ Credits or refunds

22

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## Form 4797

☐ Other basis issues

- ✓ Gifted property
- ✓ Inherited property
- ✓ Change from personal use to business

23

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## Where Does It Go? Form 4797

Were all 3 met?

1. Depreciation taken
2. Held long term
3. Disposed at a gain

YES

Report in Part III, Form 4797

NO

Was property used in trade or business or for production of rents?

YES

Was property held long term?

NO

Report in Part II, Form 4797

NO

Outside the discussion of this class

24

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### Where Does it Go?

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

25

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### Where Does it Go?

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

26

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### Where Does it Go?

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

27

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### Where Does it Go?

Type of Property	Held < 12 Months	Held > 12 Months
Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:		
a. Sold @ Gain	Part II	Part III (1245)
b. Sold @ Loss	Part II	Part I
c. Raised livestock sold @ Gain	Part II	Part I

28

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### Where Does it Go?

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

29

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### Where Does it Go?

- Part II
  - ✓Short-term transactions
  - ✓Aggregate section for all ordinary gains and losses

30

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### Where Does it Go?

#### •Part III (i.e. the cool section)

- ✓Long-term
- ✓Depreciable and/or amortizable asset
- ✓Sold at gain

#### •Part IV

- ✓Recapture under §179 and §280F(b)(2) when business use drops to less than 50%

31

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### § 1231 Property

§ 1245  
property



§ 1250  
property

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### § 1231 Property

#### ☐ “Cream of the Crop” for Sale of Business Assets

- ✓Net losses are fully deductible as ordinary losses
  - Can create a NOL
- ✓Capital gain treatment when sold at a gain

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## § 1231 Property

### ❑ What is §1231 property?

- ✓ Used in a trade or business
- ✓ All depreciable assets held longer than one year are §1231 assets
- ✓ Real property, depreciable or not, held longer than one year are §1231 assets

34

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## § 1231 Property

### ❑ Section 1231 property includes:

- ✓ Buildings
- ✓ Machinery
- ✓ Land
- ✓ Timber and other natural resources – coal/ore
- ✓ Unharvested crops

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## § 1231 Property

### ❑ Section 1231 property includes:

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

36

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### § 1231 Property

#### ☐ Section 1231 property **does not** include:

- ✓ Inventory or property held primarily for sale to customers
- ✓ Patents, inventions, models or designs, secret formulas or processes, copyrights, literary, musical, or artistic compositions, letters or memoranda or similar property

37

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37

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### Sale of Business Assets

#### ☐ **What is IRC §1245 property?**

- ✓ Code stating that depreciable property that sold at a price in excess of depreciated value may qualify for favorable capital gains tax treatment

38

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### Sale of Business Assets

#### ☐ **What is IRC §1250 property?**

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

39

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### Sale of §1245 Property – Example

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

Ordinary income up to depreciation = \$55,000

Remaining gain (\$100K-\$55K) of \$45,000 taxed at capital gains rates

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### Sale of Business Assets

❑ What is the difference between IRC §§1245/1250 and §1231 property?

- ✓ §1231 is a Categorization Provision
- ✓ Section 1231 regulates tax treatment of gains and losses of real and depreciable property held over one year in a trade or business
- ✓ Net §1231 losses are fully deductible as ordinary loss

41

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### Sale of Business Assets

❑ What is the difference between IRC §§1245/1250 and §1231 property?

- ✓ §§1245 and 1250 contains recapture rules of depreciation applying to gains from dispositions
- ✓ Capital losses limited to \$3,000 a year

42

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## Sale of Business Assets

**Beware of the §1231 Trap**

43

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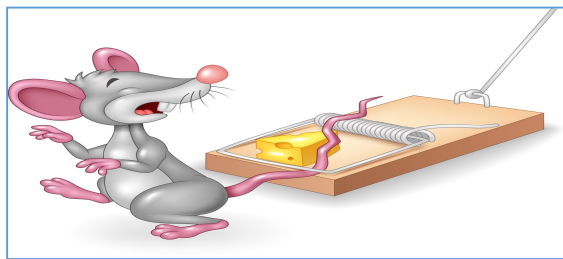
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## Sale of Business Assets



44

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## Sale of Business Assets

- ☐ If §1231 losses have been deducted in prior five (5) years, then capital gain treatment in current year is limited and you could have ordinary income
  - ✓ Capital gain goes to Schedule D
  - ✓ Ordinary income to Part II of Form 4797
  - ✓ Need last five years of tax returns
    - **Software should track if existing client**

45

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### Sale of Business Assets

**The non-recaptured § 1231 loss carryforward rule was initiated to stop taxpayers in maneuvering §1231 asset dispositions to secure ordinary loss treatment in one year and taking advantage of long-term capital gain treatment in subsequent year.**



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46

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### Sale of Business Assets

**EXAMPLE :** Beth sells a §1231 asset in 2023 which results in §1231 gain of \$20,000. However, Beth had §1231 (losses) and gains from preceding five years of:

2019	(\$3,000.00)
2020	(\$1,000.00)
2021	<u>(\$1,000.00)</u>
<b>Net 1231</b>	<b><u>(\$5,000.00)</u></b>
2023 capital gain to Schedule D	\$15,000.00
2023 ordinary income to Part II 4797	\$ 5,000.00

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47

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### § 1245 Property

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

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48

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## § 1245 Property

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

49

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49

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## § 1245 Property

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

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## § 1245 Property

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

51

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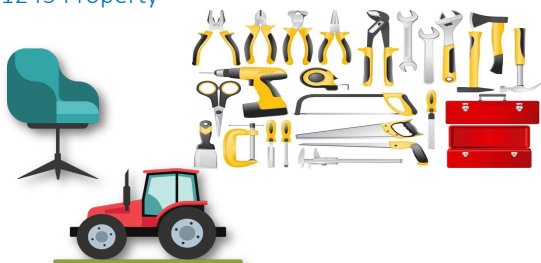
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## § 1245 Property



52

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## §1245 Property Example – Part 1

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

53

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## §1245 Property Example – Part 1

Purchased tractor	\$20,000
Less A/D	<u>\$13,800</u>
Adjusted basis	\$ 6,200

Sales price of tractor	\$ 8,000
Less adjusted basis	<u>\$ 6,200</u>
Gain	<u>\$ 1,800</u>

Ordinary income up to depreciation = \$1,800  
 Remaining gain of \$0 taxed at capital gains rates

54

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### §1245 Property Example – Part 2

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

55

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### §1245 Property Example – Part 2

Purchased tractor	\$20,000
Less A/D	<u>\$13,800</u>
Adjusted basis	\$ 6,200

Sales price of tractor	\$24,000
Less adjusted basis	<u>\$ 6,200</u>
Gain	<u>\$17,800</u>

Ordinary income up to depreciation = \$13,800

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

56

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### §1250 Property

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

❖ **Real property**

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

▪ **Is a Parking Lot Section 1250 Property?**

57

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### §1250 Property

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

58

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58

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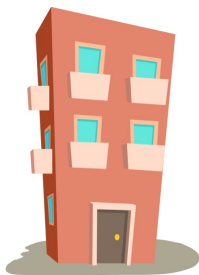
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### §1250 Property



59

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### §1250 Property

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

60

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### §1250 Property

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

61

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61

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### §1250 Property vs. §1245 Property



62

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### §1250 Property vs. §1245 Property

- ❑ **Real Property**
  - ✓ Land, anything growing on the land, and any structures permanently attached to it.
- ❑ **Personal Property**
  - ✓ All property that is not real property.

63

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63

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### §1250 Property Example

<input type="checkbox"/> Sales price	\$350,000
<input type="checkbox"/> Cost	\$250,000
<input type="checkbox"/> S/L A/D	\$ 50,000
<input type="checkbox"/> Gain	<u>\$150,000</u>

☐ **Section 1250 unrecaptured tax of 25% is limited to A/D of \$50,000**

64

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### §1231, §1245, §1250 Chart

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

65

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### §1231 Chart

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

66

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## Other Issues

☐ **Standard Mileage Rate & Depreciation**

- ✓ 26 cents for 2022
- ✓ 28 cents for 2023
- ✓ 30 cents for 2024
- ✓ 33 cents for 2025


☒ **§ 1245 recapture in year of trade or sale**

67

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## Other Issues

☐ **Section 1245 recapture for installment sales (Form 6252) in the year of sale**
☐ **Sale of partnership interest**

- ✓ **Hot assets {§751}**

68

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## Other Issues

☐ **Information on 1065 and 1120-S K-1's**

- ✓ Sale of §179 assets
  - ❖ Listed separately

☐ **Sale of Lots Safe Harbor §1237**

- ✓ No substantial improvements that enhanced
- ✓ Hold for 5 years

69

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### Other Issues

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

70

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### Other Issues

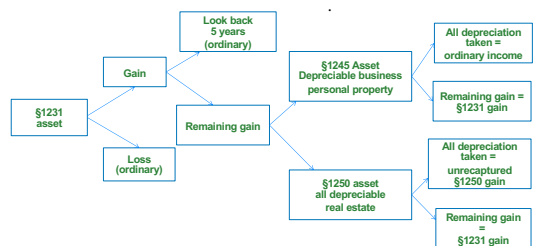
- ❑ IRC §1245 recapture IS QBI for §199A
- ❑ Unrecaptured §1250 IS NOT QBI for §199A
- ❑ Net IRC §1231 gain IS NOT QBI for §199A
- ❑ Net IRC §1231 loss REDUCES QBI for §199A

71

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71

### Flowchart §§ 1231, 1245, 1250 Assets



72

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72



### Other Types of Property

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

73

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### Tax Planning

- ❑ Tax treatment of assets included in the sale of a business for individuals and pass-through entities

- ✓ **Asset sold**
- ✓ **Seller's tax treatment**
- ✓ **Buyer's tax treatment**

74

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

75

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## Tax Planning

- ✓ **Covenant not to compete**
  - ❑ **Consideration surrounding FTC ban on non-compete contracts**

76

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76

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## Depreciation Allowed or Allowable

- ✓ **§1016(a)(2)**
- ✓ **Determine depreciation calculation**
- ✓ **Defined as the amount allowed or allowable**
- ✓ **Even if taxpayer fails to claim depreciation**
- ✓ **Basis of property still reduced**
- ✓ **Revenue Ruling 56-407**

77

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77

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## Other Issues

- ❑ **Qualified Improvement Property**
- ❑ **CARES Act Fix**
- ❑ **Depreciation fixes of QIP**
- ❑ **Cost Segregation Study**
- ❑ **§179 Depreciation & TCJA**
  - ✓ **Residential Property**
  - ✓ **Non-residential Property**

78

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78

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## Partial Disposition



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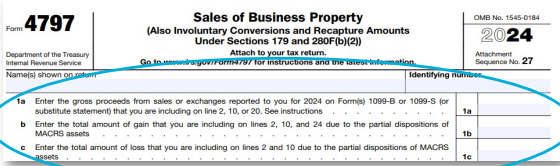
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## Partial Disposition



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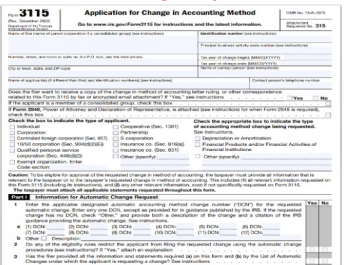
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## Improper, Missed, & Correcting Depreciation

✓ **DCN Code 7**

✓ **DCN Code 107**

**\* DCN = Designated Change Number**



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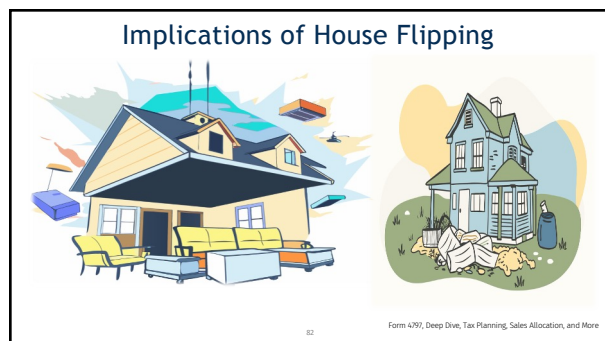
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### Allocation of Sales Prices

☒ **Basic choices**

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

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83

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### Form 8594

**8594** **Asset Acquisition Statement**  
Under Section 3065  
▶ Attach to your income tax return

OMB No. 1545-0074  
REG-100

Check the box that identifies you:  
☐ Purchaser  
☐ Seller  
☐ Other party to the transaction

Other party's identifying number: \_\_\_\_\_

Address (number, street, and room or suite no.): \_\_\_\_\_  
 City or town, state, and ZIP code: \_\_\_\_\_

2 Date of sale: \_\_\_\_\_ 3 Total sales price (grossed-up): \_\_\_\_\_

**Part II Original Statement of Assets Transferred**

Class	Aggregated fair market value (initial amount for Class I)	Allocation of sales price
Class I	\$ _____	\$ _____
Class II	\$ _____	\$ _____
Class III	\$ _____	\$ _____
Class IV	\$ _____	\$ _____
Class V	\$ _____	\$ _____
Class VI and VII	\$ _____	\$ _____
<b>Total</b>	\$ _____	\$ _____

4 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? ☐ Yes ☐ No

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84

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## Form 8594

**General Instructions****Purpose of Form**

Both the seller and purchaser of a group of assets that makes up a trade or business must use Form 8594 to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.

Form 8594 must also be filed if the purchaser or seller is amending an original or a previously filed supplemental Form 8594 because of an increase or decrease in the purchaser's cost of the assets or the amount realized by the seller.

85

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85

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## Form 8594

**Who Must File**

Generally, both the purchaser and seller must file Form 8594 and attach it to their income tax returns (Forms 1040, 1041, 1065, 1120, 1120-S, etc.) when there is a transfer of a group of assets that makes up a trade or business (defined below) and the purchaser's basis in such assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both.

86

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86

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## Form 8594

☐ **Form 8594, Asset Acquisition Statement**

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

87

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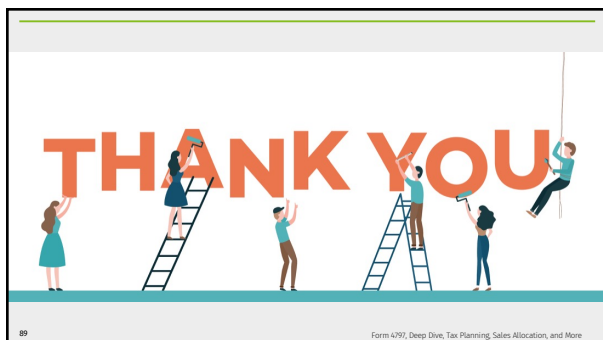
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