

# Basics of Business Entity Taxation

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## Chapter Introduction



In this text, we focus on the income taxation of business entities. We present this material in five parts, as follows:

- I. Introduction to Business Entities
- II. Taxation of Corporations
- III. Taxation of Flow-Through Entities
- IV. Choice of Business Entity
- V. Special Topics
  - Chapter 9: Choice of Business Entity
  - Chapter 10: Taxes on the Financial Statements
  - Chapter 11: Overview of Income Taxation of Trusts and Estates
  - Chapter 12: Gift and Estate Taxes
  - Chapter 13: Taxation of Multinational Transactions
  - Chapter 14: State and Local Taxation
  - Chapter 15: Taxation of Exempt Entities
  - Chapter 16: Tax Research and Professional Issues

One of the most exciting times in the lives of many individuals is when they decide to launch a new business. This decision comes with many opportunities, but also with risks and challenges. New business owners will quickly learn that managing taxes efficiently is a must for the business to be successful. The owners may be familiar with the individual income tax laws, but they quickly realize that they know little about the taxation of business entities, or about how to transfer a mature business to future generations. These new business owners would benefit from the knowledge in this text, because our focus is on applying the tax laws to business entities.

The income tax rules for business entities are similar to the income tax rules for individuals in the context of income, deductions, and property transactions. This is an advanced tax course that assumes you have already completed a fundamentals-level tax course. However, during our many years of teaching taxation of business entities, we have found that there is some content from your previous tax course that is useful to review to make sure you are prepared for the rest of this book. Therefore, in the latter sections of this chapter, we review the principles of income, deductions, and property transactions that are critical to your understanding of the material presented for business entities. We begin by providing the foundational principles for income

taxation, and then discuss the business lifecycle and the compliance responsibilities for all tax professionals.

The eight *Foundational Principles for Income Taxation* are as follows:

## Foundational Principles for Income Taxation<sup>1</sup>

### Comprehensive Principles

1. **Business,<sup>2</sup> investment, or personal activity** Every transaction engaged in by a taxpayer will be either a business activity, an investment activity, or a personal activity. This classification determines the tax effects of the transaction.
2. **Asset classification** Every asset can be classified as:
  - a. either an ordinary asset, a Section 1231 asset, or a capital asset; *and*
  - b. either personalty or realty.
3. **Basis recovery** You can recover the basis in an asset only one time, by expensing the cost, depreciating the cost, and/or recovering the cost when you sell the asset. Basis in an asset can never be less than zero.

### Income Principle

4. **Income recognition** Income will be taxable if the taxpayer's wealth has increased, the taxpayer has realized this increase in wealth, and the law does not provide a specific exclusion for this type of income. Every time you recognize income, you need to increase your basis in an asset equal to the amount of recognized income.

### Deduction Principle

5. **Deductible expenditures** Expenses incurred in operating a business or investment activity are deductible if they are ordinary, necessary, and reasonable. Expenses related to one's personal life are deductible only if a tax law specifically provides for the deduction.

### Property Transactions Principles

6. **Property transactions—Gain or loss** You must compute a realized gain or loss every time there is a sale or disposition of property. The gain or loss may be either recognized and included in taxable income, deferred, or excluded. A taxpayer must recognize all realized gains and losses unless a tax law provides otherwise.

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<sup>1</sup>A deeper discussion of these principles can be found in *Fundamentals of Taxation—Individuals and Business Entities: A Practical Approach*.

<sup>2</sup>When listing types of activities, “business” refers to activities that can also be referred to as “trade or business” in the tax law.

- 7. Property transactions—Basis** For fully taxable transactions, the basis in the asset received is always the property's fair market value. The basis of the asset received is the same as the basis in the asset transferred to the extent that the taxpayer defers the realized gain or loss.
- 8. Property transactions—Holding period** For a fully taxable transaction, the holding period of property received never includes the holding period of the property transferred. For a tax-deferred transaction, the holding period of property received always includes the holding period of the property transferred.

**Related exercise: Brief Exercise 1**

## LEARNING OBJECTIVES

## TOPICS

## PRACTICE OPPORTUNITIES

**1** Understand how income tax rules apply to various business entities.

### **1.1 Basics of Business Entity Taxation**

- Business Lifecycle
  - Formation of a Business
  - Business Operations
  - Operating Distributions to Owners
  - Liquidating Distributions or Sale of Business
- Legal Forms of Business
- Tax Classifications for Businesses

- Practice Problem 1.1.1 Formation of a Business
- Practice Problem 1.1.2 Distributions

**2** Understand the compliance requirements for business entities.

### **1.2 Tax Compliance for Business Entities**

- Filing Requirements
  - Tax Return Due Dates and Tax Forms
  - Statute of Limitations
- Taxpayer Penalties
  - Failure to File
  - Underpayment of Estimated Tax
  - Failure to Pay Penalty
  - Accuracy Penalties

- Example 1.2.1 Statute of Limitations
- Example 1.2.2 Failure to File Penalty
- Example 1.2.3 Late-Filing Penalty for Partnership
- Example 1.2.4 Underpayment Penalty
- Example 1.2.5 Failure to Pay Penalty and Interest
- Example 1.2.6 Reasonable Cause
- Example 1.2.7 Negligence
- Example 1.2.8 Fraud
- Practice Problem 1.2.1 Determining the Statute of Limitations Period
- Practice Problem 1.2.2 Determining Penalties Due—C Corporation
- Practice Problem 1.2.3 Determining Penalties Due—S Corporation

## LEARNING OBJECTIVES

## TOPICS

## PRACTICE OPPORTUNITIES

**3** Understand the fundamental rules for property transactions that apply to the taxation of business entities.

### 1.3 Review of Fundamentals of Property Transactions

- Gains and Losses from Sales and Dispositions
  - Amount Realized
  - Adjusted Basis
  - Realized Gain or Loss
  - Recognized Gains and Losses
  - Deferred Gains and Losses
  - Related-Party Losses
- Classification of Assets
  - Definition of Ordinary Assets, Capital Assets, and Section 1231 Assets
- Spotlight on the Law—Classification of an Asset
  - Realty vs. Personalty
  - Holding Period

- Example 1.3.1 Adjusted Basis
- Example 1.3.2 Sale of an Asset
- Example 1.3.3 Tax-Deferred Transaction
- Example 1.3.4 Related-Party Loss
- Example 1.3.5 Right of Offset
- Example 1.3.6 Qualified Appraisal
- Example 1.3.7 Copyrights
- Example 1.3.8 Classification of Assets
- Example 1.3.9 Personalty vs. Realty
- Practice Problem 1.3.1 Classification of Assets
- Practice Problem 1.3.2 Adjusted Basis Computation
- Practice Problem 1.3.3 Computing Recognized Gain
- Practice Problem 1.3.4 Sale of Assets between Related Parties

**4** Determine the tax consequences of disposing of Section 1231 assets.

### 1.4 Review of Section 1231 Assets

- Netting Section 1231 Gains and Losses
- Depreciation Recapture Rules
  - Section 1245 Recapture
  - Section 1250 Recapture
- Reporting Sales of Business Assets: Form 4797
- Dispositions That Do *Not* Trigger Depreciation Recapture

- Example 1.4.1 Netting Section 1231 Gains and Losses
- Example 1.4.2 Net Section 1231 Gains
- Example 1.4.3 Lookback Rule
- Example 1.4.4 Section 1245 Recapture, All Gain Is Ordinary
- Example 1.4.5 Section 1245 Recapture and Section 1231 Gain
- Example 1.4.6 Section 1245 Asset Sold at a Loss
- Example 1.4.7 Section 197 Intangibles
- Example 1.4.8 Sale of a Building—Straight-Line Depreciation
- Example 1.4.9 Sale of a Building—Accelerated Depreciation
- Example 1.4.10 Sale of a Building—Corporations
- Practice Problem 1.4.1 Determining Net Section 1231 Gains and Losses
- Practice Problem 1.4.2 Applying the Lookback Rule
- Practice Problem 1.4.3 Sale of Tangible Business-Use Asset
- Practice Problem 1.4.4 Sale of Realty by a Partnership
- Practice Problem 1.4.5 Sale of Realty by a Corporation

## LEARNING OBJECTIVES

**5** Compute the qualified business income deduction.

## TOPICS

### **1.5** Review of Qualified Business Income Deduction

- Qualified Business Income
- Rental Real Estate
- Determining the Qualified Business Income Deduction (Steps 1–5)
- Determining the Qualified Business Income Deduction (Steps 6–7)
- Determining the Qualified Business Income Deduction (Step 8)
- Advanced Topics—Drilling Down
  - QBI Losses
  - Phase-In of QBI Limitations

## PRACTICE OPPORTUNITIES

- Example 1.5.1 QBI Deduction for Case 1 Scenarios
- Example 1.5.2 QBI Deduction for Case 3 Scenarios
- Example 1.5.3 Qualified Property
- Example 1.5.4 Wage/Property Limitation for Case 1 Scenario
- Example 1.5.5 Wage/Property Limitation for Case 3 Scenario
- Example 1.5.6 Overall QBI Limitation—Scenario #1
- Example 1.5.7 Overall QBI Limitation—Scenario #2
- Example 1.5.8 Overall QBI Limitation
- Example 1.5.9 QBI Deduction for Column 2 Scenario with Specified Service Limitation
- Example 1.5.10 QBI Deduction for Column 2 Scenario with Wage/Property Limitations
- Example 1.5.11 QBI Deduction for Column 2 Scenario with Specified Service and Wage/Property Limitations
- Practice Problem 1.5.1 Calculating Qualified Business Income 1
- Practice Problem 1.5.2 Calculating Qualified Business Income 2

### Tax Forms referenced in this chapter:

Form 1040	U.S. Individual Income Tax Return
Form 1040, Schedule C	Profit or Loss from Business
Form 1040, Schedule D	Capital Gains and Losses
Form 1041	U.S. Income Tax Return for Estates and Trusts
Form 1065	U.S. Return of Partnership Income
Form 1065-X	Amended Return or Administrative Adjustment Request (AAR)
Form 1120	U.S. Corporation Income Tax Return
Form 1120-S	U.S. Income Tax Return for an S Corporation
Form 1120-X	Amended U.S. Corporation Income Tax Return
Form 1139	Corporation Application for Tentative Refund
Form 4797	Sales of Business Property
Form 7004	Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns.
Form 8275	Disclosure Statement
Form 8275-R	Regulation Disclosure Statement
Form 8949	Sales and Other Dispositions of Capital Assets

# 1.1 Basics of Business Entity Taxation

## LEARNING OBJECTIVE 1

Understand how income tax rules apply to various business entities.



VIDEO  
CONTENT

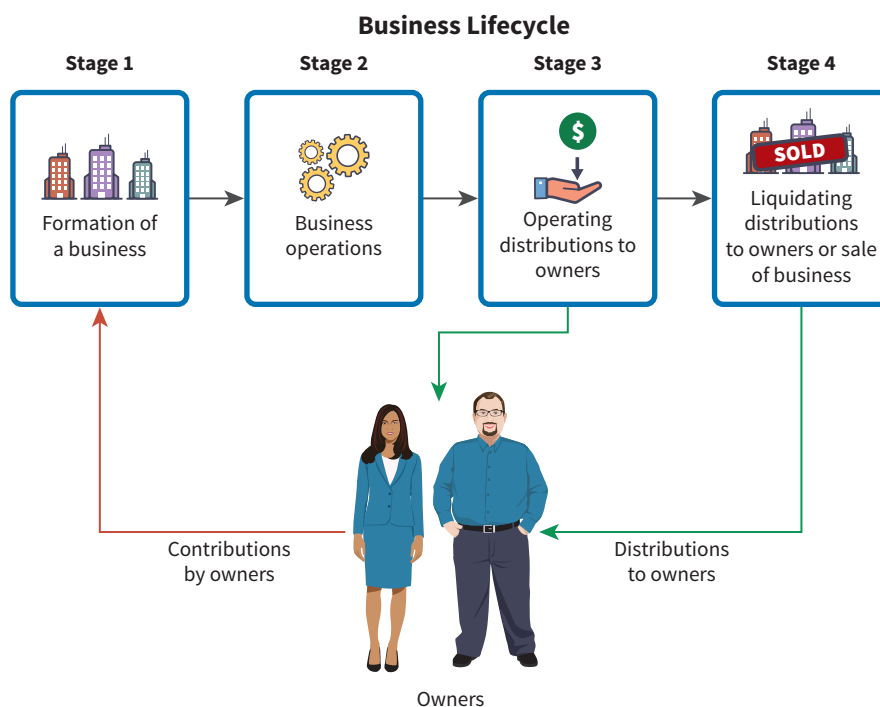
New business owners have many decisions to make when beginning and growing their venture. One of the best decisions they can make is to hire a tax professional to guide them through setting up the organization and choosing the best business entity to use. For example, the tax professional should know the owner's end goal for the business—which may seem unusual at this stage. Some business owners hope to grow a business and sell it within five to ten years. Others would like to build a business that will stay in their family for generations. Thinking through these issues places focus on the lifecycle of the business, which is our focus in this section. We begin by explaining how the income tax laws apply across the lifecycle of a business. Next, we review the types of entities that are discussed in this book.

## Business Lifecycle

When you learned the income tax rules for individuals, most of the issues discussed focused on the taxation of transactions that occurred during the tax year. For example, you learned what types of income are taxable, which expenditures are deductible, and the tax consequences of selling or disposing of assets. These topics comprise approximately 80% or more of the income tax rules for individuals. For the income taxation of business entities, however, the composition of the topics you will learn is very different. The taxation of income and deduction transactions during the year comprises approximately 20% or less of the tax law for entities. So, what makes up the other 80% of the tax law for entities?

To address this question, let's look at the lifecycle of business entities, which has four main stages (**Illustration 1.1**). The first stage is the formation of the entity, when the owners

**ILLUSTRATION 1.1** The Lifecycle of a Business Entity



contribute cash or assets to the entity in exchange for an ownership interest such as stock or a partnership interest. The second stage is the taxation of the operations of the business. The third stage is the distribution of profits to the owners. The fourth stage is when the entity ends, which can be a liquidating distribution to the owners or a sale by the owners of the business.

## Formation of a Business

A business entity must be created by the business owners. State laws must be followed to create a corporation or a limited liability company, and the partners in a partnership must come to an understanding of the co-ownership of the business and how profits and losses will be shared. Therefore, there are income tax laws that address the formation of a business entity. Consider an owner who is forming a new corporation with two other owners, with each contributing property to the corporation and receiving stock in return. Some of the tax issues that arise include:

- What is each shareholder’s realized gain or loss from the transaction?
- Is each shareholder’s realized gain or loss recognized?
- Does the corporation recognize any gains or losses?
- What basis does each shareholder have in their stock?
- What basis does the corporation have in the assets received?

These questions never have to be addressed with individual income taxation, but they are addressed in this text for the formation of corporations, partnerships, and limited liability companies. Individuals are subject to the income tax law because they are citizens of the United States, or they are conducting business or investment activities in the United States. There are no tax consequences related to “forming” an individual that needed to be discussed in your individual income tax course, but this is a key issue for business entities.

## Business Operations

Once a business is formed, its operations are subject to the income tax laws. Income and expenses, as well as tax credits, must be reported on the appropriate tax form. While your individual income tax courses spent considerable time on these topics for individuals, you will discover that for business entities these topics are considerably shorter. The main reason for this is that the fundamental income tax rules related to income, deductions, and property transaction are generally the same rules as for individuals. Therefore, in this text for business entities, we focus on the income tax rules that differ from those for individuals. For example, some of the charitable contribution rules for corporations are the same as the rules for individuals, but some contributions rules differ. Additionally, corporations are allowed a deduction for the dividends received deduction, but this deduction is not available to individuals. These topics are discussed in detail in Chapter 3, Fundamentals of Corporate Taxation.

## Operating Distributions to Owners

Under the entity theory, once a business entity has generated income, the income is owned by the entity. The business owners do not have access to the income until it is distributed to them, because of the entity theory. The **entity theory** provides that a business is a distinct entity from its owners. The entity theory is used by C corporations and for most S corporation transactions (except for the flow-through of income to S corporation shareholders).<sup>3</sup> Thus, under the entity theory, any time that cash or property passes between the entity and the owners, there are potential tax consequences. If an **operating distribution** is made to the owners, then the recipient continues to be an owner after the distribution. If a liquidating

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<sup>3</sup>The competing theory to the entity theory is the *aggregate theory*, which is used for partnerships. The aggregate theory holds that the partnership does not exist as a separate entity from the partners. That is, a partnership is simply an aggregation of the partners. To determine the tax result of a partnership transaction using the aggregate theory, you should ask what the result would be if the partnership did not exist. The aggregate theory is also used for the flow-through of income for S corporations. See Chapter 6, LO3, Taxation of Partnership Income and Guaranteed Payments, for further discussion.

distribution is received, then the recipient is no longer an owner after the distribution. The entity will remain in existence as long as it has other owners. Some of the tax issues that must be addressed for distributions are as follows:

- Does the owner have a gain or loss from the operating distribution, and what is the character of the gain or loss?
- Does the entity have a gain or loss from the operating distribution, and what is the character of the gain or loss?
- What basis does the owner take in any property received in the distribution?
- What holding period does the owner have in any property received in the distribution?

**Related exercises: Discussion Questions 1, 2**

## Liquidating Distributions or Sale of Business

The owners may decide that they want to completely terminate their interests in the business. This can be accomplished by either a liquidating distribution or by selling their ownership interests. If all owners receive a **liquidating distribution**, then the entity is dissolved. Some of the tax issues that must be addressed for distributions are as follows:

- Does the owner have a gain or loss from the liquidating distribution, and what is the character of the gain or loss?
- Does the entity have a gain or loss from the liquidating distribution, and what is the character of the gain or loss?
- What are the tax consequences if the owners sell their ownership interests?
- What are the tax consequences if two or more entities combine into one, or if one entity splits into two or more entities?

## Legal Forms of Business

A business owner has several different legal entities to choose from when forming an entity. Remember that a sole proprietorship is not a separate business entity. The most common legal forms include:

- **Corporation** A **corporation** is a business that has met a state's requirements to organize as a legal entity that is distinct from its owners. In most states, the owners file articles of incorporation with the state and elect a board of directors.
- **General partnership** A **general partnership** is a business for which two or more owners agree to assume the responsibility for managing the business, and to share profits, losses, and liquidation proceeds. All partners in a general partnership are general partners. General partners have unlimited liability, meaning that their personal assets are at risk to creditors of the partnership. Unlimited liability includes malpractice judgments against the partnership even though the partner may not have been personally involved in the malpractice.
- **Limited partnership** A **limited partnership** is a business for which two or more taxpayers agree to own and operate the business, and to share profits, losses, and liquidation proceeds. The partnership must have at least one general partner and at least one limited partner. A limited partner's personal assets are not at risk with respect to debts of the partnership. A limited partner's losses from the partnership are limited to the amount the partner has invested and promised to invest in the partnership. A limited partner cannot participate in the active management of the partnership.
- **Limited liability partnership (LLP)** A **limited liability partnership (LLP)** differs from a general partnership in that with an LLP, a partner is not liable for damages resulting from the negligence, malpractice, or fraud committed by other partners. However, each partner is personally liable for other debts of the partnership, as well as debts arising from their own negligence, malpractice, or fraud. LLPs are often used by service providers

that may not be permitted to be a LLC, such as architects, accountants, attorneys, and physicians.

- **Limited liability company (LLC)** A **limited liability company (LLC)** is a formal business relationship for which articles of organization must be filed with the state in which the LLC is legally organized. Owners of an LLC are known as members. All members have limited liability. Many states do not allow professional service providers such as accountants and attorneys to organize as an LLC.
- **Business trust** A **business trust** is a legal entity that holds the rights to an individual's stake or interest in a business. The trust technically owns the business interest, and the trustee controls the interest. The trust can have multiple beneficiaries.

## Tax Classifications for Businesses

Businesses generally report for federal income tax purposes as one of the business forms shown in **Illustration 1.2**.

**ILLUSTRATION 1.2** Tax Classifications for Businesses

Tax classification	Description	Federal tax forms used
<b>C Corporation</b> (Chapters 3–5)	C corporation that has <i>not</i> elected to be taxed as an S corporation.	<b>Form 1120</b> (U.S. Corporation Income Tax Return)
<b>Partnership*</b> (Chapters 6–7)	General partnerships, limited partnerships, LLCs, and LLPs are all generally taxed as partnerships.	<b>Form 1065</b> (U.S. Return of Partnership Income)
<b>S corporation</b> (Chapter 8)	Incorporated entity that <i>has</i> elected to be taxed as an S corporation.	<b>Form 1120-S</b> (U.S. Income Tax Return for an S Corporation)
<b>Sole proprietorship</b>	If an owner does not create a separate business entity, then the owner will report as a sole proprietorship.	<b>Schedule C**</b> (Profit or Loss from Business)
<b>Trust</b> (Chapter 11)	Legal entity that holds the rights to an individual's stake or interest in a business.	<b>Form 1041</b> (U.S. Income Tax Return for Estates and Trusts)
<b>Tax-exempt organization***</b> (Chapter 15)	A tax-exempt organization must pay tax on its unrelated business taxable income.	<b>Form 990-T</b> (Exempt Organization Business Income Tax Return)

The word *corporation* in this text always refers to a C corporation. An S corporation referenced in the text will always have an S designation.

\*If there is more than one owner, and no separate entity is formally created, the business defaults to a partnership.

\*\*As part of their Form 1040, U.S. Individual Income Tax Return.

\*\*\*This will be discussed in more detail in Chapter 15, Tax-Exempt Organizations.

To determine which of these tax-reporting forms to use for a particular business, you must use the *check-the-box regulations* discussed in Chapter 6, LO1, Definitions Related to Partnerships.

**Related exercises: Multiple Choice Questions 1, 2**

## PRACTICE PROBLEM 1.1.1

### Formation of a Business

Provide three issues that arise when forming a business.

#### SOLUTION

When an entity is formed, possible issues include:

- What is each owner's realized gain or loss from the transaction?
- Is each owner's realized gain or loss recognized?
- Does the entity recognize any gains or losses?
- What basis does each owner have in the entity?
- What basis does the entity have in the assets received?

## PRACTICE PROBLEM 1.1.2

### Distributions

Describe the difference between an operating distribution and a liquidating distribution.

#### SOLUTION

If an operating distribution is made to the owners, then the recipient continues to be an owner after the distribution. If a liquidating distribution is received, then the recipient is no longer an owner after the distribution. The entity will remain in existence as long as it has other owners. If all owners receive liquidating distributions, then the entity is dissolved.



# 1.2 Tax Compliance for Business Entities

## LEARNING OBJECTIVE 2

Understand the compliance requirements for business entities



Tax professionals need to ensure that their clients meet all compliance requirements. In this section, we review the most common penalties that business entities can incur for not filing appropriately or paying taxes in a timely manner. Most of the rules we cover in this section are for corporations, because partnerships, LLCs, and S corporations are not taxpaying entities.

## Filing Requirements

If the proper tax forms are not filed by the required due date, the IRS can assess penalties. In this section, we first review the due dates for business entity returns, then cover the statute of limitations and explain the penalties for filing late.

### Tax Return Due Dates and Tax Forms

The due dates for tax returns vary by type of business entity. If the due date falls on a weekend or holiday, the deadline is extended to the next weekday that is not a holiday.

- Corporate tax returns (other than those with a June 30 year-end) are due three and one-half months after the end of the tax year, which is April 15 for calendar-year corporations.

All business entities use the same form to request an extension of time to file the return, Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns. Corporations can request an extension of six months to file the tax return. The extension of time, though, is only to *file the return*. A business must pay the taxes due for the year by the original due date or the IRS will assess a late payment penalty. This provides businesses with more time to finalize their return for filing, but they do need to estimate their liability for the year to ensure they have paid in the appropriate amount by the original filing date.

- Corporate tax returns with a June 30 year-end are due two and one-half months after the end of the year, which is September 15. The extended due date is seven months after the due date, which is April 15 of the next year.<sup>4</sup>
- Partnership tax returns and S corporation tax returns are due two and one-half months after the end of the tax year, which is March 15 for a calendar-year business. Extensions for partnership and S corporations are for six months, which is September 15 for a calendar-year business.

**Related exercises: Discussion Question 3**  
**Multiple Choice Question 3**

## Statute of Limitations

Businesses that discover a mistake in a previously filed tax return usually need to file an amended return for that year to correct the error. Corporations file amended returns on Form 1120-X, Amended U.S. Corporation Income Tax Return. S corporations amend a return by filing another Form 1120-S, U.S. Income Tax Return for an S Corporation, and checking the box on line H(4) indicating amended return. The partnership rules for amended returns are more complicated. Generally, if the partnership is not required to e-file the amended return, it can file another Form 1065, U.S. Return of Partnership Income, and check the box on line G(5) indicating it is an amended return. If the amended return must be e-filed, the partnership uses Form 1065-X, Amended Return or Administrative Adjustment Request (AAR).<sup>5</sup>

The IRS audits certain returns to make sure businesses have complied with the law. The **statute of limitations** is the period that a taxpayer has to file an amended return or that the IRS has to assess a tax deficiency. The idea is to encourage the IRS and taxpayers to settle disputes in a timely way. If the statute of limitations has not expired for a return, then that year is an **open year**. If the statute of limitations has expired, that year is a **closed year**.

Here are key facts to remember when considering issues related to the statute of limitations as you work with a client:

- The primary statute of limitations is three years from the later of the due date of the tax return or the date the return was filed.
- The statute is extended to six years if more than 25% of the gross income is understated on the original tax return.
- The statute never expires if the taxpayer commits fraud or fails to file a return.

The period for a business to file a claim for refund is slightly different from the statute of limitations for amending a return. The statute of limitations for claiming a refund (on Form 1120-X, Amended U.S. Corporation Income Tax Return or Form 1139, Corporation Application for Tentative Refund) is the *later* of:

- two years from the date the tax was paid, *or*
- three years from the later of the due date of the tax return or the date the return was filed.

<sup>4</sup>For taxable years beginning after 2025 and ending on June 30, the due date will change to the same rule as for other corporations: three and one-half months after year-end for the due date (October 15) and a six-month extension (April 15 of the next year).

<sup>5</sup>To correct errors to partnership-related items, partnerships under the Bipartisan Budget Act (BBA) of 2015 must file an administrative adjustment request (AAR) instead of an amended return.

If no return was filed by the business, the claim must be filed within two years from the time the tax was paid.

### Tax Planning Tip

Even if your client is not required to file a tax return, it may be prudent to file a return so the statute of limitations will begin to run, and the year will eventually close for audit purposes.

## EXAMPLE 1.2.1

### Statute of Limitations



Hornet, Inc., filed Form 1120 for 2025 on March 3, 2026.

**Scenario 1:** When will the statute of limitations for Hornet's 2025 return expire?

**Scenario 2:** When will the statute of limitations expire if Hornet filed its tax return on July 17, 2026?

**Scenario 3:** When will the statute of limitations expire if Hornet never filed its 2025 tax return?

### SOLUTION

There are three different scenarios here to evaluate:

**Scenario 1: Hornet filed its 2025 return on March 3, 2026.** The due date of the return was April 15, 2026, so the later of the due date or the date the return was filed is April 15, 2026. Three years from then is April 15, 2029, which is when the statute of limitations will expire.

**Scenario 2: Hornet filed its 2025 return on July 17, 2026.** The due date of the return was April 15, 2026, so the later of the due date or the date the return was filed is July 17, 2026. Three years from then is July 17, 2029, which is when the statute of limitations will expire.

**Scenario 3: Hornet never filed its 2025 return.** If a business files a return late, the statute of limitations expires three years after the return is filed. If the business never files the return, the statute of limitations never begins running. So, the 2025 tax year will always be an open year that the IRS can audit.

Related exercises: Discussion Question 4

Multiple Choice Question 4

Application Problem 1

## Taxpayer Penalties

In this section, we discuss the four major penalties businesses may have to pay. First, the law imposes a penalty if a business fails to file a required tax return on time (*failure to file*). Second, Congress imposes a penalty if a business fails to make adequate tax payments during the year (*underpayment of estimated tax*). Third, a penalty is imposed if a business fails to pay the tax reflected on the tax return by the due date (*failure to pay*). Finally, the law imposes a penalty if a business files an inaccurate tax return (*accuracy penalty*).

### Failure to File

The tax law imposes a failure to file penalty on any business that is required to file a return if the return is not filed by the due date. If a business requests an automatic extension, this penalty does not apply unless the business files the tax return after the extended date.

**Corporations** The following is a summary of the failure to file penalties that might apply to corporations:

- The penalty for late filing is 5% per month (or portion thereof) of the tax due with the return. Thus, a tax return filed 32 days late will have a penalty rate of 10% (2 months × 5%), because even a small portion of the second month counts as a whole month. The maximum penalty is 25% of the tax due.

- The minimum penalty is the lesser of \$525 (2025) or the amount of the tax due. The minimum penalty applies only if the corporation does not file the tax return within 60 days of the due date and the computed penalty amount is less than the minimum penalty.
- If the failure to file is intentional (a case of tax fraud), the penalty is increased to 15% per month up to a maximum of 75% of the tax due with the return.
- S corporations must also pay a penalty equal to \$255 (2025) per shareholder for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months.

**Partnerships** Partnerships must pay a penalty equal to \$255 (2025) per partner for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months.

The next two Examples show the computation of the failure to file penalty for a corporation and partnership.

Locust, Inc., did not file a request for an automatic extension (Form 7004) for its 2025 tax return, which was due on March 15, 2026.

**Scenario 1:** Locust filed its tax return on May 10, 2026, and owed tax of \$10,000. How much is his failure to file penalty?

**Scenario 2:** How much is Locust's failure to file penalty if it filed on September 20, 2026?

#### SOLUTION

There are two different scenarios here to evaluate:

**Scenario 1: Locust filed its 2025 return on May 10, 2026.** Locust filed its return one full month and a portion of the second month late. The penalty rate is 10% (2 months  $\times$  5%), and the penalty is \$1,000 (\$10,000 tax due  $\times$  10%).

**Scenario 2: Locust filed its 2025 return on September 20, 2026.** Locust filed its return six full months and a portion of the seventh month late. The penalty rate is 25% (7 months  $\times$  5%, limited to 25%), and the penalty is \$2,500 (\$10,000 tax due  $\times$  25%).

#### EXAMPLE 1.2.2 Failure to File Penalty



Termite Partnership has a calendar year-end. Termite filed its Form 1065 for 2025 on November 17, 2026. Termite has 10 partners. What is Termite's penalty for late filing of its tax return?

#### SOLUTION

Termite's Form 1065 for 2025 was due on March 15, 2026, and it was filed on November 17, 2026, which is nine months late (eight full months and one partial month). Termite's penalty is computed as follows:

$$\$255 \times 10 \text{ partners} \times 9 \text{ months} = \$22,950$$

#### EXAMPLE 1.2.3 Late-Filing Penalty for Partnership



Related exercises: Multiple Choice Question 5  
Brief Exercise 2

#### Tax Planning Tip

Because the penalty percentage for most penalties is multiplied by the amount of tax due, generally no penalty is imposed if no tax is due with the return, or the taxpayer is eligible for a refund. An exception to this is if partnerships or S corporations file a return late, because the penalty is based on the number of partners or shareholders.

## Underpayment of Estimated Tax

Congress requires businesses to pay their federal tax liability throughout the tax year. They cannot postpone payment until the end of the tax year, or until the tax return is due. If they do not pay the appropriate amount of tax during the year, they are subject to a penalty for underpayment of estimated tax. This is the case even if the business has paid 100% of the tax liability by the due date of the return.

**General Rules** The due date for estimated tax payments for businesses is on the 15<sup>th</sup> of the applicable month unless the 15<sup>th</sup> is on a weekend or holiday, and then the due date is the next business day. Estimated tax payments for a calendar-year corporation are due on the following dates in 2025 for the periods shown (see the **Potential Pitfall**):

Payment 1	April 15, 2025	January 1–March 31
Payment 2	June 16, 2025	April 1–May 31
Payment 3	September 15, 2025	June 1–August 31
Payment 4	December 15, 2025	September 1–December 31

Each payment is equal to 25% of the required annual tax payment for the year. If the required annual tax payment is less than \$500, then estimated tax payments are not required. Corporations must pay the estimated tax payments through the Electronic Federal Tax Payment System.

The underpayment penalty is an interest rate computed using the federal short-term rate plus three percentage points. The IRS sets these rates on a quarterly basis. The underpayment penalty applies from the date the payment was due until the earlier of when it was paid or the due date of the tax return.

**Exceptions to the Underpayment Penalty** Corporations can avoid being subject to the underpayment penalty by meeting one of four conditions:

1. The tax liability for the year is less than \$500.
2. The tax payments made during the year were at least 100% of that year's taxes.
3. The tax payments made during the year were at least 100% of the past year's taxes (not available for the first year of the corporation).
  - a. A corporation with \$1 million or more of taxable income in any of its three preceding tax years can use the preceding year's tax exception only for its first installment. The other installments must be based on the current year's tax to avoid penalty.
  - b. If a taxpayer had a net operating loss in the previous tax year, the previous year's tax liability exception cannot be used to avoid an underpayment penalty.

### Tax Planning Tip

**For the first three exceptions, the taxes must be paid evenly throughout the tax year to satisfy the exception. For example, taxpayers cannot wait until the end of the tax year to pay 100% of the previous year's tax liability and avoid the underpayment penalty.**

4. The annualization exception has been met. To qualify for this exception, compute the actual income for each payment period, and then base each estimated tax payment on the income earned for that period. The annualization exception is computationally complex. It benefits taxpayers whose income fluctuates significantly throughout the tax year, particularly if they earn higher amounts of income later in the year. If a corporation does not meet one of the first three exceptions, always check to see if the annualization exception can reduce or eliminate the penalty.

The next Example shows how the underpayment penalty is computed when it applies.

Snail Corporation estimates that its federal income tax liability for 2025 will be \$600,000. Snail's federal income tax liability for 2024 was \$500,000. How much must Snail pay in estimated income taxes in 2025 to avoid an underpayment penalty for 2025? Assume the annualization exception is not beneficial to Snail.

#### SOLUTION

To avoid an underpayment penalty, Snail must pay estimated taxes at least equal to the lower of 100% of the 2025 tax liability or 100% of the 2024 tax liability. Therefore, Snail must pay at least \$500,000 of estimated taxes. If Snail does so, and the 2025 tax liability is \$600,000, Snail must pay the remaining \$100,000 ( $\$600,000 - \$500,000$ ) by the due date of the tax return.

### EXAMPLE 1.2.4 Underpayment Penalty



## Failure to Pay Penalty

If a business has not paid all the tax due by the filing deadline, the IRS will assess both interest and the failure to pay penalty. The IRS assesses interest on late payments beginning on the due date for filing and is calculated using the federal short-term interest rate plus three percentage points.<sup>6</sup> This penalty rate has been approximately 7% to 8% over the past two years.

The failure to pay penalty is 0.5% of the underpayment for each month (or portion thereof) the tax is paid after the filing deadline. The maximum penalty is 25%. The failure to pay penalty is 1/10 of the failure to file penalty (0.5% vs. 5%). If both the failure to pay penalty *and* the failure to file penalty potentially apply, the maximum penalty for both is limited to 5% of the tax due per month.

Earwig Corporation paid tax of \$5,000 for its 2025 tax return on May 4, 2026, 49 days late (March 15–May 4). Assume the federal short-term interest rate is 4%. How much will the IRS assess Earwig for interest and penalties?

#### SOLUTION

The interest rate is the short-term interest rate of 4% plus 3%, or 7%. Earwig will pay interest of \$47 ( $\$5,000 \times 7\% \times 49/365$ ). Earwig's failure to pay penalty will be 1% ( $0.5\% \times 2$  months), resulting in a penalty of \$50 ( $\$5,000 \times 1\%$ ).

### EXAMPLE 1.2.5 Failure to Pay Penalty and Interest



The IRS can waive the failure to file and the failure to pay penalties if a business has a reasonable cause for failing to file or failing to pay. A **reasonable cause** is one outside the control of a business, such as irregularities in mail delivery, death or serious illness, unavoidable absence, or disaster. A business generally has the burden of proving that failure was due to reasonable cause and not simply neglect.

<sup>6</sup>IRC §6621(a)(2).

## EXAMPLE 1.2.6 Reasonable Cause



Assume that in Example 1.2.5 Earwig also did not file its tax return until May 4. What would Earwig's total penalties be? What would the penalties be if Earwig had failed to file a timely return and pay taxes because a fire destroyed its records?

### SOLUTION

Earwig would pay 5% for each month (or portion thereof) that it filed and paid late. Earwig's total penalties would therefore be \$500 ( $\$5,000 \times 5\% \times 2$  months). Even though both penalties apply, the maximum penalty assessed for any month is 5%. If a fire had destroyed Earwig's records, this would qualify as a reasonable cause and excuse both penalties. Earwig would still owe interest on the underpayment.

### Potential Pitfall

Refer to Example 1.2.4. If Snail had paid estimated taxes during the year of \$500,000, it would have avoided the underpayment penalty because it would have paid 100% of the previous year's tax liability. What if the IRS later audits Snail's 2024 tax return and the actual tax liability for 2024 is changed to \$510,000? Now Snail did not pay in 2025 estimated taxes equal to 100% of the 2024 tax liability (\$500,000 was paid rather than \$510,000), so Snail is subject to the underpayment of estimated tax for 2025. However, the penalty is not based on the \$10,000 shortfall that caused the penalty. If your client does not meet one of the exceptions for the penalty, then the penalty is computed on the difference between the *total tax liability* and the amount of taxes paid, not the amount of taxes that would have been necessary to avoid the penalty. Therefore, the underpayment penalty is based on \$100,000, the difference in the liability of \$600,000 and the taxes paid of \$500,000.

### Tax Planning Tip

**Penalties paid to the IRS are not deductible by taxpayers. However, business entities can deduct interest paid because of late tax payments.**

**Why** Why is the failure to file penalty ten times larger than the failure to pay penalty? Congress set the penalty rates in this fashion to strongly encourage taxpayers to file their tax returns on time, even if they do not have the cash to pay the tax at that point. The filing of the tax return in a timely manner establishes the taxpayer's official financial record for the tax year, and Congress has emphasized its importance through the penalty structure. The IRS has several different payment plans that taxpayers can use to pay the taxes in installments over a period of time (see the **Potential Pitfall**).

**Related exercises: Discussion Question 5  
Application Problems 2, 3, 4, 5, 6, 7**

### Accuracy Penalties

The IRS may impose additional penalties if a business underpays the actual tax because of an inaccurate position taken on a tax return. An **inaccurate position** occurs when a taxpayer disregards the tax rules without reasonable cause. Before reviewing the penalties, let's look at the terminology used to determine whether the IRS can assess an accuracy penalty:

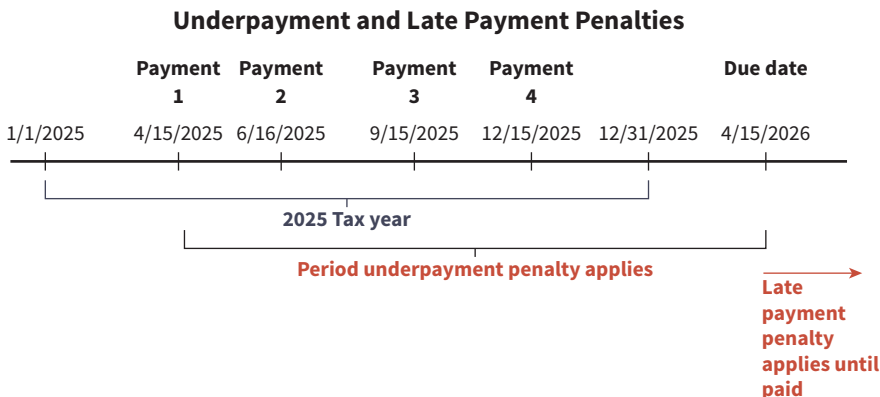
- A **reasonable basis** means that at least one primary authority supports the taxpayer's position and has not been overruled.<sup>7</sup>
- **Substantial authority** is based on the likelihood that a taxpayer's position would be supported if the matter were taken to court. While the law does not identify a specific percentage of success that represents substantial authority, it is well accepted that the likelihood does not need to exceed 40%.

**Related exercise: Discussion Question 6**

- The **more likely than not standard** means that a taxpayer has a greater than 50% chance of succeeding if the taxpayer takes the position to court.

Who determines the likelihood that a position would be sustained in a judicial proceeding? You must use professional judgment to estimate this likelihood based on your knowledge and experience and on input from others. The determination is subjective. You must clearly communicate the reasons for your estimate to your client because the client ultimately makes the decision about what position to report on the return. If the IRS audits the return, it will use its professional judgment to decide whether to assess a penalty if it disagrees with your reporting position. And if the matter goes to court, then a judge or jury makes the same subjective determination.

<sup>7</sup>Treas. Reg. §1.662-3(b).

**ILLUSTRATION 1.3** Timeline of Payment Penalties for a Calendar-Year Corporation**Potential Pitfall**

Too many taxpayers confuse the late payment penalty with the underpayment of estimated tax penalty. Remember that the late payment penalty applies only to payments of tax made after the filing deadline. The underpayment penalty applies from the date the payment was due until the earlier of when it was paid or the March 15 filing deadline (for a calendar-year corporation). This timeline is shown in **Illustration 1.3**.

Accuracy penalties vary depending upon the nature of the noncompliance, as discussed in the rest of this section.

**Negligence** is defined as an intentional disregard of rules and regulations without intent to defraud. Congress imposes a penalty of 20% of the tax due to the inaccuracy if the taxpayer's position results from negligence. The IRS will not assess this penalty if there was substantial authority for the position taken, or if the position had a reasonable basis and the taxpayer adequately disclosed it on the tax return on Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement.

The IRS audited Centipede Inc.'s 2023 tax return this year and has assessed additional tax of \$25,000. Centipede did not report a \$100,000 lawsuit it won because it did not think it was taxable. Assuming Centipede's actions were negligent but not fraudulent, what is its accuracy penalty?

**SOLUTION**

Centipede is subject to the 20% penalty for negligence in underreporting its income. The penalty is 20% of the tax due, so the penalty is \$5,000 ( $20\% \times \$25,000$ ).

**EXAMPLE 1.2.7**  
Negligence

**Substantial understatement** occurs when the additional tax due for an individual taxpayer exceeds the greater of \$5,000 or 10% of the total tax on the return. For corporations, a substantial understatement results when the understatement exceeds the lesser of 10% of the tax required to be shown on the return (or \$10,000 if that is greater) or \$10 million. The tax law imposes a penalty of 20% of the tax due because of the inaccuracy if the taxpayer substantially understates the tax. As with the penalty for negligence, the IRS will waive this penalty if there was substantial authority for the position taken, or if the taxpayer adequately disclosed the position on the tax return.

Some penalties are imposed if there is a substantial or gross overstatement of the value or basis of any property. Those penalties are assessed as follows:

- A **substantial misvaluation** occurs if the property is valued on a tax return at 150% or more of the correct amount. The penalty is 20% of the tax understatement for a substantial misvaluation.
- A **gross misvaluation** occurs if the property is valued on a tax return at 400% or more of the correct amount. The penalty is 40% of the tax understatement for a gross misvaluation.

The most serious civil accuracy penalty the IRS can assess a taxpayer is for fraud. **Fraud** is a deliberate action by a taxpayer to conceal information, misrepresent information, or deceive tax authorities about a tax deficiency. The penalty for fraud is 75% of the underpayment, and the interest due on the underpayment is increased by an additional 50%.

Accuracy penalties are civil and financial penalties only, and do not include the possibility of a criminal record or imprisonment. However, criminal penalties *do* exist for tax fraud, in addition to civil penalties. The IRS uses its discretion to decide whether the fraud is at a level that warrants criminal sanctions. Generally, the maximum criminal penalty for tax fraud is five years in prison and/or a \$100,000 fine.

### EXAMPLE 1.2.8 Fraud



Jared owns 100% of Dragonfly Corporation, which does financial planning consulting. After completing Dragonfly's tax return this year, Jared realized that Dragonfly owed \$42,000 in taxes. Instead of paying the taxes as owed, Jared added a \$150,000 advertising expense that had not actually been made to the company's expenses. How would the IRS respond to this situation?

#### SOLUTION

If the IRS later audited Dragonfly's return and Jared could not produce any evidence that Dragonfly had made the expenditure, the IRS could assess a 75% fraud penalty against Dragonfly. If the IRS felt that it could prove beyond a reasonable doubt that Jared had intentionally and knowingly violated the tax law, it might also choose to pursue criminal sanctions against him.

**Related exercises: Discussion Question 7  
Brief Exercise 3**

### PRACTICE PROBLEM 1.2.1 Determining the Statute of Limitations Period

Zella Inc. is an art gallery showing work from various artists. Zella Inc. was not aware that it needed to file a tax return for its income. Its 2025 tax return was not filed until October 31, 2026. When will the statute of limitations expire for its 2025 tax return?

#### SOLUTION

The primary statute of limitations runs for three years from the later of the due date of the tax return or the date the return is filed. Zella Inc. filed its return on October 31, 2026, so the statute of limitations expires on October 31, 2029.

### PRACTICE PROBLEM 1.2.2 Determining Penalties Due— C Corporation

Assume the same facts as in Practice Problem 1.2.1. Zella Inc. had never filed a tax return in the past because it had never sold any artwork; however, it had collected income from other sources. The 2025 tax return (filed October 31, 2026) showed a tax liability of \$13,600. Zella Inc. paid the \$13,600 when it filed its return. What penalties apply to Zella Inc.?

#### SOLUTION

Zella Inc. must pay failure to file and failure to pay penalties. It will not owe the underpayment of estimated tax penalty because it had never had a tax liability in the past. If both the failure to pay penalty and the failure to file penalty are imposed, the maximum penalty for both is limited to 5% of the tax due per month. Zella Inc. filed its return and paid the tax due seven months late. The penalty rate cannot exceed 25% (5 months). Zella Inc. must pay a penalty of \$3,400 ( $\$13,600 \times 5\% \times 5$  months).

Clay Court is an S corporation with a calendar year-end. Clay Court filed its Form 1020-S for 2025 on November 28, 2026. Clay Court has 17 shareholders. What is Clay Court's penalty for late filing of its tax return?

#### SOLUTION

Clay Court's Form 1120-S for 2025 was due on March 15, 2026, and it was filed on November 28, 2026, which is nine months late (eight full months and one partial month). Clay Court's penalty is computed as follows:

$$\$255 \times 17 \text{ shareholders} \times 9 \text{ months} = \$39,015$$

### PRACTICE PROBLEM 1.2.3

Determining  
Penalties Due—  
S Corporation



## 1.3 Review of Fundamentals of Property Transactions

### LEARNING OBJECTIVE 3

Understand the fundamental rules for property transactions that apply to the taxation of business entities.

In your previous tax course(s), you learned the fundamental rules that apply to property transactions and how these rules apply to transactions such as like-kind exchanges, involuntary conversions, and sale of a principal residence. In this text, we will cover many property transactions that apply to business entities, especially related to formations, distributions, and reorganizations. You cannot correctly determine the tax consequences of these types of transactions without knowing the fundamentals of property transactions, particularly the computation of *realized gains and losses* and *recognized gains and losses*.

It is also essential to remember that assets are classified into three mutually exclusive categories: *ordinary*, *capital*, and *Section 1231*. We review these rules, including the taxation of capital gains and losses, as well as how Section 1231 assets are taxed, including the depreciation recapture rules.



### Gains and Losses from Sales and Dispositions

Businesses must compute a *realized gain or loss* every time they sell or dispose of property. The term **sale or disposition** includes sales, exchanges, trade-ins, casualties, condemnations, thefts, and retirements. When one of these events occurs, the taxpayer must compute the realized gain or loss.

#### Amount Realized

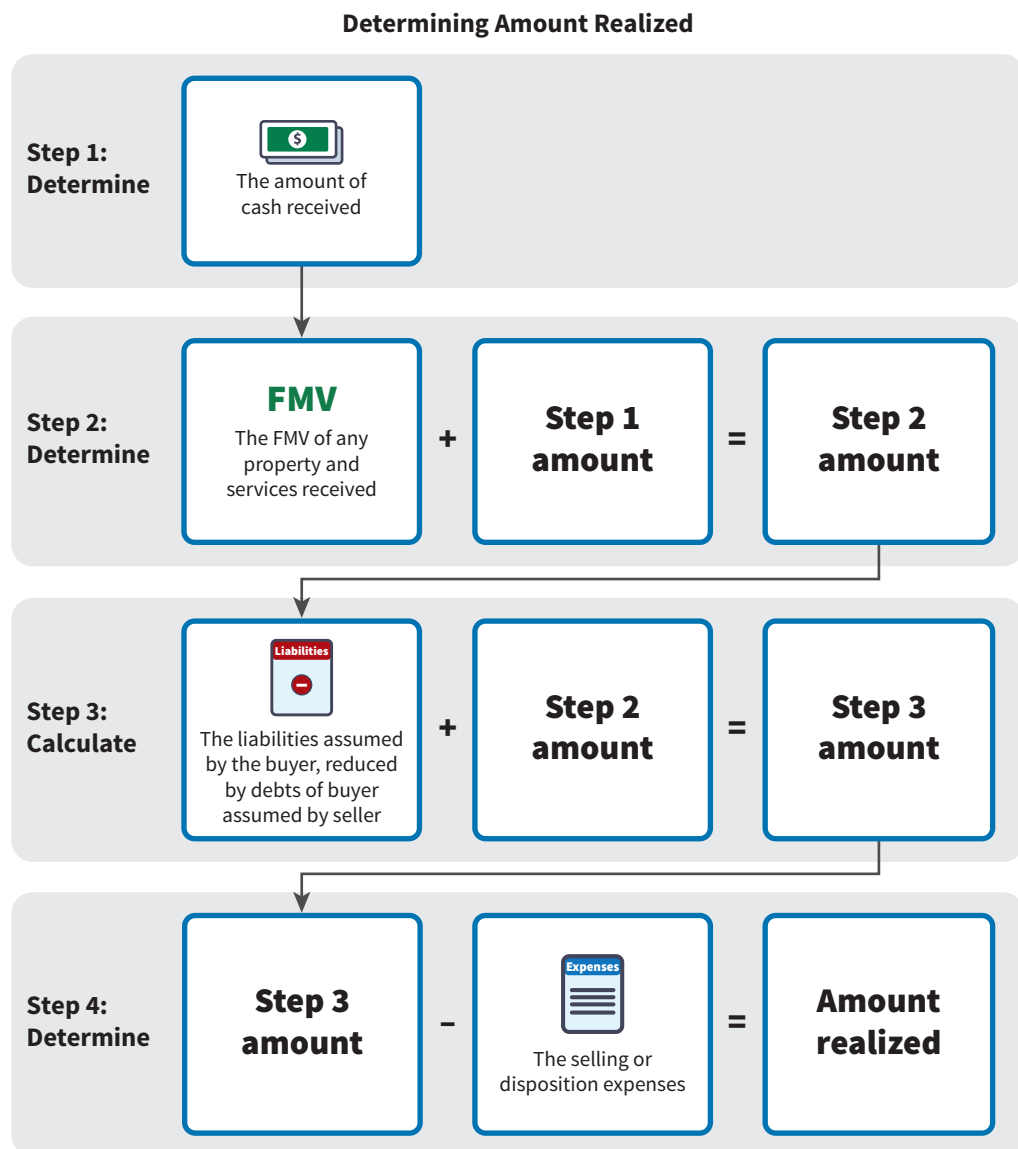
Conceptually, the **amount realized** represents the value that the owner of the property receives because of the disposition. Computing the amount realized is a four-step process, shown below (and in **Illustration 1.4**):

- Step 1. Determine: The amount of cash received.**
- Step 2. Determine: The fair market value (FMV) of any property and services received and ADD it to the amount of cash received (see step 1).**

**Step 3. Calculate:** The liabilities assumed by the buyer, reduced by debts of the buyer assumed by the seller, and ADD it to the amount calculated at the end of step 2.<sup>8</sup>

**Step 4. Determine:** The selling or disposition expenses and SUBTRACT this amount from the total calculated at the end of step 3.

**ILLUSTRATION 1.4** The Steps in Determining Amount Realized



### Potential Pitfall

Repairs to property to prepare it for sale are not selling costs. If the taxpayer is using the asset for business use, the repairs are deductible against business income.

Selling or disposition expenses include costs incurred by the property owner to complete the transaction, such as the following (also see the **Potential Pitfall**):

- Real estate commissions
- Transfer taxes
- Title policy for buyer

<sup>8</sup>The phrase “liabilities assumed by the buyer” is sometimes referred to as “debt relief.” In a real estate transaction, debt relief is often the result of the buyer assuming the seller’s mortgage on the property purchased.

- Attorney's fees
- Accounting fees

## Adjusted Basis

For some assets, taxpayers must make changes to the asset's basis after its acquisition, and the result is known as the **adjusted basis**. The tax law defines *adjusted basis* as:

Original cost  
 Plus: Capital improvements  
Less: Accumulated depreciation  
Adjusted basis

**Capital improvements** are expenditures that either restore an asset, resulting in an increase in value, extend the asset's life, or adapt the asset to a new use. Let's take a look at calculating the adjusted basis for rental real estate.

Rebecca bought a house in Year 1 for \$120,000 and has used it for rental property. In Year 11, she sold the house for \$190,000. Her accumulated depreciation at the time of sale was \$40,000. In Year 5, she added a two-car garage onto the house at a cost of \$25,000. The week before she sold the house, she spent \$150 to repair the fence in the backyard. Rebecca has asked you to compute her adjusted basis in the house at the time it was sold.

### EXAMPLE 1.3.1 Adjusted Basis



#### SOLUTION

We can calculate Rebecca's adjusted basis as follows:

Original cost	\$120,000
Plus: Capital improvements	25,000
<u>Less: Accumulated depreciation</u>	(40,000)
<u>Adjusted basis</u>	<u>\$105,000</u>

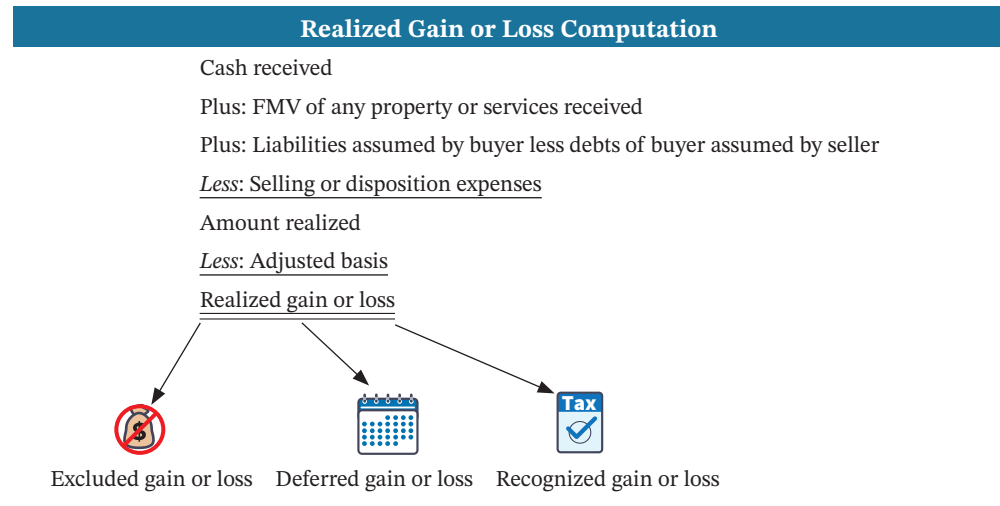
The \$150 fence repair does not affect adjusted basis because it is not a capital improvement. It is a repair expense that Rebecca can deduct in the period she incurs it.

## Realized Gain or Loss

Once you have calculated the amount realized and the adjusted basis, you can compute the **realized gain or loss** as follows:

Amount realized  
 (Adjusted basis)  
Realized gain/loss

**Illustration 1.5** combines the formulas for amount realized and realized gain or loss.

**ILLUSTRATION 1.5** Computation of Gains and Losses

### EXAMPLE 1.3.2

#### Sale of an Asset



Butterfly Company sells property with the following characteristics:

Adjusted basis	\$15,000
Mortgage	\$ 8,000
Selling expenses	\$ 1,500

The buyer assumes the mortgage and pays cash of \$17,000. Butterfly has asked you to compute its realized gain or loss.

#### SOLUTION

To determine Butterfly's realized gain or loss, we use the steps shown in Illustration 1.5:

<b>Step 1.</b> Cash received	\$17,000	
<b>Step 2.</b> Plus: FMV of any other property or services received	0	
<b>Step 3.</b> Plus: Debt relief	8,000	
<b>Step 4.</b> <u>Less: Selling expenses</u>	<u>(1,500)</u>	
Amount realized		\$23,500
<u>Less: Adjusted basis</u>		<u>(15,000)</u>
<u>Realized gain</u>		<u>\$ 8,500</u>

**Related exercises: Discussion Question 8**

**Multiple Choice Question 6**

**Application Problem 8**

## Recognized Gains and Losses

All realized gains and losses are recognized by a business unless a tax law allows the gain or loss to be deferred or excluded. A **recognized gain or loss** is one the business includes in the computation of taxable income.

## Deferred Gains and Losses

A business does not *recognize* all realized gains and losses. If a gain or loss is not recognized, it is either *excluded* or *deferred* (see **Illustration 1.5**). If it is an **excluded gain or loss**, the taxpayer never includes it in taxable income. If it is a **deferred gain or loss**, the taxpayer

includes the gain or loss in taxable income in a later year. **Assume your client must recognize all realized gains and losses unless a tax law provides otherwise.**

Related exercise: Discussion Question 9

Assume a business must recognize all realized gains and losses unless a tax law provides otherwise.

### Tax Planning Tip

The recognized gain or loss will never exceed the realized gain or loss. The realized gain or loss is the maximum amount a taxpayer can recognize.

**Why** Why does debt relief increase amount realized? Taxpayers are sometimes confused about why debt relief increases the amount realized, and question whether this overstates the amount realized. It does not. Suppose Beetle Company owns a building with the following characteristics:

Fair market value	\$350,000
Adjusted basis	\$270,000
Mortgage	\$225,000

Let's compare two scenarios, assuming Beetle sells the building.

*Scenario One:* The buyer pays Beetle \$350,000 cash. Beetle's realized gain is:

Amount realized	\$350,000
<u>Less: Adjusted basis</u>	<u>(270,000)</u>
<u>Realized gain</u>	<u>\$ 80,000</u>

Beetle then uses \$225,000 of the cash to pay off the mortgage and now has \$125,000 cash remaining.

*Scenario Two:* The buyer assumes Beetle's mortgage of \$225,000 and pays Beetle \$125,000 cash. Beetle's realized gain is:

Cash received	\$125,000
<u>Plus: Debt relief</u>	<u>225,000</u>
Amount realized	\$350,000
<u>Less: Adjusted basis</u>	<u>(270,000)</u>
<u>Realized gain</u>	<u>\$ 80,000</u>

The realized gain of \$80,000 is the same for both scenarios. Beetle also has \$125,000 of cash after each scenario. So these are two different ways to achieve the same economic result. Including the debt relief in the amount realized does not overstate it. Why? Because when the buyer assumes the seller's debt, the buyer reduces the cash payment to the seller by an equivalent amount.

**Why** Why can certain gains and losses be deferred? Congress allows certain realized gains and losses to be deferred for either of the following reasons:

- The transaction did not generate any cash for the business, so if the business did have to pay tax, the cash must come from other sources.
- The business's economic situation has not changed significantly because of the transaction, so Congress does not believe it is appropriate to tax such gains.

Related exercise: Discussion Question 10

**Qualified Property** When Congress permits businesses to defer gains and losses, some types of property will qualify for deferral and others will not. **Qualified property** is property meeting the specific requirements for a particular deferral transaction. **Boot** is any property exchanged that is not qualifying like-kind property, including cash. A business must recognize realized gains to the extent of the fair market value of the boot received. The recognized gain or loss is the *lower* of:

- realized gain or loss, *or*
- fair market value of boot received.

Boot received has no impact on the deferral of losses. A business that qualifies to defer a loss and receives boot can still defer all the realized loss.

**Related exercise: Discussion Question 11**

**Deferred Gain or Loss** When establishing a tax-deferred transaction, a business must know the amount of gain or loss that the law postpones or defers. This can be determined as follows:

$$\begin{array}{r} \text{Realized gain or loss} \\ \text{(Recognized gain or loss)} \\ \hline \text{Deferred gain or loss} \end{array}$$

**Basis in New Property Received** You must also know the basis that your client has in the asset received in the tax-deferred transaction. You use the basis of the asset transferred to determine the basis of the asset received. The law labels this a **substituted basis** because the basis of the transferred asset substitutes for the basis of the asset received. In contrast, when there is no deferral and a business recognizes all realized gains or losses, the basis of the asset received is always its fair market value.

Basis in property received can be determined with two different formulas. Both always provide the same answer. Formula 1 better reflects what is included in the new basis, while Formula 2 is simpler to apply.

$$\begin{array}{r} \text{Formula 1:} \quad \text{Adjusted basis in property transferred} \\ \text{Plus: Recognized gain} \\ \text{Less: Fair market value of boot received} \\ \text{Less: Debt relief} \\ \hline \text{Basis in property received} \end{array}$$

$$\begin{array}{r} \text{Formula 2:} \quad \text{Fair market value of property received} \\ \text{Less: Deferred gain} \\ \text{Plus: Deferred loss} \\ \hline \text{Basis in property received} \end{array}$$

Basis of boot received is the boot's fair market value.

**Holding Period of New Property** For a tax-deferred transaction, the holding period of property received always includes the holding period of the property transferred. Because the business is deferring gain or loss that has accrued on the asset transferred, it also needs to include the period during which the postponed gain or loss accrued with the holding period of the asset received.

**Related exercise: Discussion Question 12**

**Evaluating Tax Deferred Transactions** There are seven steps to follow when determining whether a business meets the rules for deferral of gain or loss, and for computing the tax consequences. You will encounter many tax-deferred transactions throughout this book, such as corporate formations in Chapter 3 (LO1, Taxation of Corporate Formations) and corporate reorganizations in Chapter 5 (LO3, Corporate Reorganizations).

**Step 1. Compute: The realized gain or loss from the exchange.**

$$\begin{array}{r} \text{Cash} \\ \text{Plus: FMV of any property or services received} \\ \text{Plus: Liabilities assumed by buyer reduced by debts of buyer assumed by seller} \\ \text{Less: Selling or disposition expenses} \\ \hline \text{Amount realized} \\ \text{Less: Adjusted basis} \\ \hline \text{Realized gain or loss} \end{array}$$

**Step 2. Ask: Does the transaction meet the criteria for the taxpayer to defer the gain or loss?** If not, then you must recognize the realized gain or loss.

**Step 3. Determine: The recognized gain.** This amount is the *lower* of:

- the realized gain, *or*
- the fair market value of the boot received

Note that if the taxpayer is deferring a loss, boot received does not cause the taxpayer to recognize gain.

**Step 4. Determine: The deferred gain.** This amount can be calculated as follows:

$$\begin{array}{r} \text{Realized gain} \\ \text{Less: Recognized gain or loss} \\ \hline \text{Deferred Gain} \end{array}$$

**Step 5. Calculate: The basis in the property received.** This amount can be determined with either of the following formulas (both always provide the same answer).

*Formula 1:*

$$\begin{array}{r} \text{Adjusted basis in property transferred} \\ \text{Plus: Recognized gain} \\ \text{Less: Fair market value of boot received} \\ \text{Less: Debt relief} \\ \hline \text{Basis in property received} \end{array}$$

*Formula 2:*

$$\begin{array}{r} \text{Fair market value of property received} \\ \text{Less: Deferred gain} \\ \text{Plus: Deferred loss} \\ \hline \text{Basis in property received} \end{array}$$

**Step 6. Determine: The basis in the boot received.** The basis in the boot received is the property's fair market value.

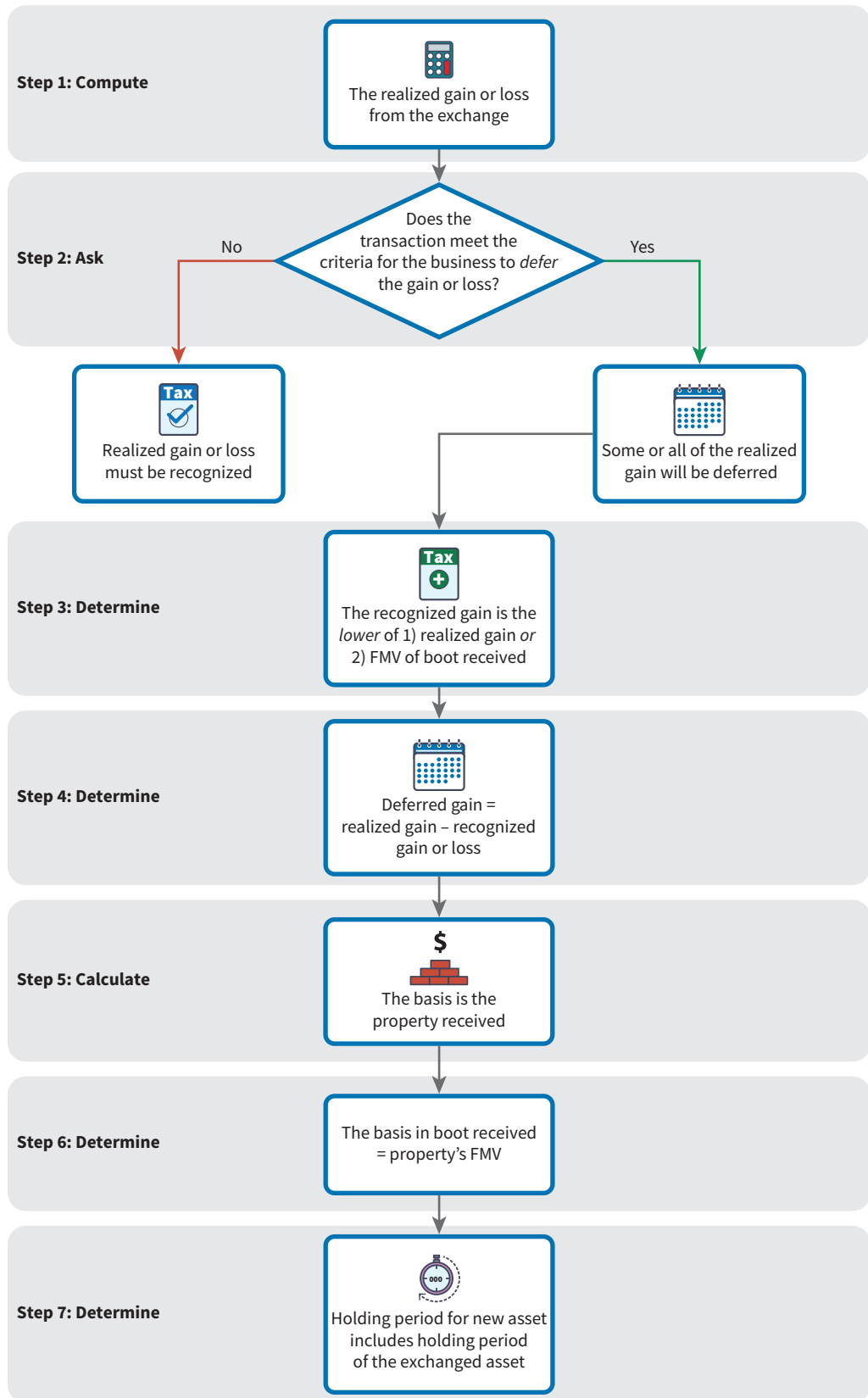
**Step 7. Determine: The holding period.** The holding period of the new asset includes the holding period of the exchanged asset.

**Illustration 1.6** provides a flow chart showing these steps.

Example 1.3.3 considers the tax implications of a qualifying tax-deferred transaction in the context of a corporate formation. Do not concern yourself with the specific rules for corporation formations, as you will learn these in Chapter 3, LO1, Corporate Formations. The focus is on the seven steps for tax-deferred transactions, which are the same for all such transactions.

**ILLUSTRATION 1.6** Seven Steps to Evaluate Tax-Deferred Transactions

**Tax-Deferred Transactions**



Noah has owned Property A, a capital asset, for three years with an adjusted basis of \$60,000 and a fair market value of \$100,000. In a tax-deferred corporate formation, Noah transfers Property A to Bedbug Corporation in exchange for stock with a fair market value of \$85,000 and cash of \$15,000. The cash received is treated as boot. Compute the tax consequences for Noah of this tax-deferred transaction.

### EXAMPLE 1.3.3 Tax-Deferred Transaction



#### SOLUTION

To determine the tax implications of this transaction, we follow the steps outlined in Illustration 1.6.

**Step 1.** We first compute Noah's realized gain or loss from the exchange.

Cash	\$ 15,000
Plus: FMV of any property or services received	85,000
Plus: Liabilities assumed by buyer reduced by debts of buyer assumed by seller	0
<u>Less: Selling or disposition expenses</u>	<u>( 0)</u>
Amount realized	\$ 100,000
<u>Less: Adjusted basis</u>	<u>( 60,000)</u>
<u>Realized gain or loss</u>	<u>\$ 40,000</u>

**Step 2.** Next, we ask if the transaction meets the criteria for Noah to defer the gain or loss. The problem states that this transaction does qualify, so we assume that the transaction meets the appropriate requirements to qualify for tax deferral.

**Step 3:** We then determine Noah's recognized gain by taking the *lower* of:

- realized gain (\$40,000), or
- fair market value of boot received (\$15,000).

Here, the recognized gain is \$15,000.

**Step 4.** Next, we need to determine Noah's deferred gain, which we can calculate as follows:

Realized gain	\$40,000
<u>Less: Recognized gain or loss</u>	<u>(15,000)</u>
<u>Deferred gain</u>	<u>\$25,000</u>

**Step 5.** We now calculate Noah's basis in the stock received with either of two different formulas. Both always provide the same answer.

<i>Formula 1:</i>	Adjusted basis in property transferred	\$60,000
	Plus: Recognized gain	15,000
	<u>Less: Fair market value of boot received</u>	<u>(15,000)</u>
	<u>Less: Debt relief</u>	<u>0</u>
	<u>Basis in stock received</u>	<u>\$60,000</u>
<i>Formula 2:</i>	Fair market value of property received	\$85,000
	<u>Less: Deferred gain</u>	<u>(25,000)</u>
	<u>Plus: Deferred loss</u>	<u>0</u>
	<u>Basis in stock received</u>	<u>\$60,000</u>

Both formulas ensure that if Noah were to immediately sell the stock received, he would recognize the deferred gain of \$25,000 (\$85,000 amount realized less \$60,000 adjusted basis).

**Step 6.** Next, we determine Noah's basis in the boot received, which is the fair market of the cash (\$15,000).

**Step 7.** Finally, we determine Noah's holding period of stock, which will include the holding period of the exchanged asset. Noah's holding period in the stock is three years, because it includes the holding period of Property A.

## Related-Party Losses

Another important part of property transactions is understanding how the related-party loss rules apply to business entities and their owners. Realized losses from the sale or disposition of an asset between related parties cannot be recognized, but the buyer may be able to benefit from the disallowed loss in the future. The term **related party** includes the following family members: spouse, children, grandchildren/other descendants, parents, grandparents/other ancestors, and brothers and sisters. Aunts, uncles, and cousins are not related parties, and neither are in-laws.<sup>9</sup>

**Definitions for Businesses** The related-party loss rules apply to many situations other than sales between family members. The definition of related party also includes relationships between individuals and business entities, and between certain business entities. Other examples of related parties include:<sup>10</sup>

- An individual and a corporation in which the individual owns, directly or indirectly, more than 50% of the corporation by value of the outstanding stock.
- A partner and a partnership in which the partner owns, directly or indirectly, more than 50% of the partnership's capital interest or profits interest.
- Two corporations, two partnerships, or two S corporations if the same individual owns more than 50% of the stock of both.
- A partnership and a corporation if the same owners own more than 50% of both.
- An S corporation and a C corporation if the same owners own more than 50% of both.

The disallowed loss from a related-party sale creates a **right of offset**, which taxpayers can use to reduce a gain upon the ultimate sale of the property to an unrelated taxpayer. The right of offset cannot create a loss, nor can it make a loss greater. Once the related-party buyer sells the asset to a third party, the related-party buyer permanently loses any unused right of offset.<sup>11</sup>

**Why** **Why are losses from related-party sales disallowed?** Luisa owns 500 shares of stock in LU Corporation, which she purchased on June 1, Year 1. She also owns 100% of Ant Corporation. Her adjusted basis in the LU stock is \$150,000, and its current fair market value (FMV) is \$180,000. Luisa has sold other investments during the current year, and her net capital gain from these sales is \$30,000. She would rather not have to pay tax on the \$30,000 gain, so she sells the 500 shares of LU stock to Ant for \$120,000 on July 10, Year 9. This creates a \$30,000 realized loss (\$120,000 amount realized less \$150,000 adjusted basis) that she intends to use to reduce her net capital gain to zero. However, because Luisa owns more than 50% of Ant, she cannot recognize the \$30,000 loss, and her net capital gain remains at \$30,000. The related-party loss rules exist to prevent this type of tax avoidance.

Luisa reduced her net worth by \$30,000 when she sold the stock to LU because she sold it for less than its fair market value. Why would she be willing to do this? While individually Luisa has incurred a \$30,000 loss, her corporation, Ant, still holds the stock.

**Evaluating Related-Party Transactions** There are four steps to solving all issues for a related-party transaction. **Illustration 1.7** provides a flow chart showing these steps.

**Step 1. Compute: The realized gain or loss from the transaction.** If a realized gain, then the taxpayer must recognize it. If a realized loss, go to step 2.

**Step 2. Ask: Are the buyer and seller related parties?** If NO, then you can recognize the realized loss. If YES, then you cannot recognize the realized loss, and must proceed to step 3.

**Step 3. Calculate: The right of offset is equal to the amount of the realized loss.**

<sup>9</sup>IRC §267(c)(4).

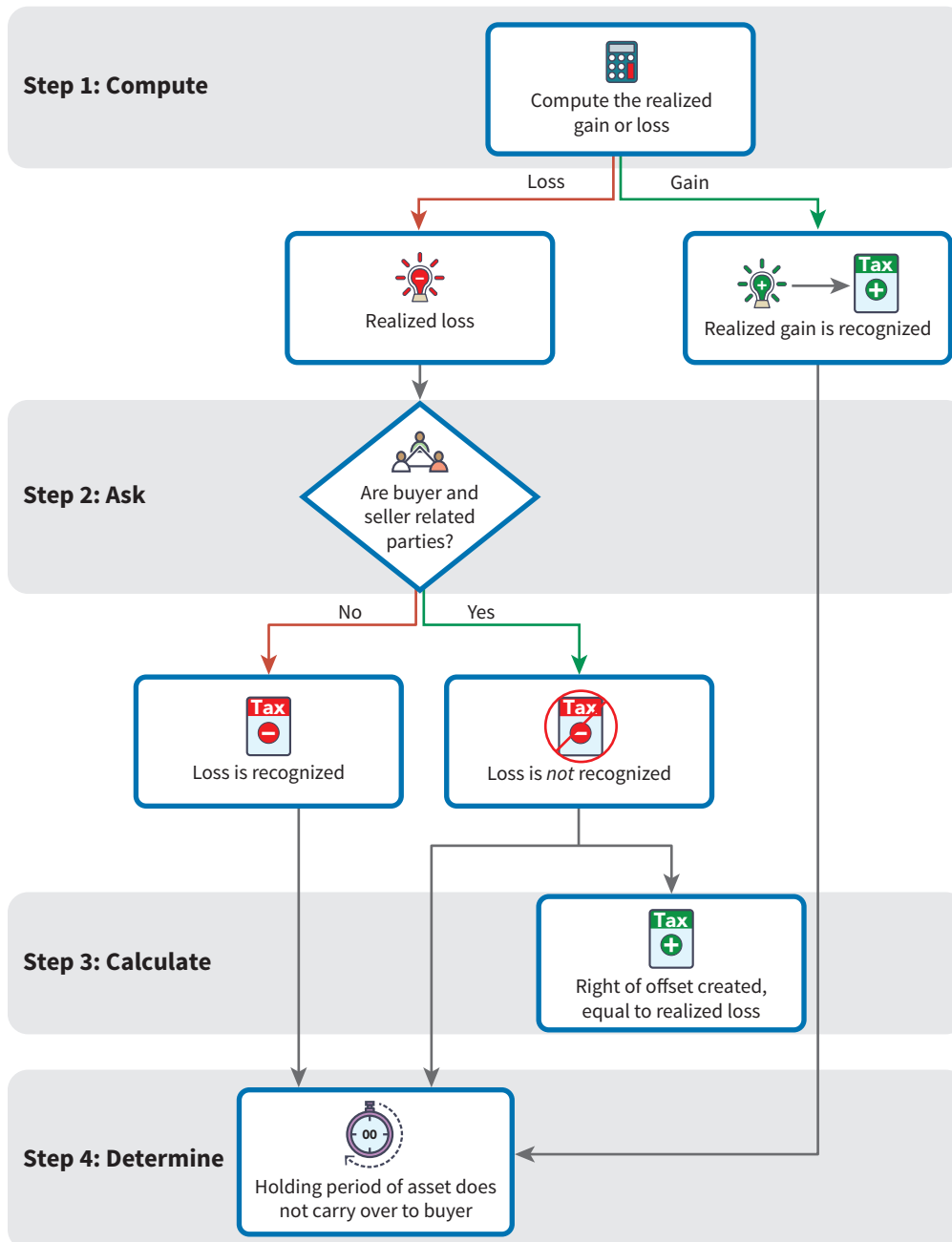
<sup>10</sup>IRC §267(b) and IRC §707(b)(1).

<sup>11</sup>IRC §267(d).

**Step 4. Determine:** The holding period of the new owner of the asset. This period begins on the day after the date the taxpayer purchased the property from the related party and does not include the holding period of the seller.

**ILLUSTRATION 1.7** The Four Steps for Assessing Related-Party Transactions

**Assessing Related-Party Transactions**



### EXAMPLE 1.3.4 Related-Party Loss



Continue with the facts given for Luisa in the **Why** section above. Determine the realized gain or loss, the recognized gain or loss, the right of offset (if any), and the holding period for the new owner of the asset.

#### SOLUTION

**Step 1.** First, we compute Luisa’s realized gain or loss.

Amount realized	\$120,000
<u>Less: Adjusted basis</u>	<u>( 150,000)</u>
<u>Realized loss</u>	<u>(\$ 30,000)</u>

**Step 2.** Next, we ask: Are the buyer and seller related parties? Luisa and Ant Corporation are related parties because she owns more than 50% of Ant, so the realized loss is not recognized. The deferred loss is \$30,000.

**Step 3.** We then calculate the right of offset, which is equal to the amount of the realized loss. Here, the right of offset available for Ant to use in the future is \$30,000.

**Step 4.** Finally, we determine the holding period of the new owner of the asset. Ant’s holding period for the stock begins on July 11, the day after the date of the transaction.

#### Tax Return Guidance

Sales of capital assets are reported on Form 8949, Sales and Other Dispositions of Capital Assets (see Appendix B for a full copy of Form 8949). In Example 1.3.4, Luisa would report the sale of the stock as shown in Illustration 1.8. Her gain or loss is long-term because she owned the stock for eight years. The “L” in box (f) indicates that this is a nondeductible loss other than a wash sale. The amount of the disallowed loss is shown in box (g).

ILLUSTRATION 1.8 Form 8949 (Example 1.3.4)

**Part II Long-Term.** Transactions involving capital assets you held more than 1 year are generally long-term (see instructions). For short-term transactions, see page 1.

**Note:** You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren’t required to report these transactions on Form 8949 (see instructions).

**You must check Box D, E, or F below. Check only one box.** If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- (D) Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see Note above)
- (E) Long-term transactions reported on Form(s) 1099-B showing basis **wasn’t** reported to the IRS
- (F) Long-term transactions not reported to you on Form 1099-B

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the Note below and see Column (e) in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g).
						(f) Code(s) from instructions	(g) Amount of adjustment	
	LU Corporation - 500 shares to Ant			120,000	150,000	L	30,000	0

Now let’s examine the tax consequences for Ant Corporation’s later sale of the stock.

Assume the same facts as in Example 1.3.4 and the **Why** section above. Determine Ant's recognized gain or loss if it holds the stock for two years and then sells it to an unrelated party for \$140,000. Alternatively, assume sales prices of \$160,000 and \$115,000.

### EXAMPLE 1.3.5 Right of Offset



#### SOLUTION

Once a related-party sale with a deferred loss has occurred, the buyer of the asset can use the right of offset to reduce gain when selling or disposing of the asset.

	<u>A</u>	<u>B</u>	<u>C</u>
<b>Sales price</b>	<b>\$140,000</b>	<b>\$160,000</b>	<b>\$115,000</b>
Amount realized	\$140,000	\$160,000	\$115,000
<u>Less: Adjusted basis</u>	<u>(120,000)</u>	<u>(120,000)</u>	<u>( 120,000)</u>
Gain (loss) before right of offset	\$ 20,000	\$ 40,000	(\$ 5,000)
<u>Less: Right of offset</u>	<u>( 20,000)</u>	<u>( 30,000)</u>	<u>0</u>
<u>Recognized gain (loss)</u>	<u>\$ 0</u>	<u>\$ 10,000</u>	<u>(\$ 5,000)</u>

In scenario A, Ant can use only \$20,000 of the right of offset because the right of offset cannot create a loss. In scenario B, the entire right of offset can reduce the gain. In scenario C, Ant cannot use any of the right of offset because it would increase a loss. In scenarios A and C, the unused right of offset cannot be used in the future.

A situation that may sometimes occur is that a related party has a qualified appraisal verifying that they sold the asset for its actual value and a loss is realized. In such cases, the loss is still disallowed, as we will see in the next Example.

How would the answer to Example 1.3.4 change if Luisa had a qualified appraisal that verified the fair market value of her shares was \$120,000, rather than \$180,000?

### EXAMPLE 1.3.6 Qualified Appraisal



#### SOLUTION

The answer would not change. The related-party loss rules apply any time a realized loss occurs on a transaction between related parties, even if the seller uses the proper fair market value and is not using a false value to create a tax loss.

**Related exercises:** Discussion Questions 13, 14  
Multiple Choice Questions 7, 8  
Brief Exercises 5, 6  
Application Problem 10  
Tax Planning Problem 1

## Classification of Assets

There are many areas of tax law in which you must classify assets correctly as either *ordinary*, *Section 1231*, or *capital* before you can develop appropriate tax planning recommendations. You also need to be able to classify assets as either *personalty* or *realty*. We cannot overemphasize how necessary it is for you to be able to properly classify assets for tax purposes.

## Definition of Ordinary Assets, Capital Assets, and Section 1231 Assets

**Ordinary assets** produce ordinary income and ordinary loss when disposed of or sold. Individuals must pay tax on **ordinary income**, such as the distributive share that flows to a partner from a partnership, at their marginal tax rate, which currently ranges from 10% to 37%. **Ordinary losses** can reduce ordinary income and capital gains, whereas capital losses can reduce only capital gains and up to \$3,000 (\$1,500 for married filing separately) of ordinary income for individuals. For corporations, capital losses can offset only capital gains. Excess capital losses can be carried back three years and carried forward five years.

The more common types of ordinary assets are:

- Inventory, accounts receivable, and notes receivable
- Depreciable property and realty used in a trade or business that the taxpayer has owned for one year or less
- Copyrights and musical, artistic, and literary works, if held by the taxpayer who created the work (though a composer can elect to have their musical work treated as a capital asset instead)

**Section 1231 assets** are depreciable property and realty used in a trade or business that the business has owned for more than one year. For example, a florist's Section 1231 assets include the land and building where the shop is located, the refrigeration units used to store the flowers, and vans used to deliver flowers. (See the **Potential Pitfall**.)

The tax law defines a **capital asset** as any asset that is not an ordinary asset or a Section 1231 asset.<sup>12</sup> The most common types of capital assets are property held for investment use and property held for personal use. Goodwill is also a capital asset. Copyrights are capital assets when not held by the taxpayer who created the work.

Net long-term capital gains for individuals are taxed at a preferential rate of either 0%, 15%, or 20%. Corporations do not have a preferential tax rate for net long-term capital gains. LTCGs for corporations are taxed at a 21% rate, the same as ordinary income.

**Related exercises: Discussion Question 15**

The next two Examples show how to determine the character of an asset.

### Potential Pitfall

Assets that a business owns and uses for one year or less are ordinary assets. However, taxpayers often misclassify these as short-term capital assets.

### EXAMPLE 1.3.7 Copyrights



Cicada Corporation is a publisher focused on scientific research. Cicada has created a new Encyclopedia of Insects and has obtained a copyright for the book. Five years later, Cicada sells the copyright to National Geographic for \$750,000. What type of asset is the copyright for Cicada and for National Geographic?

#### SOLUTION

In Cicada's hands, the copyright was an ordinary asset. National Geographic has purchased the copyright as part of a trade or business, because it hopes to sell enough copies of the Encyclopedia to produce a large profit. The copyright is a capital asset for National Geographic.

<sup>12</sup>IRC §1221.

Classify each of the following assets as ordinary, Section 1231, or capital.

- a. Land held as an investment
- b. Clothing held for sale in a retail store
- c. Truck owned for four years and used in landscaping business
- d. Patent owned by business that created the patent
- e. Real estate owned by a partnership that is a dealer in land
- f. Equipment used in restaurant and sold after being owned for eight months
- g. Land owned for 10 years and used by hardware store as a parking lot
- h. Land owned for 10 years but not used by the business for its operations

### EXAMPLE 1.3.8

#### Classification of Assets



#### SOLUTION

- a. Capital; all investments are capital assets.
- b. Ordinary; this is inventory.
- c. Section 1231; asset used in a business and owned for more than one year.
- d. Ordinary; patents owned by the created are ordinary assets.
- e. Ordinary; the real estate is inventory because it is held by a dealer in land.
- f. Ordinary; asset used in a business and owned for one year or less.
- g. Section 1231; asset used in a business and owned for more than one year.
- h. Capital; because it is not used in a business, the land is an investment.

In classifying the assets above, you needed to know what type of activity applied in each case. For example, land owned for 10 years and used in a business activity is a Section 1231 asset, but if the landowner holds the same parcel of land as an investment, it is a capital asset.

### Spotlight on the Law

#### Classification of an Asset: Sell Now or Later?

Emelio Estes is 100% shareholder in an S corporation that owns a popular theater downtown that offers live shows, a restaurant, and a gift shop. The S corporation purchased a plot of land near the theater to use for parking on January 2 of the current year for \$85,000. It is now December 22, and the land has substantially appreciated in value, to \$140,000. Emelio is considering selling the land instead of building on it. He would like to know if it is best to sell the land by December 31 or wait until the end of January of the following year. Emelio's marginal tax rate is 35%.

If a business-use asset is held for one year or less, it is an ordinary asset, and the sale would create ordinary income of \$55,000. The S corporation would report the income, and it would flow through to Emelio, who would have a tax liability of \$19,250 ( $\$55,000 \times 35\%$ ). If a business-use asset is held for more than one year, it is a Section 1231 asset, and the sale would create a Section 1231 gain of \$55,000. The net Section 1231 gains for the S corporation would flow through to Emelio and be treated as a long-term capital gain on his tax return. Emelio would pay tax at a preferential rate of 15%. The tax liability would be \$8,250 ( $\$55,000 \times 15\%$ ). Thus, if the S corporation holds the asset until January 3 of the following year, this will reduce Emelio's tax liability by \$11,000 ( $\$19,250 - \$8,250$ ).

## Realty vs. Personalty

In addition to classifying all assets as ordinary, Section 1231, or capital, the tax law also categorizes them as either realty or personalty. **Realty** is land and any structure permanently attached to the land. The most common type of asset that is permanently attached to land is buildings, so realty is land and buildings. Other examples of realty include fences, silos, railroad tracks, and landscaping. Accountants sometimes refer to realty as “real property.”

**Personalty** is any asset that is not realty. Taxpayers often refer to personalty as personal property. However, the term “personal property” can be misunderstood to mean property held for “personal use,” which causes confusion and incorrect conclusions. Therefore, we use the term “personalty” throughout this book.<sup>13</sup>

**Related exercise: Discussion Question 16**

There are three categories of personalty. **Tangible property** has physical qualities and can be touched and moved. For example, cars and machinery are examples of tangible property. **Intangible property** does not have a physical form but is an abstraction that represents an ownership right. Patents, trademarks, copyrights, and goodwill are examples of intangible property. **Natural resources**, the third type of personalty, are a source of wealth that occurs in a natural state and has value, such as timber, mineral deposits, and water. Unextracted natural resources are considered to be attached to land and are treated as realty. Once a natural resource is extracted, it becomes personalty.

**Related exercises: Multiple Choice Questions 9, 10, 11, 12**

### EXAMPLE 1.3.9 Personalty vs. Realty



Classify each of the following assets as realty, personalty (tangible asset), personalty (intangible asset), or personalty (natural resource).

- a. Undeveloped land used/held as an investment
- b. Desk and chair in a business office
- c. Building used by retail stores near a mall
- d. Projector in a classroom used to display images on a screen
- e. Automobile
- f. Boeing 747 airplane
- g. Football stadium
- h. Commercial office building
- i. Extracted natural gas
- j. Copyright for a book

#### SOLUTION

- a. Realty; land is always realty.
- b. Personalty (tangible asset); it is not land or a building, and it can be touched.
- c. Realty; buildings are always realty.
- d. Personalty (tangible asset); it is not land or a building, and it can be touched.
- e. Personalty (tangible asset); it is not land or a building, and it can be touched.
- f. Personalty (tangible asset); it is not land or a building, and it can be touched.
- g. Realty; it is permanently attached to land.
- h. Realty; buildings are always realty.
- i. Personalty (natural resource); it exists in a natural state, has been extracted, and has value.
- j. Personalty (intangible asset); it is not land or a building, and it cannot be touched.

**Related Exercises: Application Problems 11, 12**

<sup>13</sup>Law dictionaries routinely define “personalty” as personal property and “realty” as real property.

## Holding Period

Before we leave the topic of asset classification, let's look at the concept of *holding period*. The **holding period** is the amount of time that a business has owned an asset. The holding period always begins the day after the business acquires the asset and ends on the day the asset is sold.

- A **long-term holding period** means that a business has owned the asset for more than one year.
- A **short-term holding period** means that a business has owned the asset for one year or less.

Holding period is relevant in two situations related to classification of assets.

- A business must own a capital asset for more than one year to be eligible for long-term capital gain treatment.
- A business owner must own an asset used in a trade or business for more than one year for it to be a Section 1231 asset. Otherwise, it is an ordinary asset. ***In this book, always assume business assets are owned for more than one year unless informed otherwise.***

**In this book, always assume business assets are owned for more than one year unless informed otherwise.**

**Related exercises: Discussion Question 17  
Brief Exercise 7**

Classify each of the following assets as ordinary, Section 1231, or capital.

- 60-inch TV in a company's employee lounge, owned for two years
- Sofas and loveseats held for resale in a furniture store
- Heavy circular saw used in a construction business for four years
- 500 shares of stock in Netflix
- Equipment used for business and sold after three months
- Storefront property used as an ice cream shop

### PRACTICE PROBLEM 1.3.1

#### Classification of Assets

#### SOLUTION

- Section 1231; this is used in a trade or business and has been owned for more than one year.
- Ordinary; this is inventory.
- Section 1231; this is used in a trade or business and has been owned for more than one year.
- Capital; this is an investment.
- Ordinary; this is used in a trade or business and has been owned for one year or less.
- Section 1231; this is used in a trade or business and has been owned for more than one year.

Rumba Inc. purchased a building for its business in 2021 for \$580,000. In 2025, Rumba expanded the building's office space at a cost of \$55,000. The depreciation on the building has totaled \$62,000. What is Rumba's adjusted basis in the building?

### PRACTICE PROBLEM 1.3.2

#### Adjusted Basis Computation

#### SOLUTION

Rumba's adjusted basis is computed as follows:

Original cost	\$580,000
Plus: Capital improvements	55,000
<u>Less: Accumulated depreciation</u>	<u>(62,000)</u>
<u>Adjusted basis</u>	<u>\$573,000</u>

## PRACTICE PROBLEM 1.3.3

### Computing Recognized Gain

Jamaica Partnership sold its rental property for cash of \$100,000 and the assumption of its mortgage of \$345,000. Jamaica paid a real estate commission of \$23,000. It had purchased the rental property for \$325,000 several years earlier. Jamaica remodeled the bathrooms last year for \$15,000. The accumulated depreciation was \$58,000 as of the date of sale. What is Jamaica's recognized gain?

#### SOLUTION

Jamaica's adjusted basis is computed as follows:

Original cost	\$325,000
Plus: Capital improvements	15,000
<u>Less: Accumulated depreciation</u>	<u>(58,000)</u>
<u>Adjusted basis</u>	<u>\$282,000</u>

We compute its recognized gain as follows:

Cash	\$100,000
Plus: FMV of any property or services received	0
Plus: Liabilities assumed by buyer reduced by debts of buyer assumed by seller	345,000
<u>Less: Selling or disposition expenses</u>	<u>(23,000)</u>
Amount realized	\$422,000
<u>Less: Adjusted basis</u>	<u>(282,000)</u>
<u>Realized and recognized gain</u>	<u>\$140,000</u>

## PRACTICE PROBLEM 1.3.4

### Sale of Assets between Related Parties

Jamie owns an apartment building with an adjusted basis of \$108,000 and fair market value of \$90,000. She sells the building to Windy Inc. for \$85,000. Jamie is a 75% shareholder in Windy. Windy Inc. then sells the building to an unrelated third party for \$115,000.

- What is Jamie's realized gain/loss and recognized gain/loss? What is Windy's basis in the building purchased?
- What is Windy's realized gain/loss and recognized gain/loss?
- Assume the same facts given except that Windy sells the building to an unrelated third party for \$92,000. What is Windy's realized gain/loss and recognized gain/loss?
- Assume the same facts given except that Windy sells the building to an unrelated third party for \$76,000. What is Windy's realized gain/loss and recognized gain/loss?

#### SOLUTION

- We will first determine if Jamie has a realized gain or loss on this transaction, as follows:

Amount realized	\$ 85,000
<u>Less: Adjusted basis</u>	<u>(108,000)</u>
<u>Realized loss</u>	<u>(\$ 23,000)</u>

Because Jamie owns more than 50% of Windy Inc., Jamie and the corporation are related parties. Taxpayers cannot deduct realized losses from the sale or exchange of property between related parties. Jamie's recognized loss is \$0. Windy's basis in the building purchased is its purchase price of \$85,000.

- Because Jamie cannot recognize the loss of \$23,000 from the sale to Windy, this creates a right of offset of \$23,000 that Windy can use to reduce any realized gain to zero when it sells the property. When Windy sells the building, we can determine its realized and recognized gains as follows:

Amount realized	\$115,000
<u>Less: Adjusted basis</u>	<u>(85,000)</u>
Realized gain	\$ 30,000
<u>Less: Right of offset</u>	<u>(23,000)</u>
<u>Recognized gain</u>	<u>\$ 7,000</u>

Windy reduces its gain by the right of offset of \$23,000. Therefore, Windy's recognized gain is \$7,000.

c. Because Jamie cannot recognize the loss of \$23,000 from the sale to Windy, this creates a right of offset of \$23,000 that Windy can use to reduce any realized gain to zero when it sells the property. When Windy sells the building, we can determine its realized and recognized gain/loss as follows:

Amount realized	\$92,000
<u>Less: Adjusted basis</u>	<u>(85,000)</u>
Realized gain	\$ 7,000
<u>Less: Right of offset</u>	<u>(7,000)</u>
<u>Recognized gain</u>	<u>\$ 0</u>

Windy reduces its gain by the right of offset, but only to the extent of its realized gain of \$7,000. The right of offset cannot create or increase a loss. Windy's recognized gain is \$0. The remaining \$16,000 (\$23,000 - \$7,000) of the right of offset is forfeited.

d. Because Jamie cannot recognize the loss of \$23,000 from the sale to Windy, this creates a right of offset of \$23,000 that Windy can use to reduce any realized gain to zero when it sells the property. When Windy sells the building for \$76,000, we can determine its realized and recognized gain/loss as follows:

Amount realized	\$76,000
<u>Less: Adjusted basis</u>	<u>(85,000)</u>
<u>Realized loss</u>	<u>(\$ 9,000)</u>

The right of offset cannot create or increase a loss, so none of it can be used. Windy's recognized loss is \$9,000. The \$23,000 right of offset is forfeited.



## 1.4 Review of Section 1231 Assets

### LEARNING OBJECTIVE 4

Determine the tax consequences of disposing of Section 1231 assets.

When Section 1231 assets have been sold, you must determine if any depreciation recapture exists, and you net all Section 1231 gains and Section 1231 losses at the end of the tax year. You determine the net Section 1231 gain or loss *before* the net capital gain or loss. (It is necessary to use this order because if there is a net Section 1231 gain, this amount is included in the netting of capital gains and losses.) We first review the netting rules for Section 1231 gains and losses, and then we summarize the depreciation rules.



## Netting Section 1231 Gains and Losses

There are three steps to follow when netting Section 1231 gains and losses. **Illustration 1.9** provides a flow chart showing these steps.

**Step 1. Net: All casualty and theft gains and losses on business property held for more than one year.**

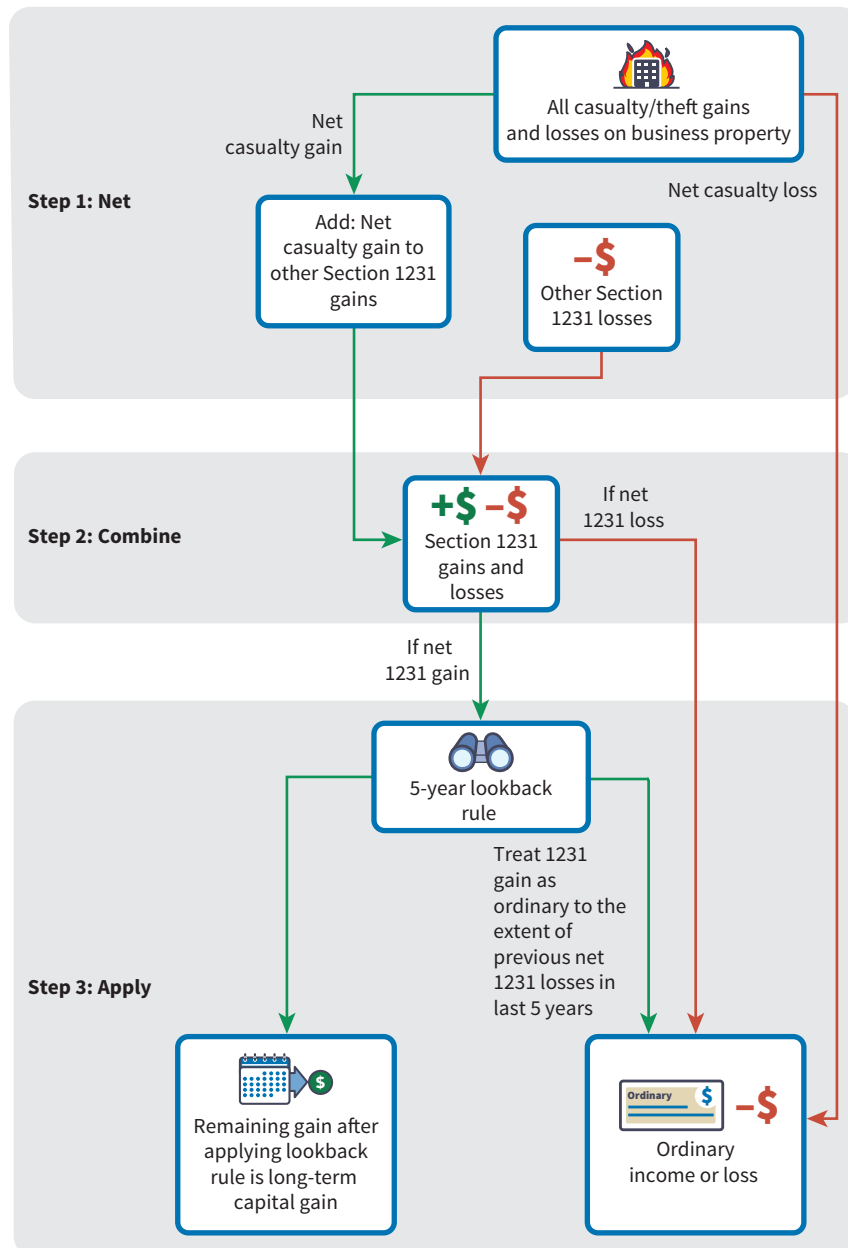
- If the losses exceed gains, treat them as ordinary losses and gains and do not net them with other Section 1231 gains and losses.

**Related exercise: Discussion Question 18**

- If the gains exceed losses, the net gain is combined with other Section 1231 gains and losses.

**ILLUSTRATION 1.9** The Three Steps in the Section 1231 Netting Process

### Section 1231 Netting Process



**Step 2. Combine:** The net Section 1231 casualty and theft gain (if any) from step 1 with all other Section 1231 gains and losses recognized for the tax year.

- To the extent that Section 1231 gains exceed Section 1231 losses, treat the net gain as a long-term capital gain (subject to the lookback rule; see step 3).
- If Section 1231 losses exceed Section 1231 gains, the net loss is deductible as an ordinary loss.

**Related exercise: Application Problem 13**

**Step 3. Apply: The lookback rule.** The **lookback rule** provides that net Section 1231 gains must be reduced by net Section 1231 losses from the five preceding tax years that have not already been recaptured. To the extent of these losses, the net Section 1231 gain is treated as ordinary income. Any remaining gain is treated as long-term capital gain.

**Related exercise: Discussion Questions 19, 20**

### Potential Pitfall

The lookback rule applies *only* in years that have a net Section 1231 gain. Net Section 1231 losses from the previous *five years* can cause the gain to be taxed as ordinary income. The lookback rule never applies in years that have a net Section 1231 loss.

Mayfly Partnership has the following transactions for the current tax year. It has not recognized any net Section 1231 losses in the last five years.

- Gain of \$20,000 from the sale of land used in its business for the last five years
- Loss of \$8,000 on the sale of depreciable property used in its business for seven years
- \$3,000 loss when a car used in its business for the last 15 months was involved in a collision (the car was not insured)

Mayfly has asked you to identify the tax consequences of these transactions.

### SOLUTION

- Step 1.** First, we net all casualty and theft gains and losses on business property held for more than one year. The net gain or loss from the casualty in this case is the \$3,000 loss when the business vehicle was involved in a collision. That loss is treated as an ordinary loss.
- Step 2.** Next, we combine the net Section 1231 casualty and theft gain, if any, from step 1 with all other Section 1231 gains and losses recognized for the tax year. Mayfly has an \$8,000 Section 1231 loss and a \$20,000 Section 1231 gain. These net to a Section 1231 gain of \$12,000 (\$20,000 – \$8,000). This gain is treated as a long-term capital gain and is combined with Mayfly’s other capital gains and losses.
- Step 3.** The lookback rule does not apply because Mayfly has had no net Section 1231 losses in the last five years.

For these transactions, Mayfly has a \$3,000 ordinary loss and a \$12,000 long-term capital gain.

### EXAMPLE 1.4.1 Netting Section 1231 Gains and Losses



A net Section 1231 gain is netted with other capital gains and losses for the tax year, as shown in the next Example.

Assume the same facts as in Example 1.4.1 and note that Mayfly’s only other capital transaction for the year resulted in a \$7,000 net capital loss. Identify the tax consequences of these new circumstances.

### SOLUTION

Mayfly can net the \$7,000 capital loss with the \$12,000 long-term capital gain from the Solution to Example 1.4.1 to produce a net long-term capital gain of \$5,000.

### EXAMPLE 1.4.2 Net Section 1231 Gains



**Related exercise: Brief Exercise 8**

The next Example demonstrates how to apply the lookback rule in step 3. When applying the lookback rule, begin the analysis with the year that is five years in the past, and then work forward. If you begin with the year just prior, you are moving in the wrong direction chronologically and will not arrive at the proper result.

### EXAMPLE 1.4.3 Lookback Rule



Wasp LLC has had net Section 1231 gains and losses as follows since beginning its business in Year 1:

- \$10,000 loss in Year 1
- \$6,000 gain in Year 2
- \$20,000 loss in Year 3
- \$15,000 gain in Year 4

In Year 5, Wasp has a \$30,000 net Section 1231 gain. Identify the tax consequences of this gain in Year 5.

#### SOLUTION

The tax consequences of each of Wasp's gains and losses are as follows:

**Year 1:** Wasp has a net Section 1231 loss of \$10,000, which is an ordinary loss.

**Year 2:** Wasp has a net Section 1231 gain of \$6,000. Wasp looks back to Year 1, and because it has recognized net Section 1231 losses in the previous five years of at least \$6,000, the \$6,000 is taxed as ordinary income. Year 1 has \$4,000 of net Section 1231 losses remaining that can cause future Section 1231 gains to be ordinary income.

**Year 3:** Wasp has a net Section 1231 loss of \$20,000, which is an ordinary loss.

**Year 4:** Wasp has a net Section 1231 gain of \$15,000. Wasp looks back to Year 1, and the remaining \$4,000 of Section 1231 loss causes \$4,000 of the gain to be taxed as ordinary income. The remaining \$11,000 of gain (\$15,000 – \$4,000) is taxed as ordinary income because of the \$20,000 Section 1231 loss in Year 3. Year 3 has \$9,000 (\$20,000 – \$11,000) of net Section 1231 losses remaining that can cause future Section 1231 gains to be ordinary income.

**Year 5:** The first \$9,000 of Section 1231 gain in Year 5 is taxed as ordinary income due to the remaining Section 1231 loss in Year 3. The remaining \$21,000 (\$30,000 – \$9,000) is taxed as long-term capital gain.

The calculations are tabulated as follows:

	<u>Section 1231</u>	<u>Ordinary loss</u>	<u>Ordinary income</u>	<u>LTCG gain</u>
<b>Year 1</b>	\$10,000 loss	\$10,000		
<b>Year 2</b>	\$ 6,000 gain		\$ 6,000	
			Recharacterized \$6,000 loss from Year 1	
<b>Year 3</b>	\$20,000 loss	\$20,000		
<b>Year 4</b>	\$15,000 gain		\$15,000	
			Recharacterized \$4,000 loss from Year 1	
			Recharacterized \$11,000 loss from Year 3	
<b>Year 5</b>	\$30,000 gain		\$ 9,000	\$21,000
			Recharacterized \$9,000 loss from Year 3	

#### Potential Pitfall

Step 2 in Example 1.4.1 mentions that Mayfly has a \$20,000 Section 1231 gain for the sale of land. Would you be correct if you had classified this as a \$20,000 long-term capital gain? No, but this is a common mistake. When a Section 1231 asset is sold, the gain or loss from that transaction must be categorized as a Section 1231 gain or loss. The later characterization as ordinary loss or long-term capital gain does not happen until all Section 1231 gains and losses have been netted at the end of the year.

**Why** **Why does the lookback rule exist?** Assume a business that is managed by a sole proprietor owns two Section 1231 assets. Asset G has an unrealized gain of \$100,000, and Asset L has an unrealized loss of \$100,000. If the business sells both assets in the current year, the \$100,000 Section 1231 gain and \$100,000 Section 1231 loss will net to zero.

Alternatively, assume the following:

- Asset L is sold on December 31, Year 1, for a \$100,000 Section 1231 loss.
- Asset G is sold on January 1, Year 2, for a \$100,000 Section 1231 gain.
- The marginal tax rate for ordinary income is 37%.
- The marginal rate for long-term capital gains is 20%.

Year 1 would have a net Section 1231 loss of \$100,000, treated as an ordinary loss. Year 1 tax savings from the deduction would be \$37,000 ( $\$100,000 \times 37\%$ ). Year 2 would have a net Section 1231 gain of \$100,000, which would be treated as a long-term capital gain if there were no lookback rule. The tax due for this sale in Year 2 would be \$20,000 ( $\$100,000 \times 20\%$ ). For the two years combined, the entity would have positive cash flow from the tax results of \$17,000 ( $\$37,000 - \$20,000$ ), compared to no positive cash flow if the assets were sold in the same year. It is illogical for tax results to vary this much between two options, and for the law to reward taxpayers for selling their Section 1231 assets with losses in one year and those with gains in the next year.

The lookback rule exists to prevent this type of tax scheme. In Year 2, the lookback rule requires the business to treat the \$100,000 of Section 1231 gain as ordinary income, because it had net Section 1231 losses in the previous five years. The tax due on the gain will be \$37,000 ( $\$100,000 \times 37\%$ ), so the positive cash flow will be zero, just as if the business had sold the assets in the same year.

**Related exercises:** Multiple Choice Question 13  
Application Problems 14, 15, 16, 17, 18

### Tax Planning Tip

Even with the lookback rule, one planning opportunity exists for the timing of Section 1231 gains and losses. Taxpayers can sell their assets with Section 1231 gains in the year before selling the assets with Section 1231 losses. In the scenario above, what would be the results if the order of the sales were switched?

- Asset G is sold on December 31, Year 1, for a \$100,000 Section 1231 gain.
- Asset L is sold on January 1, Year 2, for a \$100,000 Section 1231 loss.

In Year 1, there would be a \$100,000 long-term capital gain, with a tax due of \$20,000, because there were no net Section 1231 losses in the preceding five years. In Year 2, the net Section 1231 loss will be an ordinary loss that results in \$37,000 of tax savings.

The reason this order provides a different tax result is that the lookback rule does not apply in Year 2, because it does not apply to net Section 1231 losses. To use this strategy again, the taxpayer must wait more than five years, because the net Section 1231 loss in Year 2 will convert future gains to ordinary income under the lookback rule for the next five years.

It's therefore a good idea to evaluate a business's Section 1231 transactions several weeks before year-end. If there is a net Section 1231 gain for the year, consider whether selling Section 1231 assets with losses before year-end is appropriate to reduce the net gain.

## Depreciation Recapture Rules

There are two sets of rules for depreciation recapture. Section 1245 recapture applies to personally used in a trade or business, and Section 1250 recapture applies to buildings. We begin with the Section 1245 recapture rules.

## Section 1245 Recapture

The character of the gain or loss from the sale of business assets will not always be Section 1231. Some of the gain will be taxed as ordinary income due to the depreciation recapture rules. Depreciation recapture applies to the sale of Section 1231 assets to potentially convert Section 1231 gain into ordinary income. Depreciation recapture is computed before Section 1231 gains and losses are netted, because recapture reduces the amount of Section 1231 gain. This section describes the depreciation recapture rules for Section 1245 assets—personalty used in a trade or business.

**Why** **Why does depreciation recapture exist?** Assume a solely owned S corporation purchases a machine for use in its business for \$1,000, and the depreciation expense in the first two years is \$300. The following steps illustrate the illogical tax consequences that would result *if there were no depreciation recapture*.

1. If the S corporation shareholder's tax bracket is 35%, the depreciation expense deduction saves taxes of \$105 ( $\$300 \times 35\%$ ).
2. The adjusted basis for the machine is \$700 ( $\$1,000 - \$300$ ).
3. The machine is a Section 1231 asset because it is used in a trade or business, and it has been owned for more than one tax year.
4. If the S corporation sells the machine for \$1,000, its gain is \$300.

Amount realized	\$1,000
<u>Less: Adjusted basis</u>	<u>(700)</u>
<u>Recognized gain</u>	<u>\$ 300</u>

5. *Tax result with no depreciation recapture.* Section 1231 gains have the potential to be taxed as long-term capital gains. If that was the case and the shareholder's long-term capital gain rate was 20%, the shareholder would owe taxes of \$60 on the gain ( $\$300 \times 20\%$ ).
6. The S corporation sold the asset for the same amount it paid for it, \$1,000. There was no change in the economic value of the asset. Yet there is a positive cash flow of \$45 when comparing the taxes saved from the depreciation (\$105) and the taxes owed on the gain (\$60). The \$45 arises because the depreciation expense reduces ordinary income, which is taxed at ordinary rates, while the gain created by the reduction in basis due to the depreciation expense is taxed at LTCG rates.

To prevent taxpayers from creating cash flow when assets do not change in value, Congress added Section 1245, which taxes the \$300 gain as ordinary income because it was created by the depreciation expense. Applying Section 1245, the \$300 gain is taxed at 35% and the taxes owed are \$105, the same amount of taxes saved by the depreciation expense.

**Defining Section 1245 Assets** **Section 1245 assets** include any tangible, depreciable, or amortizable property, other than land or buildings, that is used in a trade or business and that has been owned for more than one year. All Section 1231 assets (other than land and buildings) are Section 1245 assets, including:

- Certain livestock and crops
- Purchased patents
- Machinery and equipment
- Office furniture
- Business automobiles
- Assets used in rental real estate, such as a stove, refrigerator, and air conditioner

Section 1245 depreciation includes cost recovery, Section 179 immediate expensing, first-year bonus depreciation, and amortization of Section 197 intangibles. The recapture is the *lesser* of:

- the recognized gain, *or*
- all depreciation taken on the asset.

Gain in excess of the recaptured amount is treated as Section 1231 gain. Section 1245 recapture is taxed as ordinary income. The recapture rules do not apply to losses. So, if the asset is disposed of at a recognized loss, the loss is a Section 1231 loss, and no depreciation is recaptured.

**Related exercise: Discussion Question 21**

**Evaluating Section 1245 Depreciation Recapture** There are four steps to follow when determining Section 1245 depreciation recapture. **Illustration 1.10** provides a flow chart showing these steps. We assume that all realized gains are recognized in this section.

**Step 1. Calculate: The recognized gain or loss from the sale.** This amount can be determined as follows:

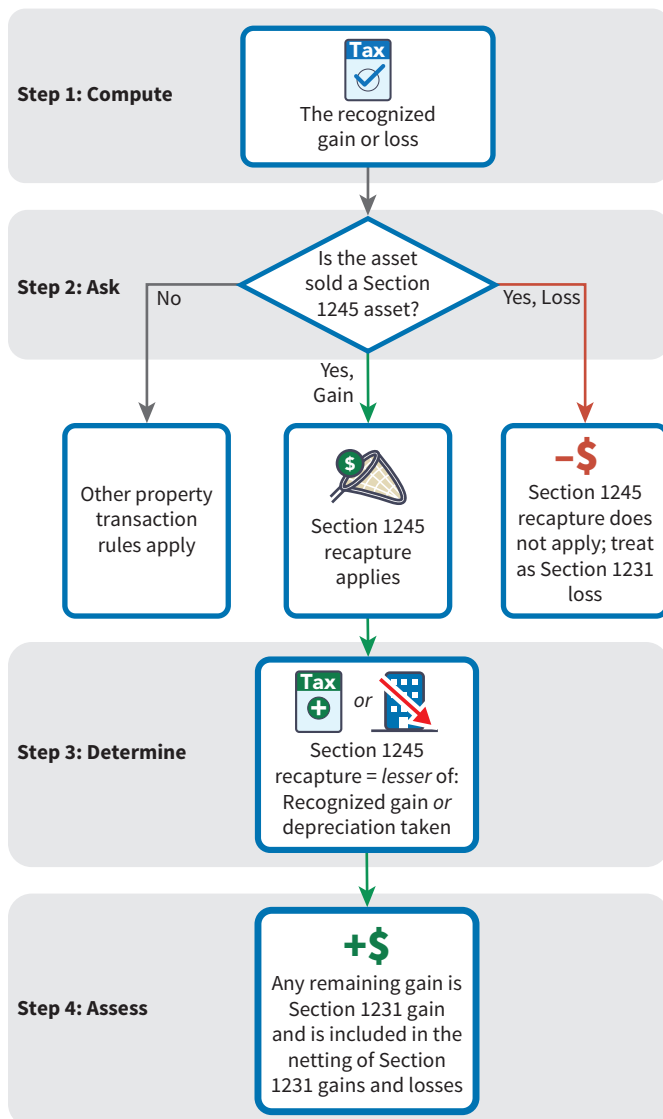
$$\begin{array}{l} \text{Amount realized} \\ \text{Less: Adjusted basis (Cost less accumulated depreciation)} \\ \hline \text{Recognized gain} \end{array}$$

Recapture applies only to recognized gains.

**Step 2. Ask: Is the asset sold a Section 1245 asset?** If the asset is a Section 1245 asset and was sold for a gain, the Section 1245 depreciation recapture rules apply. If the asset is a Section 1245 asset and was sold for a loss, Section 1245 depreciation

**ILLUSTRATION 1.10** The Four Steps for Determining Section 1245 Depreciation Recapture

### Section 1245 Depreciation Recapture



#### Potential Pitfall

Do not make the mistake of evaluating the lookback rule after step 4. At this point, you have computed the Section 1231 gain for one asset sale. The lookback rule is not used until all Section 1231 gains and losses are netted at the end of the tax year, and must be used if there is a net Section 1231 gain.

recapture does not apply, and the loss is treated as a Section 1231 loss. (If the asset sold is *not* a Section 1245 asset, then other transaction rules apply.)

**Step 3. Determine: The Section 1245 recapture**, which is the *lesser* of:

- the recognized gain, *or*
- all depreciation taken on the asset.

**Step 4. Assess: Any remaining Section 1231 gain.** Any remaining gain is considered a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year. The Section 1231 gain is included in the netting of all Section 1231 gains and losses at the end of the tax year.

The two following Examples explore different Section 1245 recapture situations.

### EXAMPLE 1.4.4 Section 1245 Recapture, All Gain Is Ordinary



Bee Partnership sells a machine that has been used in its business for six years with the following characteristics:

• Original cost	\$10,000
• Accumulated depreciation	\$ 7,000
• Sales price	\$ 4,500

Bee has asked you to advise on the amount and character of any gain or loss.

#### SOLUTION

To determine the amount and character of Bee's gain or loss, we will follow the steps outlined in Illustration 1.10.

**Step 1.** First, we calculate Bee's recognized gain or loss from the sale, as follows:

Amount realized	\$4,500
<u>Less: Adjusted basis</u>	<u>(3,000)</u> [Cost (\$10,000) less accumulated depreciation (\$7,000)]
<u>Recognized gain</u>	<u>\$1,500</u>

**Step 2.** Next, we need to determine whether the asset sold is a Section 1245 asset. A machine is not a building or land, so it is a Section 1245 asset.

**Step 3.** Now, we need to determine the Section 1245 depreciation recapture, which is the *lesser* of:

- the recognized gain (\$1,500), *or*
- all depreciation taken on the asset (\$7,000).

The recapture in this case is \$1,500.

**Step 4.** Finally, we need to determine what gain, if any, remains after the recapture. Any such remaining gain would be a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year. We can calculate this as follows:

Recognized gain	\$1,500
<u>Less: Section 1245 recapture</u>	<u>(1,500)</u>
<u>Section 1231 gain</u>	<u>\$ 0</u>

Thus, Bee has \$1,500 of ordinary income and no Section 1231 gain as a result of this transaction.

**Related exercises: Brief Exercise 9  
Application Problem 19  
Tax Planning Problem 2**

Assume the same facts as in Example 1.4.4, except that the asset is sold for \$11,000. What is the amount and character of any gain or loss now?

### SOLUTION

To determine the amount and character of Bee's gain or loss in this new scenario, we will again follow the steps outlined in Illustration 1.10.

**Step 1.** First, we calculate Bee's recognized gain or loss from the sale:

Amount realized	\$11,000
<u>Less: Adjusted basis</u>	<u>(3,000)</u> [Cost (\$10,000) less accumulated depreciation (\$7,000)]
<u>Recognized gain</u>	<u>\$ 8,000</u>

**Step 2.** We know from the previous example that the machine Bee sold is a Section 1245 asset.

**Step 3.** Next, we calculate the Section 1245 recapture, which is the *lesser* of:

- the recognized gain (\$8,000), *or*
- all depreciation taken on the asset (\$7,000).

In this new situation, the lesser amount is \$7,000, so this is the Section 1245 recapture.

**Step 4.** Finally, we need to determine what, if any, is the remaining Section 1231 gain.

Recognized gain	\$8,000
<u>Less: Section 1245 recapture</u>	<u>(7,000)</u>
<u>Section 1231 gain</u>	<u>\$1,000</u>

Thus, in this scenario, Bee has a Section 1231 gain of \$1,000, and ordinary income (from the Section 1245 recapture) of \$7,000.

### EXAMPLE 1.4.5 Section 1245 Recapture and Section 1231 Gain



### Tax Planning Tip

**In Example 1.4.5, the asset was purchased for \$10,000 and appreciated in value to \$11,000. The appreciation of \$1,000 is the amount that is taxed as Section 1231 gain. This demonstrates that, to the extent that the asset appreciates, the gain from the sale of the asset will be Section 1231 gain, and the remaining gain will be Section 1245 recapture, taxed as ordinary income. Congress allows Section 1231 gain preferential treatment to the extent that the asset increases in value. However, it is very rare that a Section 1245 asset ever appreciates in value after it is purchased. Thus, in most situations, all of the gain from the sale of Section 1245 assets is recaptured as ordinary income.**

The next Example illustrates that the recapture rules do not apply to losses.

Assume the same facts as in Example 1.4.4, except that the asset is sold for \$2,500. What is the amount and character of any gain or loss now?

### SOLUTION

To determine the amount and character of Bee's gain or loss in this new situation, we will again follow the steps outlined in Illustration 1.10.

**Step 1.** First, we calculate Bee's recognized gain or loss from the sale:

Amount realized	\$2,500
<u>Less: Adjusted basis</u>	<u>( 3,000)</u> [Cost (\$10,000) less accumulated depreciation (\$7,000)]
<u>Recognized loss</u>	<u>(\$ 500)</u>

### EXAMPLE 1.4.6 Section 1245 Asset Sold at a Loss



- Step 2.** We know from the previous example that the machine Bee sold is a Section 1245 asset.
- Step 3.** We do not need to calculate the Section 1245 recapture in this situation, because the Section 1245 recapture rules do not apply to losses.
- Step 4.** The \$500 recognized loss is thus a Section 1231 loss.

**Related exercises: Multiple Choice Questions 14, 15, 16  
Application Problem 20**

The Section 1245 recapture rules also apply to the amortization claimed on Section 197 intangible assets. The rules operate in the same manner as for tangible personal property, as you will see in the following Example.

### EXAMPLE 1.4.7 Section 197 Intangibles



Moth Corporation purchased the assets of LSU Corporation three years ago for \$2,000,000. As part of the acquisition, Moth acquired four trademarks and assigned \$200,000 of the purchase price to them. In the current year, Moth sells the trademarks for \$270,000. Total amortization claimed on the trademarks at the date of sale was \$40,000. Moth has asked you to calculate the tax consequences of this sale.

#### SOLUTION

To determine the tax consequences for Moth's sale, we will follow the steps outlined in Illustration 1.10.

**Step 1.** First, we calculate Moth's recognized gain or loss from the sale:

Amount realized	\$270,000
<u>Less: Adjusted basis</u>	<u>(160,000)</u> [Cost (\$200,000) less accumulated amortization (\$40,000)]
<u>Recognized gain</u>	<u>\$110,000</u>

**Step 2.** Next, we determine whether the asset sold is a Section 1245 asset. A trademark purchased as part of a business acquisition is a Section 1245 asset.

**Step 3.** Next, we calculate the Section 1245 recapture, which is the *lesser* of:

- the recognized gain (\$110,000), or
- all amortization taken on the asset (\$40,000).

The lesser amount in this case is \$40,000, so this is the Section 1245 recapture.

**Step 4.** Finally, we need to determine what, if any, is the remaining gain (which is a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year):

Recognized gain	\$110,000
<u>Less: Section 1245 recapture</u>	<u>( 40,000)</u>
<u>Section 1231 gain</u>	<u>\$ 70,000</u>

In this situation, Moth has \$40,000 of ordinary income and a Section 1231 gain of \$70,000.

**Related exercises: Discussion Question 22  
Application Problem 21**

## Section 1250 Recapture

Section 1250 recapture applies to only one type of asset—buildings. Whereas gain from the sale of Section 1245 property can be taxed at two different rates (ordinary income and LTCG), three types of gain (discussed below) can apply to the sale of Section 1250 property. The Section 1250 recapture rules are different for regular corporations than for individuals, partnerships, LLCs, and S corporations. We first review the rules for individuals, partnerships, LLCs, and S corporations, and then for corporations.

**Defining Section 1250 Assets** Section 1250 assets are defined as depreciable buildings used in a trade or business and owned for more than one year. When determining Section 1250 recapture, you use the *lesser* of:

- the recognized gain, or
- the *excess depreciation*.

**Excess depreciation** is the depreciation claimed in excess of the amount that would have been claimed under the straight-line depreciation method.

$$\begin{array}{r} \text{Depreciation claimed} \\ \text{Less: Straight-line depreciation} \\ \hline \text{Excess depreciation} \end{array}$$

IRC Section 1250 provides that excess depreciation is subject to being recaptured as ordinary income. The following rules also apply to Section 1250 gains and losses for individuals, partnerships, and S corporations:

- If the property is disposed of at a recognized loss, the loss is a Section 1231 loss. No depreciation is recaptured.
- Gain in excess of the recaptured amount is treated as either *unrecaptured Section 1250 gain* or Section 1231 gain. **Unrecaptured Section 1250 gain** is capital gain taxed at a maximum tax rate of 25% to the extent of accumulated straight-line depreciation claimed on the real estate. If the taxpayer's marginal tax rate for ordinary income is less than 25%, then the ordinary income rate is used.
- Section 1250 recapture also applies to rental real estate, because rental buildings are depreciable.

**Related exercises:** Discussion Questions 23, 24

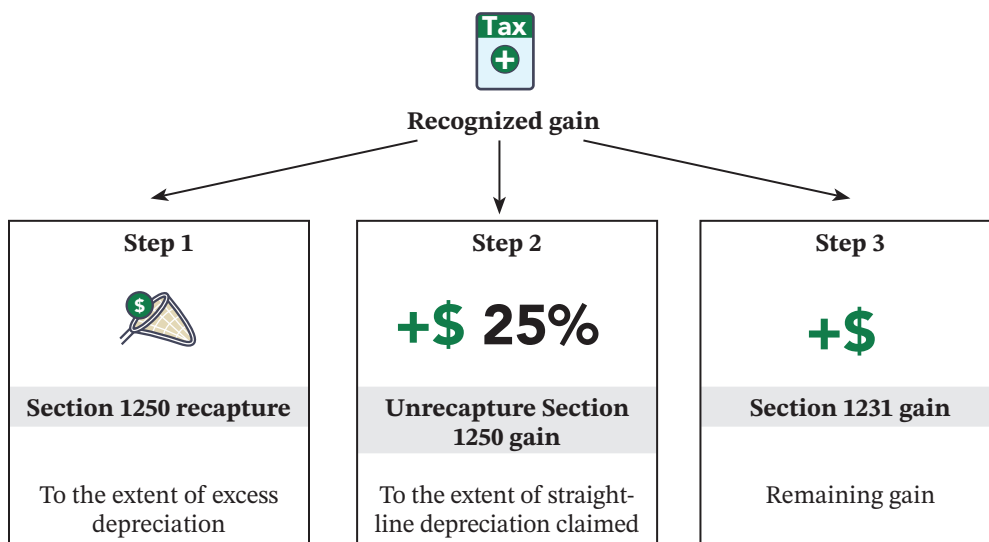
**Illustration 1.11** summarizes the three types of gain an individual, partnership, or S corporation can have when a building that is a Section 1231 asset is sold, and the gain is allocated to these categories in the order shown:

**Step 1:** Section 1250 recapture

**Step 2:** Unrecaptured Section 1250 gain

**Step 3:** Section 1231 gain

**ILLUSTRATION 1.11** Types of Gain from Sale of a Building—Individuals, Partnerships, and S Corporations



#### Potential Pitfall

For Section 1245 assets, all depreciation claimed is subject to being recaptured. For Section 1250 assets, only excess depreciation has the potential to be taxed as ordinary income. Be careful not to confuse these rules.

**Tax Planning Tip**

The only situation for which you may have Section 1250 recapture is for buildings placed in service before 1987. If a building is depreciated using straight-line depreciation, there will be no Section 1250 recapture because there is no excess depreciation. Accelerated depreciation is not available for buildings placed in service after 1986.

**Evaluating Section 1250 Depreciation Recapture—Individuals, Partnerships, and S Corporations** There are six steps to follow when determining Section 1250 depreciation recapture for individuals, partnerships, and S corporations. **Illustration 1.12** provides a flow chart showing these steps.

**Step 1. Calculate: The recognized gain or loss from the sale.** This can be determined as follows:

$$\begin{array}{r} \text{Amount realized} \\ \text{Less: Adjusted basis (Cost less accumulated depreciation)} \\ \hline \text{Recognized gain} \end{array}$$

**Step 2. Ask: Is the asset sold a Section 1250 asset? If YES, then proceed to step 3. Otherwise, different property transaction rules apply.**

**Step 3. Calculate: Excess depreciation.** This can be determined as follows:

$$\begin{array}{r} \text{Depreciation claimed} \\ \text{Less: Straight-line depreciation} \\ \hline \text{Excess depreciation} \end{array}$$

**Step 4. Determine: The Section 1250 recapture,** which is the *lesser* of:

- the recognized gain, *or*
- the excess depreciation.

**Step 5. Calculate: The gain remaining after step 4 is taxed as unrecaptured Section 1250 gain up to the amount of straight-line depreciation claimed.** Unrecaptured Section 1250 gain, limited to the taxpayer's net capital gain as reported on Form 1040, Schedule D, is taxed at the *lower* of the taxpayer's ordinary income tax rate or 25%.

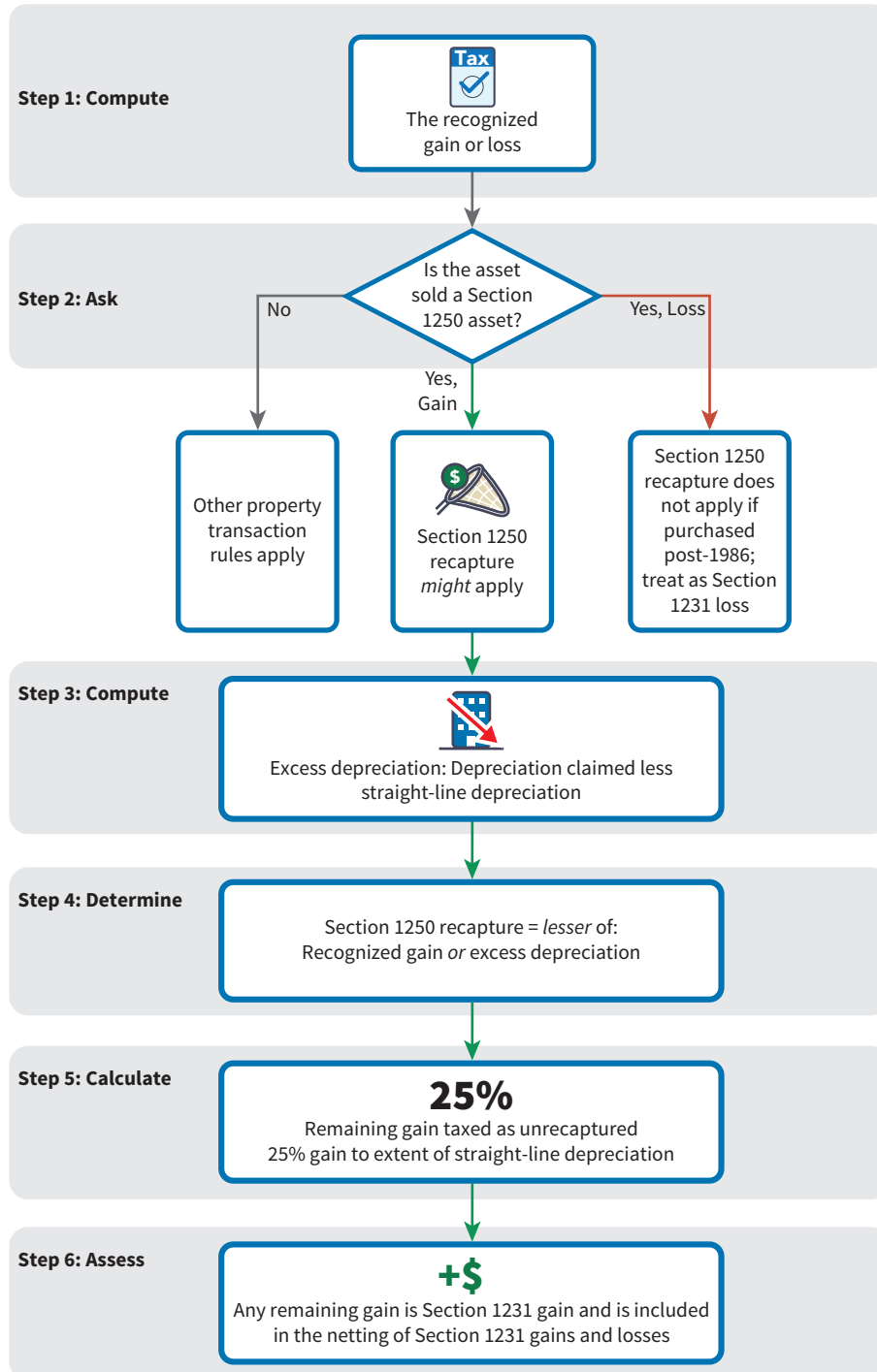
**Step 6. Assess: Any remaining Section 1231 gain.** Any remaining gain is considered Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year.

$$\begin{array}{r} \text{Recognized gain} \\ \text{Less: Section 1250 recapture} \\ \text{Less: Unrecaptured Section 1250 gain} \\ \hline \text{Section 1231 gain} \end{array}$$

The Section 1231 gain is included in the netting of all Section 1231 gains and losses at the end of the tax year.

**ILLUSTRATION 1.12** The Six Steps in Determining Section 1250 Depreciation Recapture—Individuals, Partnerships, and S Corporations

### Section 1250 Depreciation Recapture—Individuals, Partnerships, and S Corporations



The two following Examples explore different Section 1250 depreciation scenarios.

## EXAMPLE 1.4.8

### Sale of a Building—Straight-Line Depreciation



Scorpion LLC sells a building that it has used in its business for the last 10 years. Scorpion's cost for the building was \$500,000, and accumulated straight-line depreciation is \$170,000. Scorpion sells the building for \$600,000 in the current year. Assuming Scorpion has no sales of capital assets this year, compute the recognized gain or loss from this sale and determine its character.

#### SOLUTION

To determine the tax consequences for Scorpion's disposition, we will follow the steps outlined in Illustration 1.12.

**Step 1.** First, we calculate the recognized gain or loss from the disposition:

Amount realized	\$600,000
<u>Less: Adjusted basis</u>	<u>(330,000)</u> [Cost (\$500,000) less accumulated depreciation (\$170,000)]
<u>Recognized gain</u>	<u>\$270,000</u>

**Step 2.** Next, we determine if the asset sold is a Section 1250 asset. Scorpion sold a depreciable building held for more than one year, so this is a Section 1250 asset.

**Step 3.** Now we calculate any excess depreciation, as follows:

Depreciation claimed	\$170,000
<u>Less: Straight-line depreciation</u>	<u>(170,000)</u>
<u>Excess depreciation</u>	<u>\$ 0</u>

**Step 4.** Next, we determine the Section 1250 recapture, which is the *lesser* of:

- the recognized gain (\$270,000), or
- the excess depreciation (\$0).

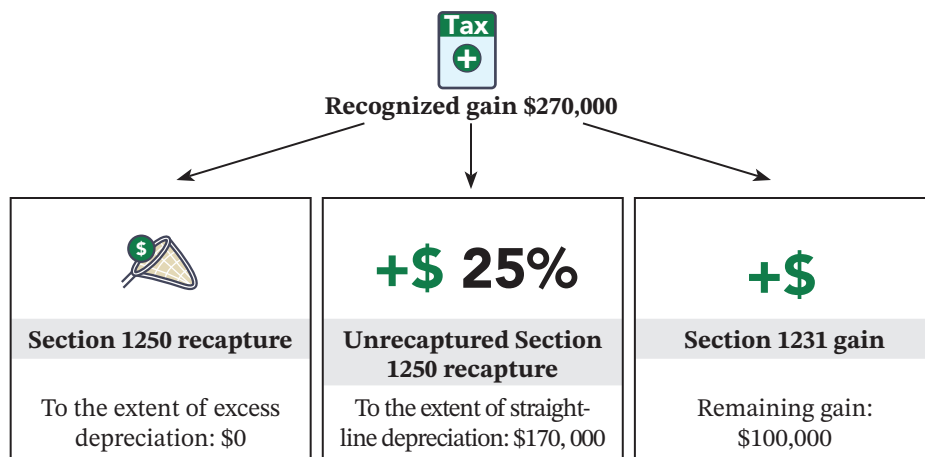
The lesser amount is \$0, so this is the Section 1250 recapture.

**Step 5.** The remaining gain is next taxed as unrecaptured Section 1250 gain, up to the amount of straight-line depreciation claimed. Thus, \$170,000 of the gain is taxed as unrecaptured Section 1250 gain at the *lower* of Scorpion's ordinary income rate or 25%.

**Step 6.** Finally, whatever gain from the disposition that remains (if any) is considered a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year. It can be calculated as follows:

Recognized gain	\$270,000
<u>Less: Section 1250 recapture</u>	<u>(0)</u>
<u>Less: Unrecaptured Section 1250 gain</u>	<u>(170,000)</u>
<u>Section 1231 gain</u>	<u>\$100,000</u>

The tax consequences of the disposition are summarized in the diagram below:



In 1979, Thrips Company, an S corporation, purchased a building at a cost of \$1,000,000 and elected to depreciate it using the 150% declining balance method with a useful life of 50 years. This year, Thrips sells the building for \$2,400,000. Accumulated depreciation at the time of sale was \$890,000. Straight-line depreciation would have been \$800,000. Compute the recognized gain or loss from this sale and determine its character.

## EXAMPLE 1.4.9 Sale of a Building—Accelerated Depreciation



### SOLUTION

To determine the tax consequences of Thrips's sale of the building, we will follow the steps outlined in Illustration 1.12.

**Step 1.** First, we'll calculate the recognized gain or loss from the sale, as follows:

Amount realized	\$2,400,000
<u>Less: Adjusted basis</u> (110,000) [Cost (\$1,000,000) less accumulated depreciation (\$890,000)]	
<u>Recognized gain</u>	<u>\$2,290,000</u>

**Step 2.** Next, we determine whether the asset sold is a Section 1250 asset. Thrips sold a depreciable building owned for more than one year, so this is a Section 1250 asset.

**Step 3.** Next, we calculate any excess depreciation:

Depreciation claimed	\$890,000
<u>Less: Straight-line depreciation</u>	<u>(800,000)</u>
<u>Excess depreciation</u>	<u>\$ 90,000</u>

**Step 4.** Next, we determine the Section 1250 recapture, which is the *lesser* of:

- the recognized gain (\$2,290,000), or
- the excess depreciation (\$90,000).

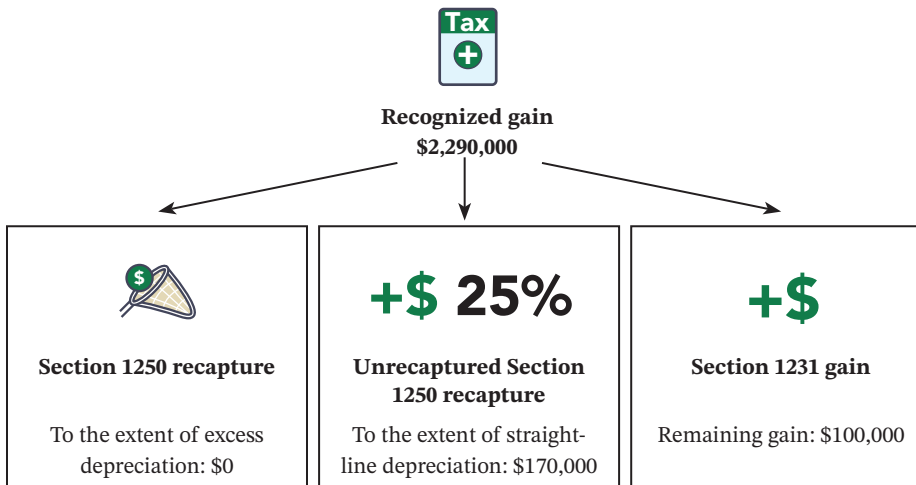
The lesser amount is \$90,000, so this is the Section 1250 recapture.

**Step 5.** The remaining gain is next taxed as unrecaptured Section 1250 gain, up to the amount of straight-line depreciation claimed. So \$800,000 of the gain is taxed as unrecaptured Section 1250 gain at the lower of Thrips's ordinary income rate or 25%.

**Step 6.** Finally, whatever gain from the sale that remains (if any) is considered a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year. This can be calculated as follows:

Recognized gain	\$2,290,000
<u>Less: Section 1250 recapture</u>	<u>( 90,000)</u>
<u>Less: Unrecaptured Section 1250 gain</u>	<u>( 800,000)</u>
<u>Section 1231 gain</u>	<u>\$1,400,000</u>

The tax consequences of the disposition are summarized in the diagram below:



Just as with Section 1245 assets, to the extent that the asset appreciates [\$1,400,000 for Thrrips in Example 1.4.9 (\$2,400,000 – \$1,000,000)], the gain will be Section 1231 gain, and the remaining gain will be Section 1250 recapture or unrecaptured Section 1250 gain.

**Related exercises:** Multiple Choice Questions 17, 18  
Application Problem 23  
Tax Planning Problem 4

### Tax Planning Tip

**In contrast to the case for Section 1245 assets, when Section 1250 assets are sold, some of the gain is often taxed as Section 1231 gain. Whereas personal property rarely appreciates in value from its original cost, real property values tend to increase over time. Therefore, with Section 1250, most, if not all, of the gain is taxed either as unrecaptured Section 1250 gain or as Section 1231 gain. It is unusual that any of the gain is taxed as ordinary income, because the only situation for which you may have Section 1250 recapture is for buildings placed in service before 1987.**

**Evaluating Section 1250 Depreciation Recapture—Corporations** For Section 1250 property (buildings) for corporations, the accumulated depreciation claimed in excess of straight-line depreciation is subject to being recaptured as ordinary income, just as with individuals, partnerships, and S corporations. However, the unrecaptured Section 1250 gain rule does *not* apply for corporations. Instead, **Section 291 depreciation recapture** applies and is computed by assuming the property is actually Section 1245 property, as follows:

Section 1245 recapture IF the property had been Section 1245 property  
Less: Actual Section 1250 recapture  
Excess amount  
× 20%  
Section 291 recapture

Section 291 recapture for C corporations is in addition to Section 1250 recapture and does not take the place of Section 1250 recapture. Step 5 of the evaluation for determining Section 1250 recapture is thus changed as follows for corporations.

**Step 5. Calculate:** The remaining gain is next taxed as Section 291 recapture and is treated as ordinary income, in addition to any Section 1250 recapture.

### EXAMPLE 1.4.10 Sale of a Building— Corporations



Continue with the facts of Example 1.4.8 except that Scorpion is a corporation. Scorpion sells a building that it has used in its business for the last 10 years. Scorpion's cost for the building was \$500,000, and accumulated straight-line depreciation is \$170,000. Scorpion sells the building for \$600,000 in the current year. Assuming Scorpion has no sales of capital assets this year, compute the recognized gain or loss from this sale and determine its character.

### SOLUTION

To determine the tax consequences for Scorpion's disposition, we will follow the steps outlined in Illustration 1.12. Steps 1–4 are the same as in Example 1.4.8.

**Step 1.** First, we calculate the recognized gain or loss from the disposition:

Amount realized	\$600,000
<u>Less: Adjusted basis</u>	<u>(330,000) [Cost (\$500,000) less accumulated depreciation (\$170,000)]</u>
<u>Recognized gain</u>	<u>\$270,000</u>

**Step 2.** Next, we determine if the asset sold is a Section 1250 asset. Scorpion sold a depreciable building held for more than one year, so this is a Section 1250 asset.

**Step 3.** Now, we calculate any excess depreciation, as follows:

Depreciation claimed	\$170,000
<u>Less: Straight-line depreciation</u>	<u>(170,000)</u>
<u>Excess depreciation</u>	<u>\$ 0</u>

**Step 4.** Next, we determine the Section 1250 recapture, which is the *lesser* of:

- the recognized gain (\$270,000), or
- the excess depreciation (\$0).

The lesser amount is \$0, so this is the Section 1250 recapture.

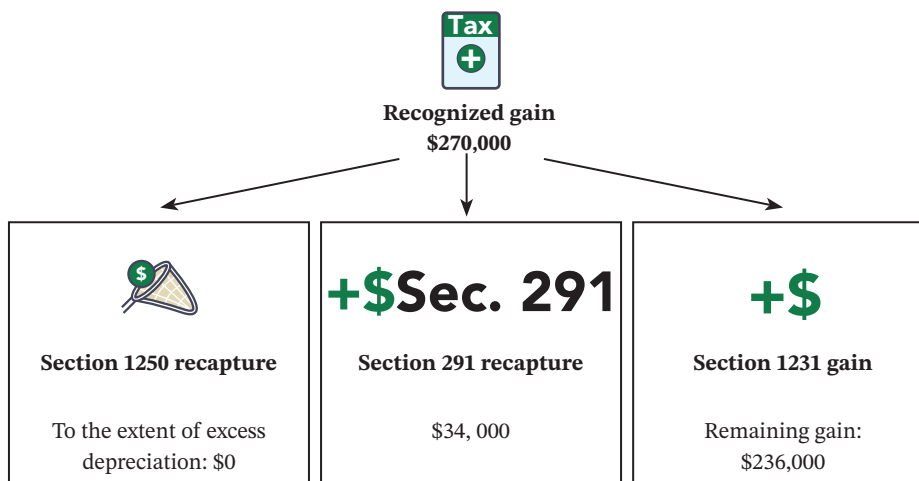
**Step 5.** The remaining gain is next taxed as Section 291 recapture and is treated as ordinary income, in addition to any Section 1250 recapture. If the building had been Section 1245 property, the Section 1245 recapture would have been \$170,000, which is the lower of the depreciation claimed of \$170,000 or the recognized gain of \$270,000. The Section 291 recapture is computed as follows:

Section 1245 recapture IF the property had been Section 1245 property	\$170,000
<u>Less: Actual Section 1250 recapture</u>	<u>0</u>
Excess amount	\$170,000
× 20%	× 20%
<u>Section 291 recapture</u>	<u>\$ 34,000</u>

**Step 6.** Finally, whatever gain from the disposition that remains (if any) is considered a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year. It can be calculated as follows:

Recognized gain	\$270,000
<u>Less: Section 1250 recapture</u>	<u>(0)</u>
<u>Less: Section 291 recapture</u>	<u>(34,000)</u>
<u>Section 1231 gain</u>	<u>\$236,000</u>

The tax consequences of the disposition are summarized in the diagram below:



## Reporting Sales of Business Assets: Form 4797

Business assets that a taxpayer sells or disposes of are reported on Form 4797, Sale of Business Property. The items discussed in this chapter are reported as follows.

- Part I reports Section 1231 gains and losses. For the gain or loss from the sale to be included in Part I, the business asset must have been held for more than one year when sold.
- If the business asset sold was *not* held for more than one year, then the gain or loss is reported in Part II. Part II reports ordinary income and loss from the sale of these assets. Part II also reports the recapture from Section 1245 and Section 1250 assets.
- Section 1245 and Section 1250 assets held for more than one year and sold at a gain are initially reported in Part III on page 2 of Form 4797. The depreciation recapture is reported as ordinary income and is transferred from Part III, Line 31 and included on Part II, Line 13 as ordinary income. The amount of gain taxed as Section 1231 gain is transferred from Part III, Line 32 to Part I, Line 6.
- Section 1245 and Section 1250 assets sold at a loss are reported in Part I if held for more than one year, and in Part II otherwise.
- Unrecaptured Section 1250 gain is reported on Form 1040, Schedule D, Part III, Line 19.

These reporting rules are summarized in **Illustration 1.13**.

**ILLUSTRATION 1.13** Where to Make First Entry on Form 4797 for Certain Business Gains and Losses

	Held one year or less	Held more than one year
<b>Section 1245 and Section 1250 property:</b>		
Sold at a gain	Part II	Part III
Sold at a loss	Part II	Part I
<b>Land:</b>		
Sold at a gain	Part II	Part I
Sold at a loss	Part II	Part I

**Related exercise: Discussion Question 25**

## Dispositions That Do Not Trigger Depreciation Recapture

There are some transactions for which, if there is a sale or disposition of Section 1250 property, the recapture rules do *not* apply. Section 1245 also does not apply to these transactions. In some of these cases, the depreciation recapture potential stays with the property and carries over to the new owner. Examples of such transactions include:

- **Gifts:** recapture potential carries over to the donee
- **Death:** recapture potential is eliminated (does not carry over to the one who inherits the property)
- **Charitable transfers:** recapture potential reduces charitable contribution deduction
- **Certain tax-free exchanges, such as like-kind exchanges and involuntary conversions:** recapture potential carries over to the new owner with the property received in the exchange

**Related exercises: Discussion Question 26**

**Brief Exercise 10**

**Application Problem 25**

**Tax Planning Problem 5**

Pepe sold several assets used in his boat manufacturing business, operated as Pepe Inc., an S corporation. S corporations are flow-through entities, and the shareholders report their share of income and loss items on their tax returns, Pepe is the sole owner of Pepe Inc. Its total gains and losses are:

- Section 1231 gains \$5,200
- Section 1231 losses \$7,000

Pepe Inc. also sold stock at a loss of \$3,500. What are the tax effects of these transactions?

## PRACTICE PROBLEM 1.4.1

### Determining Net Section 1231 Gains and Losses

#### SOLUTION

Pepe Inc. has a net Section 1231 loss of \$1,800 (\$5,200 gains – \$7,000 losses). Net Section 1231 losses are treated as ordinary losses and are fully deductible against other items of income on Pepe's individual tax return as a separately stated flow-through item. The \$3,500 stock sale loss is a capital loss because the stock is a capital asset to Pepe Inc. The \$3,500 loss will be reported on Pepe's individual tax return as a separately stated flow-through item. Individual taxpayers are limited to a capital loss deduction of \$3,000. Pepe will have a capital loss carryforward of \$500.

SEJ Inc. has been operating as a C corporation since Year 1. SEJ has reported the following:

- Year 1:** No Section 1231 gains or losses
- Year 2:** \$4,500 net Section 1231 gain
- Year 3:** \$8,000 net Section 1231 loss
- Year 4:** \$2,500 net Section 1231 loss
- Year 5:** \$6,000 net Section 1231 gain

In Year 6, SEJ has a net Section 1231 gain of \$9,500. How should this gain be taxed to SEJ?

## PRACTICE PROBLEM 1.4.2

### Applying the Lookback Rule

#### SOLUTION

We need to use the lookback rule for this problem to determine how SEJ's gain in Year 6 would be taxed:

- Year 2:** \$4,500 net Section 1231 gain—treated as a long-term capital gain
- Year 3:** \$8,000 net Section 1231 loss—treated as an ordinary loss
- Year 4:** \$2,500 net Section 1231 loss—treated as an ordinary loss
- Year 5:** \$6,000 net Section 1231 gain—treated as an ordinary gain, due to the \$8,000 ordinary loss in Year 3. \$2,000 of the loss from Year 3 (\$8,000 – \$6,000) remains available to recharacterize net Section 1231 gains for future years.
- Year 6:** \$9,500 net Section 1231 gain—treated as an ordinary gain of \$4,500 and a long-term capital gain of \$5,000. Year 3 has \$2,000 of ordinary losses remaining, and Year 4 has a \$2,500 loss. The \$4,500 combined from Year 3 and Year 4 will be used to partially recharacterize the Year 6 Section 1231 gain.

	Net Section 1231	Ordinary loss	Ordinary income	LT CG gain
<b>Year 2:</b>	\$4,500 gain			\$4,500
<b>Year 3:</b>	\$8,000 loss	\$8,000		
<b>Year 4:</b>	\$2,500 loss	\$2,500		
<b>Year 5:</b>	\$6,000 gain		\$6,000	
			Recharacterized \$6,000 loss from Year 3	
<b>Year 6:</b>	\$9,500 gain		\$4,500	\$5,000
			Recharacterized \$2,000 loss from Year 3	
			Recharacterized \$2,500 loss from Year 4	

## PRACTICE PROBLEM 1.4.3

### Sale of Tangible Business-Use Asset

Amara LLC has been a CPA firm since Year 1. In Year 6, Amara sells the office furniture for \$10,000. It purchased the office furniture in Year 1 for \$15,000 and has taken depreciation expense of \$12,000. What is Amara's gain and its character?

#### SOLUTION

Following the steps outlined in Illustration 1.10 results in the following:

Amount realized	\$10,000
<u>Less: Adjusted basis</u>	<u>( 3,000)</u> [Cost (\$15,000) – Accumulated depreciation (\$12,000)]
<u>Recognized gain</u>	<u>\$ 7,000</u>

Office furniture is a Section 1245 asset. Section 1245 recapture is the *lesser* of:

Recognized gain	\$ 7,000
Accumulated depreciation	\$12,000

Thus, all the recognized gain of \$7,000 is taxed as ordinary income.

## PRACTICE PROBLEM 1.4.4

### Sale of Realty by a Partnership

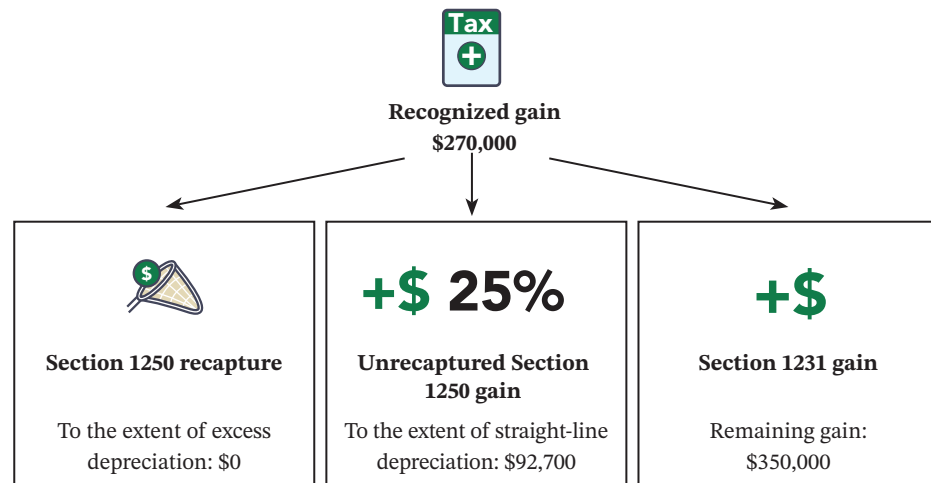
Cayton is a 70% partner in a partnership that owns a two-flat rental apartment building in Wrigleyville, Chicago, which it is selling for \$1,200,000 in Year 7. The partnership purchased the building in Year 5 for \$850,000 and has taken straight-line depreciation of \$92,700. What is the partnership's gain and its character? How much of the gain flows to Cayton?

#### SOLUTION

We first calculate the recognized gain from the sale:

Amount realized	\$1,200,000
<u>Less: Adjusted basis</u>	<u>( 757,300)</u> [Cost (\$850,000) – Accumulated depreciation (\$92,700)]
<u>Recognized gain</u>	<u>\$ 442,700</u>

Because straight-line depreciation was taken on the building, there is no Section 1250 recapture. The unrecaptured Section 1250 gain of \$92,700 is taxed at a maximum rate of 25%. The remaining \$350,000 gain is a Section 1231 gain.



Cayton's share of these gains is 70%: \$64,900 ( $\$92,700 \times 70\%$ ) 25% gain and \$245,000 ( $\$350,000 \times 70\%$ ) Section 1231 gain.

French Corporation purchased a strip mall on March 9, 2022, for \$360,000 and sold the building on November 28, 2025, for \$520,000. French deducted straight-line depreciation of \$33,856 for years 2022–2025. Determine the recognized gain and its character.

## PRACTICE PROBLEM 1.4.5

### Sale of Realty by a Corporation

#### SOLUTION

Following the steps outlined in Illustration 1.12 results in the following:

**Step 1.** First, we calculate the recognized gain or loss from the disposition:

Amount realized	\$520,000
<u>Less: Adjusted basis</u>	<u>( 326,144)</u> (\$360,000 – \$33,856)
<u>Recognized gain</u>	<u>\$193,856</u>

**Step 2.** Next, we determine if the asset sold is a Section 1250 asset. French sold a depreciable building held for more than one year, so this is a Section 1250 asset.

**Step 3.** Now, we calculate any excess depreciation, as follows:

Depreciation claimed	\$33,856
<u>Less: Straight-line depreciation</u>	<u>(33,856)</u>
<u>Excess depreciation</u>	<u>\$ 0</u>

**Step 4.** Next, we determine the Section 1250 recapture, which is the *lesser* of:

- the recognized gain (\$193,856), or
- the excess depreciation (\$0).

The lesser amount is \$0, so this is the Section 1250 recapture.

**Step 5.** The remaining gain is next taxed as Section 291 recapture and is treated as ordinary income, in addition to any Section 1250 recapture. If the building was Section 1245 property, the Section 1245 recapture would be \$33,856, which is the lower of the depreciation claimed of \$33,856 or the recognized gain of \$193,856. The Section 291 recapture is computed as follows:

Section 1245 recapture IF the property had been Section 1245 property	\$33,856
<u>Less: Actual Section 1250 recapture</u>	<u>0</u>
Excess amount	\$33,856
<u>× 20%</u>	<u>× 20%</u>
<u>Section 291 recapture</u>	<u>\$ 6,771</u>

**Step 6.** Finally, whatever gain from the disposition that remains (if any) is considered a Section 1231 gain, because the asset was used in a trade or business and was owned for more than a year. It can be calculated as follows:

Recognized gain	\$193,856
<u>Less: Section 1250 recapture</u>	<u>( 0)</u>
<u>Less: Section 291 recapture</u>	<u>( 6,771)</u>
<u>Section 1231 gain</u>	<u>\$187,085</u>

# 1.5 Review of Qualified Business Income Deduction

## LEARNING OBJECTIVE 5

Compute the qualified business income deduction.

Taxpayers can take advantage of the **qualified business income (QBI) deduction**, which is computed as 20% of the taxpayer's income from flow-through entities (partnerships, limited liability companies, and S corporations) and sole proprietorships. To qualify for the QBI deduction, the taxpayer must generally conduct business activity in the United States.<sup>14</sup>

**Why** **Why did Congress create the QBI deduction?** Congress created the QBI deduction for tax years after 2017 at the same time it changed the corporate income tax rate to a flat rate of 21%. The highest marginal income tax rate for individuals is 37%, meaning that income from sole proprietorships and flow-through entities taxed on individual returns could be taxed at 37%. On the other hand, business income generated by corporations is now taxed at 21%. This differential of 37% versus 21% seemed inequitable, so Congress created the QBI deduction. If a taxpayer is eligible for the QBI deduction, then only 80% of business income from sole proprietorships and flow-through entities is taxed on individual returns. This lowers the highest marginal tax rate on this income from 37% to 29.6%, reducing the disparity between this effective rate and the corporate rate of 21%.

It is important to note that the QBI deduction is not a deduction for adjusted gross income (AGI), nor is it an itemized deduction. Rather, the tax law provides that the QBI deduction is taken *from* adjusted gross income.

**Related exercise: Multiple Choice Question 20**

## Qualified Business Income

QBI must be derived from a “qualified business,” which includes businesses conducted as sole proprietorships and flow-through income from partnerships, limited liability companies, and S corporations. It does *not* include performance of services by an employee, guaranteed payments to a partner, investment income, or payments made to a partner in a capacity other than serving as a partner. It also does not include reasonable compensation paid to an owner or income earned in foreign countries. **Illustration 1.14** summarizes the types of income that qualify for this deduction.

**Related exercise: Multiple Choice Question 21**

**ILLUSTRATION 1.14** Definition of Qualified Business Income

Qualified business income includes:	Qualified business income does <i>not</i> include:
Sole proprietorship income	Capital gains and capital losses
Partnership ordinary business income	Dividends
S corporation ordinary business income	Interest income
Rental real estate income if certain conditions are met	Certain other investment items
	Compensation earned by an employee or an owner
	Guaranteed payments made to a partner for services rendered

<sup>14</sup>IRC §199A.

## Rental Real Estate

Income from rental real estate activities qualifies for the QBI deduction if the rental activity is a trade or business. We assume the activity is a trade or business if individuals complete at least 250 hours of service activities related to the rental real estate activity each year. Owners do not have to complete the rental services themselves; the 250 hours includes services completed by employees and contractors.<sup>15</sup>

Services included in the 250 hours are:

- Advertising to rent the real estate
- Negotiating and executing leases
- Verifying information in prospective tenant applications
- Collecting rent
- Conducting daily operation, maintenance, and repair
- Managing the real estate
- Purchasing materials
- Supervising employees and contractors

Services *not* included in the 250 hours are:

- Conducting financial or investment management activities
- Studying and reviewing financial statements
- Planning, managing, or constructing long-term capital improvements
- Traveling to and from the real estate

## Determining the Qualified Business Income Deduction (Steps 1–5)

We will use **Illustration 1.15** to facilitate your understanding of how to compute the QBI deduction. As you can see in the illustration, there are three limitations that can reduce the QBI deduction. The limitations apply differently depending on whether the taxpayer's modified taxable income places them in Column 1, 2, or 3. Once you identify the proper column for a taxpayer, you will know which limitations apply.

**ILLUSTRATION 1.15** QBI Limitations for Married Filing Jointly (MFJ), Married Filing Separately (MFS), and Other Filers (2025)

	COLUMN 1	COLUMN 2	COLUMN 3
	2025 Modified taxable income	2025 Modified taxable income	2025 Modified taxable income
<b>Filing status</b>	MFJ: ≤ \$394,600 MFS: ≤ \$197,300 Other: ≤ \$197,300	MFJ: > \$394,600 and < \$494,600 MFS: > \$197,300 and < \$247,300 Other: > \$197,300 and < \$247,300	MFJ: ≥ \$494,600 MFS: ≥ \$247,300 Other: ≥ \$247,300
<b>Wage/property limitation</b>	Limitations does not apply	Limitations phased in; partially applies	Wage limitation fully phased in
<b>Specified services limitation</b>	Limitations does not apply; QBI deduction allowed	QBI deduction partially allowed	QBI deduction not allowed
<b>20% of Taxable income limitation applies?</b>	Yes	Yes	Yes

<sup>15</sup>Rev. Proc. 2019-38, 2019-42 IRB 942.

There are eight steps in determining the qualified business income deduction. The first five steps are as follows:

**Step 1. Compute: The qualified business income.** In general, the QBI is the owner's share of the net income from a business. To compute the qualified business income, you must first reduce the activity's taxable income by each of the following:

- 50% of the self-employment tax
- The self-employed health insurance deduction
- Any retirement plan contributions based on this income<sup>16</sup>

**Related exercises: Brief Exercise 11  
Application Problem 26**

**Step 2. Calculate: The QBI deduction.** To calculate the QBI deduction before any limitations, the computation is:

$$\text{QBI} \times 20\% = \text{QBI deduction}$$

**Step 3. Calculate: The taxpayer's modified taxable income.** The taxpayer's **modified taxable income (MTI)** is taxable income *before* the QBI deduction.

**Step 4. Ask: Is the trade or business a specified service trade or business?** If the answer is NO, then you can proceed to step 6. If the answer is YES, then whether the QBI deduction is limited will be determined in step 5. The business is a **specified service trade or business** if the owners perform services in the fields of:

- |  |  |
|--|--|
| <ul style="list-style-type: none"> <li>• health</li> <li>• law</li> <li>• accounting</li> <li>• actuarial sciences</li> <li>• performing arts</li> <li>• consulting</li> </ul> | <ul style="list-style-type: none"> <li>• athletics</li> <li>• financial services</li> <li>• brokerage services</li> <li>• any business where the principal asset is the reputation of an employee or owner.</li> </ul> |
|--|--|

**Illustration 1.16** summarizes the types of businesses Congress included as specified services.

**Related exercises: Discussion Question 27  
Multiple Choice Question 22**

### Potential Pitfall

The tax law usually affords architects and engineers the tax provisions that apply to those performing professional services. However, Congress did not include services performed by architects and engineers as a specified service trade or business, so architects and engineers are not subject to the same limitations on their QBI deduction as the professions listed.

### ILLUSTRATION 1.16 Specified Service Trades or Businesses

Specified service trades or businesses include any trade or business whose principal asset is the reputation of one or more of its employees or owners:

Health	Law	Accounting
Actuarial science	Performing arts	Consulting
Athletics	Financial services*	Brokerage services*

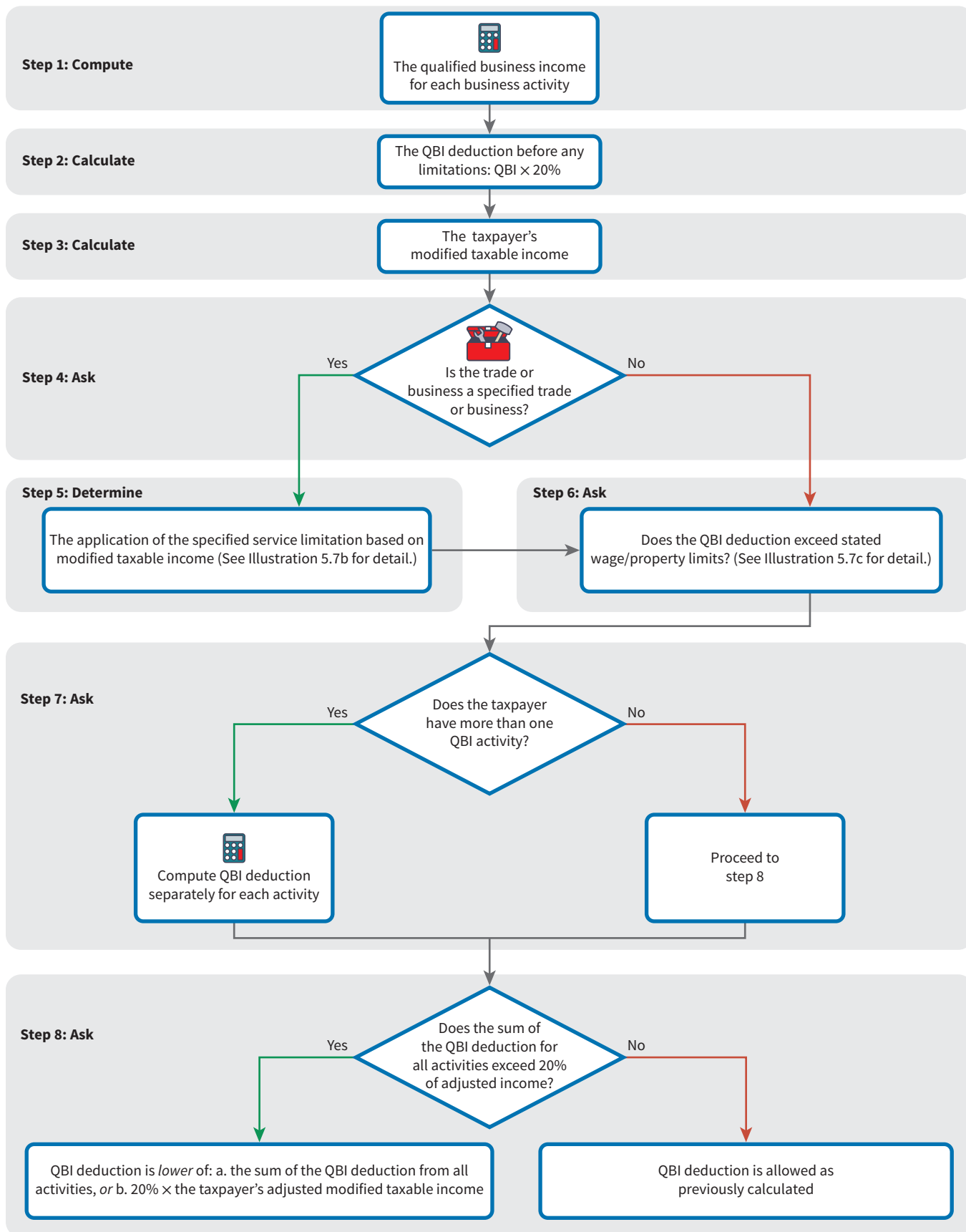
\*Financial service and brokerage services include and investment management and trading or dealing in securities, partnerships interests, or commodities.

**Illustration 1.17a** provides a flowchart for all eight steps used to determine the QBI deduction, while **Illustrations 1.17b** and **1.17c** show details for steps 5 and 6.

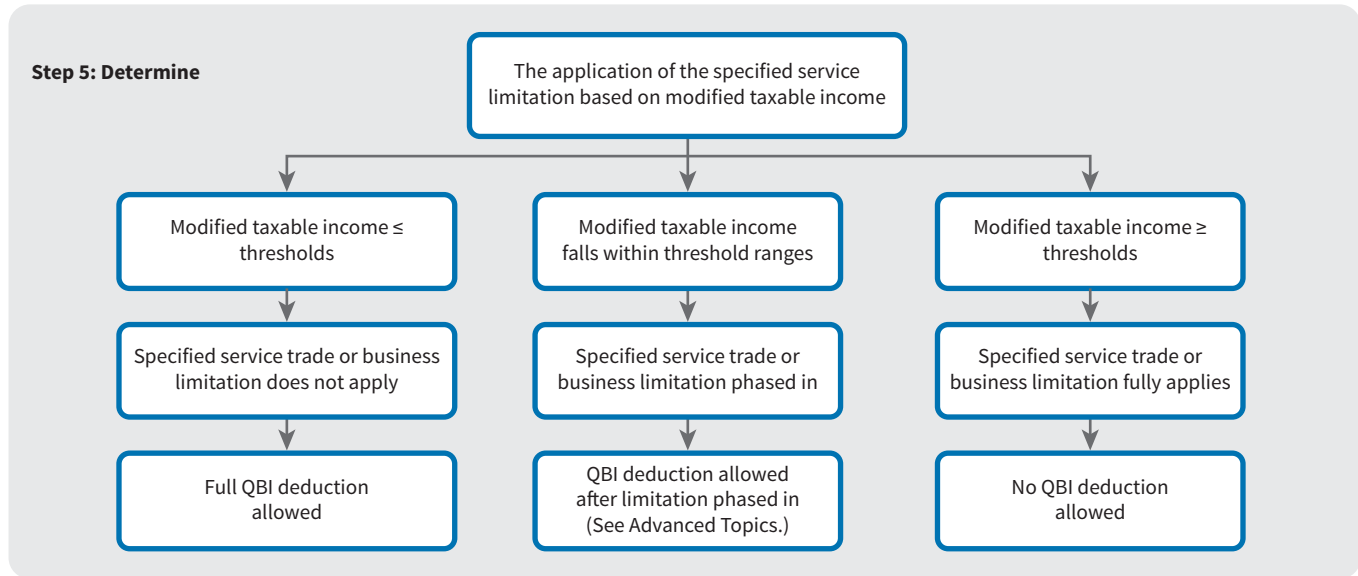
<sup>16</sup>QBI from a particular activity is reduced by these items only to the extent that the individual's gross income from the trade or business activity is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business activity (see Treas. Reg. §1.199A-3(b)(1)(vi)).

ILLUSTRATION 1.17A Flowchart for QBI Deduction Computation

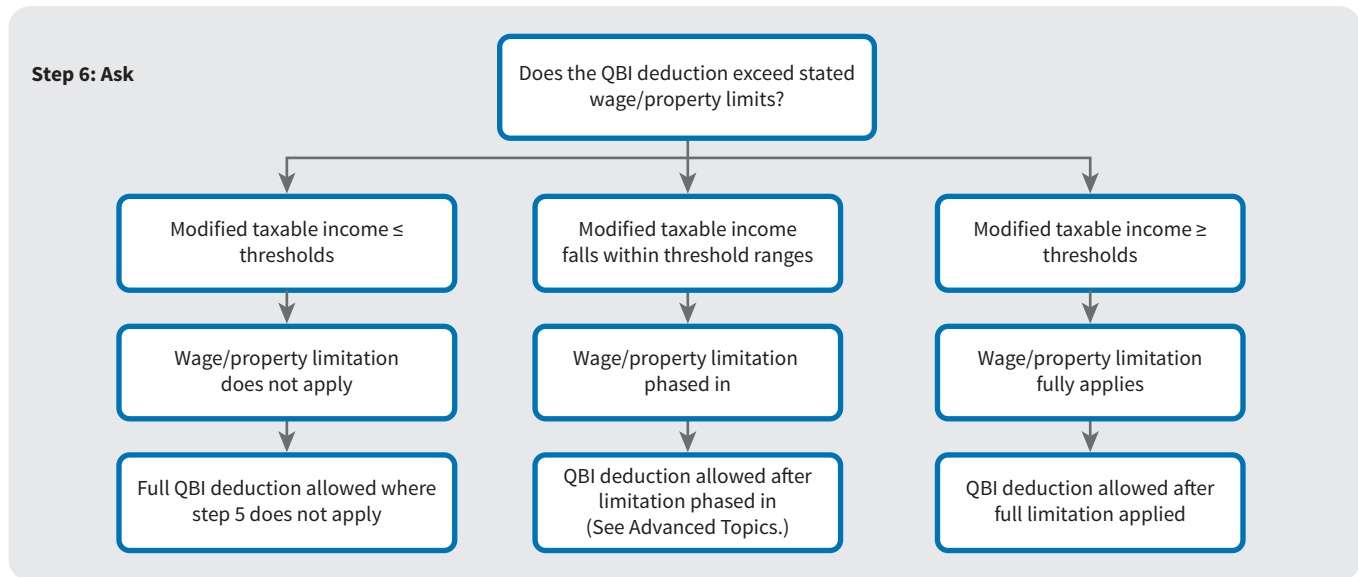
**Qualified Business Income Deduction Computation**



**ILLUSTRATION 1.17B** Detail for Step 5 for QBI Deduction Computation



**ILLUSTRATION 1.17C** Detail for Step 6 for QBI Deduction Computation



**Step 5. Determine:** The application of the specified service limitation based on the taxpayer's modified taxable income. (Refer to Illustrations 1.15 and 1.17b for this step.) Once you have calculated the taxpayer's modified taxable income (step 3) and answered step 4 as YES, limitation of the QBI deduction falls into one of three cases:

**Case 1:** The limitation described in step 4 does *not* apply to specified service trades or businesses if the modified taxable income of the taxpayer is *less than or equal to* the following thresholds (2025) (see Column 1 in Illustration 1.15):

Married filing jointly	\$394,600
Married filing separately	\$197,300
Other	\$197,300

**Case 2:** If modified taxable income of the taxpayer falls into the range (2025) shown in Column 2 of Illustration 1.15:

Married filing jointly	> \$394,600 and < \$494,600 (\$100,000 range)
Married filing separately	> \$197,300 and < \$247,300 (\$50,000 range)
Other	> \$197,300 and < \$247,300 (\$50,000 range)

and the QBI is from a specified service trade or business, then the computation of the QBI deduction is very complex and is discussed as an Advanced Topic at the end of this section.

**Case 3:** If the modified taxable income of the taxpayer *equals or exceeds* the thresholds (2025) shown below (see Column 3 in Illustration 1.15):

Married filing jointly	\$494,600
Married filing separately	\$247,300
Other	\$247,300

and the QBI is from a specified service trade or business, then the QBI deduction is \$0.

Before we proceed with the last three steps in determining the qualified business income deduction, let's look at some Examples of how the first five steps would apply in real-world situations.

Marcos is single and owns a sole proprietorship that provides financial consulting, which is a specified service trade or business. For 2025, his QBI from the business is \$150,000 and his modified taxable income is \$159,200. Calculate his QBI deduction.

#### SOLUTION

Financial consulting is a specified trade or business. However, Marcos's modified taxable income is less than \$197,300, so the limitation for specified service trades or businesses does not apply. His QBI deduction is calculated as follows:

$$\begin{aligned} \text{QBI} \times 20\% &= \text{QBI deduction} \\ \$150,000 \times 20\% &= \$30,000 \end{aligned}$$

#### EXAMPLE 1.5.1 QBI Deduction for Case 1 Scenarios



## EXAMPLE 1.5.2

### QBI Deduction for Case 3 Scenarios



Assume the same facts as in Example 1.5.1, except that Marcos's modified taxable income is \$250,000. Calculate his QBI deduction.

#### SOLUTION

Marcos's new modified taxable income amount places him into a Case 3 situation (the amount exceeds \$247,300). Because of this, and the fact that his income is from a specified service trade or business, his QBI deduction amount would now be \$0.

**Illustration 1.18** summarizes the previous two Examples and shows how the specified service limitation applies in each of the three columns in Illustration 1.13 for a taxpayer who files as married filing jointly.

**ILLUSTRATION 1.18** Specified Service Limitation for Married Filing Jointly

Modified Taxable Income		
\$0	\$394,600	\$494,600
Full QBI deduction allowed	QBI deduction phased out	QBI deduction is \$0
Column 1 (Case 1) (Example 1.5.1)	Column 2 (Case 2) (See Advanced Topics)	Column 3 (Case 3) (Example 1.5.2)

**Why** **Why is the QBI deduction limited for specified service trades or businesses?** The tax law does not permit a QBI deduction for wages paid to an employee. The daily activities and responsibilities of those who deliver professional services through their own business look very similar to the activities of employees who work in their profession. For example, when you visit your medical doctor and she provides health services to you, her actions will appear the same whether she owns her own healthcare facility, or she is an employee of a facility. Therefore, Congress decided to limit the QBI deduction for those rendering specified services, but only if their modified taxable income exceeds certain thresholds. If your medical doctor's modified taxable income places her in step 5, Case 1, and she provides services through her sole proprietorship or flow-through entity, she will receive the full QBI deduction.

## Determining the Qualified Business Income Deduction (Steps 6–7)

We'll now review the next two steps needed to determine the qualified business income deduction. Step 6 is summarized in **Illustration 1.17c**.

**Step 6. Ask: Does the QBI deduction exceed stated wage/property limits?** The second limitation on the QBI deduction is that the amount of the deduction cannot exceed the *greater* of:

1. 50% of the taxpayer's share of the W-2 wages paid by the business, *or*
2. 25% of the taxpayer's share of the W-2 wages paid by the business, plus 2.5% of the *unadjusted basis* of qualified property.

**Qualified property for QBI** is tangible property subject to depreciation that the taxpayer used in the production of QBI. Taxpayers can include assets in this computation until the end of their depreciable life or 10 years, whichever is later.

#### Potential Pitfall

Because the formula uses *unadjusted* basis, do not reduce the basis of the asset by depreciation, including bonus depreciation, when applying this formula.

The wage/property limitation is subject to the same conditions as Cases 1–3 in step 5:

**Case 1:** The wages/property limitation described in step 6 does *not* apply to taxpayers with modified taxable income *less than or equal to* the thresholds (2025) shown below (see Column 1 in Illustration 1.15):

Married filing jointly	\$394,600
Married filing separately	\$197,300
Other	\$197,300

**Case 2:** If modified taxable income of the taxpayer falls into the range (2025) shown in Column 2 of Illustration 1.15:

Married filing jointly	> \$394,600 and < \$494,600 (\$100,000 range)
Married filing separately	> \$197,300 and < \$247,300 (\$50,000 range)
Other	> \$197,300 and < \$247,300 (\$50,000 range)

the computation of the QBI deduction in this scenario is very complex and is discussed as an Advanced Topic at the end of this section.

**Case 3:** If the modified taxable income of the taxpayer *equals or exceeds* the thresholds (2025) shown below (see Column 3 in Illustration 1.15):

Married filing jointly	\$494,600
Married filing separately	\$247,300
Other	\$247,300

then the wage/property limitation fully applies.

**Step 7. Ask: Does the taxpayer have more than one QBI activity?** If so, compute the QBI deduction separately for each activity using the limitations discussed in steps 4–6.

Let's now look at some Examples of how steps 6 and 7 in determining the qualified business income deduction might apply in real-world situations.

Denzel operates a sole proprietorship for which he purchased 7-year equipment this year at a cost of \$80,000. How should this equipment be considered when he calculates his QBI deduction?

#### SOLUTION

Denzel will include the full \$80,000 cost in the QBI wage/asset limitation computation for the next 10 years. After 10 years, he will not include any of this asset's cost in the computation.

### EXAMPLE 1.5.3 Qualified Property



Una, a married taxpayer, operates a sole proprietorship selling outdoor supplies. She has one employee who is paid \$40,000 per year. During 2025, the taxable income of the business is \$120,000. Una's unadjusted basis in qualified property is \$100,000. Una and her spouse's tax return for the year reports modified taxable income of \$300,000. Compute Una's QBI deduction.

#### SOLUTION

Because Una and her spouse's taxable income does not exceed the threshold of \$394,600 for married filing jointly, the wage/property limitation does not apply in this situation. Una's QBI deduction is computed as follows:

$$\$120,000 \times 20\% = \$24,000$$

### EXAMPLE 1.5.4 Wage/Property Limitation for Case 1 Scenario



### EXAMPLE 1.5.5 Wage/Property Limitation for Case 3 Scenario



Assume the same facts as in Example 1.5.4 except Una and her spouse's modified taxable income is \$500,000. Calculate Una's QBI deduction.

#### SOLUTION

Because the couple's taxable income places them in a Case 3 scenario, the wage/property limitation fully applies and is the *greater* of:

1. 50% of the taxpayer's share of the W-2 wages paid by the business (\$40,000), or \$20,000 in this case, *or*
2. 25% of the taxpayer's share of the W-2 wages paid by the business (\$40,000), plus 2.5% of the *unadjusted* basis of qualified property (\$100,000). In this case:

$$(25\% \times \$40,000) + (2.5\% \times \$100,000) = \$10,000 + \$2,500 = \$12,500$$

Una's QBI deduction is then computed as the *lower* of:

- $\$120,000 \times 20\% = \$24,000$  *or*
- wage/property limitation of \$20,000.

Una's QBI deduction is \$20,000.

**Why** Why does the wage/property limitation rule exist? As mentioned previously, one reason Congress created the QBI deduction was to better align the top marginal rate on business income from corporations and other business forms. One important goal of Congress is to provide tax laws that incentivize job creation. Legislators want to provide the QBI deduction for higher-income taxpayers only if they are maintaining or creating jobs. Thus, the law limits the QBI deduction to a certain percentage of the W-2 wages paid to employees. Congress also included qualified property in the limitation for businesses that rely more on assets than on employees for their business activity, because the purchase of new assets also stimulates economic growth.

## Determining the Qualified Business Income Deduction (Step 8)

The last step of the QBI computation is to apply the third limitation for the QBI deduction.

**Step 8. Ask:** Does the sum of the QBI deduction for all activities exceed 20% of *adjusted modified taxable income*? As shown in the last row of Illustration 1.15, this overall limitation applies to all modified taxable income levels (Columns 1, 2, and 3). Whether there is one QBI activity or more than one, the total QBI deduction reported on the tax return from all QBI activities cannot exceed 20% of the taxpayer's *adjusted* modified taxable income, computed as:

Modified taxable income
<i>Less:</i> Net capital gain
<i>Less:</i> Qualified dividend income
<u>Adjusted modified taxable income</u>

The QBI deduction is the *lower* of:

- a. the sum of the QBI deduction from all activities, *or*
- b.  $20\% \times$  the taxpayer's adjusted modified taxable income.

Net positive QBI deductions that are limited because there is not sufficient *adjusted* modified taxable income cannot be carried forward to future years.

What happens if some QBI activities have a loss? If the net QBI deduction from all activities is negative, this net negative QBI deduction is carried forward to future years.<sup>17</sup>

The next two Examples demonstrate the application of Step 8.

Assume the same facts as in Example 1.5.1, except that Marcos has modified taxable income of \$140,000. Calculate his QBI deduction.

#### SOLUTION

His QBI deduction will be \$28,000, the *lower* of:

- $\$150,000 \times 20\% = \$30,000$ , or
- $\$140,000 \times 20\% = \$28,000$

#### EXAMPLE 1.5.6 Overall QBI Limita- tion—Scenario #1



**Related exercises: Brief Exercise 12**  
**Application Problems 28, 29, 30**

Fynn and Sarah are married, and their modified taxable income is \$300,000. This amount includes \$50,000 of net capital gains and \$5,000 of qualified dividend income. They have qualified business income or losses from two separate businesses.

The QBI and QBI deduction for each activity, after considering the wage limitation and the specified service limitation, is:

	QBI	QBI deduction
• Partnership A	\$156,000	\$31,200
• S Corporation B	\$104,000	\$20,800

Calculate their QBI deduction.

#### SOLUTION

Their QBI deduction for the year before considering the overall limitation is \$52,000 (\$31,200 + \$20,800). They must limit the deduction to 20% of *adjusted* modified taxable income:

Modified taxable income	\$300,000
Less: Net capital gains	(50,000)
Less: Qualified dividend income	(5,000)
Adjusted modified taxable income	\$245,000
<u>× 20%</u>	<u>× 20%</u>
<u>Overall limitation</u>	<u>\$ 49,000</u>

We must limit their QBI deduction to \$49,000. The \$3,000 potential QBI deduction that is disallowed (\$52,000 – \$49,000) cannot be carried forward to future years.

#### EXAMPLE 1.5.7 Overall QBI Limita- tion—Scenario #2



**Related exercise: Application Problem 31**

<sup>17</sup>In some circumstances, a taxpayer can elect to aggregate businesses, which may result in increasing the QBI deduction. This topic is beyond the complexity level of this book.

## Advanced Topics—Drilling Down

### QBI Losses

If a QBI activity has a loss, the way we handle it depends on whether there are also QBI activities with income.

- If a QBI activity has a loss and there are no QBI activities with net income, the loss is carried forward and reduces QBI income in future years.
- If a QBI activity has a loss and there is one QBI activity with net income, we net the income and losses from the QBI activities.
- If a QBI activity has a loss and there is more than one activity with a gain, the activity with the loss must be allocated against the activities with income, in proportion to their positive QBI.

### EXAMPLE 1.5.8 Overall QBI Limitation



Assume the same facts as in Example 1.5.7 except S Corporation B now has a loss of (\$70,000) and modified taxable income is \$200,000.

	QBI
• Partnership A	\$156,000
• S Corporation B	(\$ 70,000)

Calculate the QBI deduction.

#### SOLUTION

The net QBI income for Partnership A is \$86,000 (\$156,000 – \$70,000) after reduction for the loss from S Corporation B. Now the QBI deduction for both entities combined is  $\$86,000 \times 20\% = \$17,200$ . We must limit this amount to 20% of *adjusted* modified taxable income:

Modified taxable income	\$200,000
Less: Net capital gains	(50,000)
Less: Qualified dividend income	(5,000)
Adjusted modified taxable income	\$145,000
$\times 20\%$	$\times 20\%$
<u>Overall limitation</u>	<u>\$ 29,000</u>

The 20% overall limitation is greater than \$17,200, so the full \$17,200 can be taken as the QBI deduction.

Related exercise: Tax Planning Problem 6

### Phase-In of QBI Limitations

Let's return to Case 2 in steps 5 and 6. If a taxpayer is in Column 2 of Illustration 1.15, meaning that the specified service limitation and the wage/property limitation are being phased in, then the computation of QBI is very complicated. Case 2 applies when the modified taxable income of the taxpayer falls into the range (2025) shown in Column 2 of Illustration 1.15:

Married filing jointly	> \$394,600 and < \$494,600 (\$100,000 range)
Married filing separately	> \$197,300 and < \$247,300 (\$50,000 range)
Other	> \$197,300 and < \$247,300 (\$50,000 range)

We use the following process in this computation:

1. If a taxpayer has qualified business income from a specified service trade or business, the taxpayer includes only the applicable percentage of QBI and adjusts the components of the wage/property limitation by the applicable percentage, as follows:

- a. *Determine the applicable percentage.*

$$\text{Applicable percentage} = 100\% - \frac{\text{Taxable income before the QBI deduction} - \text{Applicable threshold}}{\$100,000 \text{ (MFJ) or } \$50,000 \text{ (Others)}}$$

- b. *Determine reduced components of QBI deduction.* This can be determined as follows:

1.  $20\% \times \text{QBI} \times \text{applicable percentage}$
2. Reduced components of the wage/property limitation are as follows, but not to exceed the greater of:
  - $50\% \times \text{wages} \times \text{applicable percentage}$ , or
  - $(25\% \times \text{wages}) + (2.5\% \times \text{unadjusted basis of qualified property}) \times \text{applicable percentage}$

*Note:* If the specified service limitation does *not* apply, then the amounts do *not* have to be reduced by the applicable percentage.

2. If the taxpayer is in Column 2 of Illustration 1.15 and the wage/property limitation is reducing the deduction, the general QBI deduction is used, but reduced as follows:

- a. Determine the excess between the general 20% QBI deduction as reduced in 1b above and the full wage/property limitation.
- b. Determine the reduction ratio:

$$\frac{\text{Taxable income before the QBI deduction} - \text{Applicable threshold}}{\$100,000 \text{ (MFJ) or } \$50,000 \text{ (Others)}}$$

- c. Determine the reduction in the wage/property limitation:

$$\text{Excess from part 2a} \times \text{Reduction ratio from part 2b}$$

3. Determine the final QBI deduction amount:

General 20% QBI deduction amount from 1b

Less: Reduction from 2c

Final QBI amount

4. The final QBI deduction cannot exceed  $20\% \times$  modified taxable income.

The next three Examples demonstrate the computation of QBI when the limitations are being phased in as follows:

**Specified service limitation applies? Wage/property limitation applies?**

Example 1.5.9	Yes	No
Example 1.5.10	No	Yes
Example 1.5.11	Yes	Yes

Rhys is a physician who files as married filing jointly in 2025. He and his wife have QBI of \$380,000 from his medical practice and modified taxable income of \$427,000. Rhys pays \$300,000 of W-2 wages, so the wage/property limitation does not apply because the QBI deduction does not exceed 50% of W-2 wages. Calculate Rhys's QBI deduction.

**EXAMPLE 1.5.9**  
QBI Deduction for  
Column 2 Scenario  
with Specified Ser-  
vice Limitation



**SOLUTION**

Rhys's modified taxable income falls into the range (2025) shown in Column 2 of Illustration 1.15:

Married filing jointly      > \$394,600 and < \$494,600

This means that the specified service and wage/property limitations potentially need to be phased in. Therefore, the QBI deduction is computed as follows:

1. Because Rhys has qualified business income from a specified service trade or business, he includes only the *applicable percentage* of QBI and adjusts the components of the wages/property limitation by the applicable percentage, as follows:

a. *Determine the applicable percentage.*

Applicable percentage =

$$100\% - \frac{\text{Taxable income before the QBI deduction} - \text{Applicable threshold}}{\$100,000 \text{ (MFJ) or } \$50,000 \text{ (Others)}}$$

In Rhys's example, because he is in a specified service trade or business:

$$\text{Applicable percentage} = 100\% - \frac{\$427,000 - \$394,600}{\$100,000} = 67.6\%$$

- b. *Determine reduced components of QBI deduction.* Because Rhys is in a specified service trade or business, the QBI deduction amount needs to be reduced by the applicable percentage.

1.  $20\% \times \text{QBI} \times \text{applicable percentage} = 20\% \times \$380,000 \times 67.6\% = \$51,376$
2. Reduced components of the wage/property limitation are as follows, but not to exceed the *greater* of:
  - $50\% \times \text{wages} (\$300,000) \times \text{applicable percentage} = \$150,000 \times 67.6\% = \$101,400$ ,  
*or*
  - $[25\% \times \text{wages} (\$300,000)] + [2.5\% \times \text{unadjusted basis of qualified property} (\$0)] \times 67.6\% = \$50,700$

Rhys's reduced QBI deduction is \$51,376. Rhys's reduced wage/property limitation is \$101,400.

2. If a taxpayer is in Column 2 of Illustration 1.15 and the wage/property limitation is reducing the deduction, the general QBI deduction is used, but reduced using a formula. Here, though, the wage/property limitation is not reducing Rhys's QBI deduction, so this part of the process is not used.
3. We can determine Rhys's final QBI deduction amount as follows:

General 20% QBI deduction amount from 1b	\$51,376
Less: Reduction from 2	(     0)
<u>Final QBI amount</u>	<u>\$51,376</u>

4. Finally, we check whether Rhys's final QBI deduction of \$51,376 exceeds  $20\% \times$  modified taxable income (\$427,000), or \$85,400. As it does not, Rhys's final QBI amount remains \$51,376.

### EXAMPLE 1.5.10

#### QBI Deduction for Column 2 Scenario with Wage/Property Limitations



Continuing with the facts from Example 1.5.4, Una, a married taxpayer, operates a sole proprietorship selling outdoor supplies. She has one employee who is paid \$40,000 per year. During 2025, the taxable income of the business is \$120,000. Una's unadjusted basis in qualified property is \$100,000. Una and her spouse's tax return for the year reports modified taxable income of \$397,000. Determine Una's QBI deduction.

**SOLUTION**

The specified service limitation does *not* apply to Una. Una's modified taxable income falls into the range (2025) shown in Column 2 of Illustration 1.15:

$$\text{Married filing jointly} \quad > \$394,600 \text{ and } < \$494,600$$

This means that the specified service and wage/property limitations potentially need to be phased in. Therefore, the QBI deduction is determined as follows:

1. No reduction is necessary for this step because Una is *not* operating a specified trade or business, so the applicable percentage is not used to reduce the amounts.

$$\text{QBI deduction} = 20\% \times \text{QBI} = 20\% \times \$120,000 = \$24,000$$

2. Because Una is in Column 2 and the wage/property limitation is reducing the deduction, the general QBI deduction is used, but reduced as follows:

- a. Determine the excess between Una's general 20% QBI deduction as shown in 1 above (\$24,000) and her full wage/property limitation (\$20,000): \$4,000 (\$24,000 – \$20,000). (Shown in Example 1.5.5)

- b. Determine Una's reduction ratio:

$$\frac{\text{Taxable income before the QBI deduction} - \text{Applicable threshold}}{\$100,000 \text{ (MFJ) or } \$50,000 \text{ (Others)}} \\ = \frac{(\$397,000 - \$394,600)}{\$100,000} = 2.4\%$$

- c. Determine the reduction in Una's wage/property limitation:

$$\text{Excess from part 2a } (\$4,000) \times \text{Reduction ratio from part 2b } (2.4\%) = \$96$$

3. We can determine Una's final QBI deduction amount as follows:

General 20% QBI deduction amount from 1	\$24,000
<u>Less: Reduction from 2c</u>	<u>( 96)</u>
<u>Final QBI amount</u>	<u>\$23,904</u>

4. Finally, we check whether UNA's final QBI deduction of \$23,904 exceeds 20% × modified taxable income (\$397,000), or \$79,400. Because it does not, Una's final QBI amount remains \$23,904

Next, we continue with facts similar to those from Example 1.5.10, except that Una, a married taxpayer, is an attorney and operates a sole proprietorship providing legal services. She has one employee, who is paid \$40,000 per year. During 2025, the taxable income of the business is \$120,000. Una's unadjusted basis in qualified property is \$100,000. Una and her spouse's tax return for the year reports modified taxable income of \$397,000. Calculate Una's QBI deduction.

**SOLUTION**

The specified service limitation now applies because Una is providing legal services. Una's modified taxable income falls into the range (2025) shown in Column 2 of Illustration 1.15:

$$\text{Married filing jointly} \quad > \$394,600 \text{ and } < \$494,600$$

This means that the specified services and wage/property limitations potentially need to be phased in. Therefore, the QBI deduction is computed as follows:

### EXAMPLE 1.5.11

#### QBI Deduction for Column 2 Scenario with Specified Service and Wage/Property Limitations



1. Because Una has qualified business income from a specified service trade or business, she includes only the *applicable percentage* of QBI and adjusts the components of the wage/property limitation by the applicable percentage, as follows:

- a. Determine the applicable percentage.

Applicable percentage =

$$100\% - \frac{\text{Taxable income before the QBI deduction} - \text{Applicable threshold}}{\$100,000 \text{ (MFJ) or } \$50,000 \text{ (Others)}}$$

In Una's example, because she is in a specified service trade or business:

$$\text{Applicable percentage} = \frac{100\% - \$397,000 - \$394,600}{\$100,000} = 97.6\%$$

- b. Determine reduced components QBI deduction. Because Una is in a specified service trade or business, the QBI deduction amount needs to be reduced by the applicable percentage.

1.  $20\% \times \text{QBI} \times \text{Applicable percentage} = 20\% \times \$120,000 \times 97.6\% = \$23,424$

2. Reduced components of the wage/property limitation are as follows, but not to exceed the *greater* of:

- $50\% \times \text{wages } (\$40,000) \times \text{applicable percentage} = \$20,000 \times 97.6\% = \$19,520$ , or

- $[25\% \times \text{wages } (\$40,000)] + [2.5\% \times \text{unadjusted basis of qualified property } (\$100,000)] \times 97.6\% = \$12,200$

Una's reduced QBI deduction is \$23,424 after reduction for the specified service limitation. The reduced wage/property limitation is \$19,520.

2. Because Una is in Column 2 and the wage/property limitation is reducing the deduction, the general QBI deduction is used, but reduced as follows:

- a. Determine the excess between the general 20% QBI deduction as reduced in 1b1 above (\$23,424) and the full wage/property limitation as reduced in 1b2 (\$19,520): \$3,904 (\$23,424 - \$19,520).

- b. Determine Una's reduction ratio:

$$\frac{\text{Taxable income before the QBI deduction} - \text{Applicable threshold}}{\$100,000 \text{ (MFJ) or } \$50,000 \text{ (Others)}} \\ (\$397,000 - \$394,600) = 2.4\% \\ \$100,000$$

- c. Determine the reduction in Una's wage/property limitation:

$$\text{Excess from part 2a } (\$3,904) \times \text{Reduction ratio } (2.4\%) = \$94$$

3. We can determine UNA's final QBI deduction amount as follows:

General 20% QBI deduction amount from 1b	\$23,424
<u>Less: Reduction from 2c</u>	<u>( 94)</u>
<u>Final QBI amount</u>	<u>\$23,330</u>

4. Finally, we check whether Una's final QBI deduction of \$23,300 exceeds  $20\% \times$  modified taxable income (\$397,000), or \$79,400. Because it does not, Una's final QBI amount remains \$23,330.

Chih-Chen owns a bicycle and repair shop as a sole proprietorship and has net revenue from operations of \$57,000. What is her qualified business income? Assume that her deduction for self-employment tax is \$4,027.

### SOLUTION

Chih-Chen is allowed a self-employment tax deduction for adjusted gross income of \$4,027. (The self-employment tax deduction is calculated as follows:  $\$57,000 \times 0.9235 \times 0.153 \times 50\%$ .) Therefore, Chih-Chen's qualified business income is  $\$57,000 - \$4,027$ , or \$52,973.

## PRACTICE PROBLEM 1.5.1

### Calculating Qualified Business Income 1

Novak is a single taxpayer who owns and operates a sporting goods store. He has no employees. In 2025, he reported qualified business income from the store of \$98,000 and AGI of \$105,000. He has no itemized deductions and claims the standard deduction of \$15,000 on his 2025 Form 1040. What is Novak's qualified business income deduction?

### SOLUTION

Novak's modified taxable income can be calculated as follows:

$$\begin{aligned} \text{AGI} - \text{Standard deduction} &= \text{Modified taxable income} \\ \$105,000 - \$15,000 &= \$90,000 \end{aligned}$$

His QBI deduction can then be calculated as the *lower* of:

- $20\% \times \text{QBI} = 20\% \times \$98,000 = \$19,600$ , or
- $20\% \times \text{adjusted modified taxable income} = 20\% \times \$90,000 = \$18,000$ .

In this case, Novak's qualified business income deduction would be \$18,000.

## PRACTICE PROBLEM 1.5.2

### Calculating Qualified Business Income 2



INTERACTIVE  
SELF-SCORING QUIZZES

# Review and Practice

## Chapter Summary

The income tax rules for business entities are similar to the income tax rules for individuals in the context of income, deductions, and property transactions. But there are also significant differences. We began this introductory chapter by providing the foundational principles for income taxation. We then discussed the business lifecycle. We followed with a discussion of the compliance responsibilities of all tax professionals. Finally, we reviewed the principles of income, deductions, and property transactions that are critical to your understanding of the material presented for business entities.

### 1 Understand how income tax rules apply to various business entities.

- For the income taxation of business entities, the composition of the topics you will learn is very different from that for the taxation of individuals.

- The taxation of income and deduction transactions during the year comprises approximately 20% or less of the tax law for business entities. The remaining 80% relates to transactions that occur the lifecycle of the business.
- The lifecycle has four main stages: the formation of the entity, the taxation of the operations of the business, the distribution of profits to the owners, and the dissolution of the business.

## 2 Understand the compliance requirements for business entities.

- Corporate tax returns (other than those with a June 30 year-end) are due three and one-half months after the end of the tax year, which is April 15 for calendar-year corporations. All business entities use the same form to request an extension of time to file the return, Form 7004, Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns. Corporations can request an extension of six months to file the tax return. The extension of time, though, is only to *file the return*. The taxpayer must pay the taxes due for the year by the original due date or the IRS will assess a late payment penalty. Corporate tax returns with a June 30 year-end are due two and one-half months after the end of the year, which is September 15. The extended due date is seven months after the due date, which is April 15 of the next year.
- Partnership tax returns and S corporation tax returns are due two and one-half months after the end of the tax year, which is March 15 for a calendar-year business. Extensions for partnerships and S corporations are for six months, which is September 15 for a calendar-year business.
- The primary **statute of limitations** runs for three years from the later of the due date of the tax return or the date the return is filed.
- There are four major tax penalties that corporations may have to pay. First, a penalty is imposed if the taxpayer fails to file a required tax return on time (failure to file). Second, a penalty is imposed if the taxpayer fails to make adequate tax payments during the year (underpayment of estimated tax). Third, a penalty is imposed if the taxpayer fails to pay the tax reflected on the tax return by the due date (failure to pay). Finally, a penalty is imposed if the taxpayer files an inaccurate tax return (accuracy penalty).
- S corporations must pay a penalty equal to \$255 (2025) per shareholder for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months. Partnerships must pay a penalty equal to \$255 (2025) per partner for each month, or part of a month, that the return is late. The penalty is assessed for no more than 12 months.

## 3 Understand the fundamental rules for property transactions that apply to the taxation of business entities.

- You must compute a **realized gain or loss** every time there is a **sale or disposition** of property. The gain or loss may be either **recognized** and included in taxable income, **deferred**, or **excluded**. A taxpayer must recognize all realized gains and losses unless a tax law provides otherwise.
- The basis of the asset received is the same as the basis in the asset transferred to the extent that the taxpayer defers the realized gain or loss. For fully taxable transactions, the basis in the asset received is always the property's fair market value.
- For a tax-deferred transaction, the **holding period** of property received always includes the holding period of the property transferred. For a fully taxable transaction, the holding period of property received never includes the holding period of the property transferred.

- Realized losses from the sale or disposition of an asset between related parties cannot be recognized. The term **related party** includes the following family members: spouse, children, grandchildren/other descendants, parents, grandparents/other ancestors, and brothers and sisters. Aunts, uncles, and cousins are not related parties, and neither are in-laws. The related-party loss rules apply to many situations other than sales between family members. The definition of *related party* includes relationships between individuals and business entities, and between certain business entities.
- Every asset can be classified as:
  - either an **ordinary asset**, a **Section 1231 asset**, or a **capital asset**; and
  - either **personalty** or **realty**.

## 4 Determine the tax consequences of disposing of Section 1231 assets.

- A **Section 1231 asset** is an asset used in a trade or business and held for over one year (long-term). An **ordinary asset** is one that is used in a trade or business and that produces ordinary income or loss when disposed of or sold.
- All Section 1245 and Section 1250 assets are also Section 1231 assets.
- To the extent that Section 1231 gains exceed Section 1231 losses, the net gain is treated as a long-term capital gain (subject to the lookback rule). If Section 1231 losses exceed Section 1231 gains, the loss is deductible as an **ordinary loss**.
- The **lookback rule** provides that the net Section 1231 gains must be offset by net Section 1231 losses from the five preceding tax years that have not already been recaptured. To the extent of these losses, the net Section 1231 gain is treated as **ordinary income**.
- **Section 1245 assets** include all tangible depreciable or amortizable property used in a trade or business other than land or buildings. Section 1245 recapture is the *lesser* of:
  - the recognized gain, *or*
  - all depreciation taken on the asset.
- **Section 1250 assets** are defined as depreciable buildings used in a trade or business and owned for more than one year. **Excess depreciation** is the depreciation claimed in excess of the amount that would have been claimed under the straight-line depreciation method. The excess depreciation is subject to being recaptured as ordinary income under Section 1250. Section 1250 recapture is the *lesser* of:
  - the recognized gain, *or*
  - the excess depreciation.
- For individuals, gain in excess of the recaptured amount is treated as either unrecaptured Section 1250 gain or Section 1231 gain. **Unrecaptured Section 1250 gain** is gain taxed at a maximum tax rate of 25% to the extent of accumulated straight-line depreciation taken on the real estate.
- For corporations, gain in excess of the Section 1250 recapture amount is treated first as **Section 291 recapture**, and then as Section 1231 gain.

## 5 Compute the qualified business income deduction.

- Taxpayers can take advantage of the **qualified business income (QBI) deduction**, which is computed as 20% of the taxpayer's income from pass-through entities (partnerships, limited liability companies, and S corporations) and sole proprietorships.
- Three significant limitations can reduce the QBI deduction, depending on the taxpayer's modified taxable income.
- The first limitation affects **specified service trades or businesses**—those involved in the services of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, or any business where the principal asset is the reputation of an employee or owner.

Additional steps are required to determine the QBI deduction, if any, for owners of such trades or businesses.

- The second limitation is that the QBI deduction cannot exceed the *greater* of:
  - 50% of the taxpayer's share of the W-2 wages paid by the business, *or*
  - 25% of the taxpayer's share of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis of qualified property.
- If a taxpayer has more than one QBI activity, we compute the QBI deduction separately for each activity using the limitations discussed above.
- The third limitation is that the total QBI deduction reported on the tax return from all QBI activities cannot exceed 20% of the taxpayer's modified taxable income.

## Communication Application

Communication

### Identifying Use of Asset and Character of Gain

**(LO4)** Fernando LLC has owned 10 acres of land in rural Arkansas for several years and is considering selling them. The land's adjusted

basis is \$100,000, and the fair market value is \$230,000. Fernando LLC has requested that you explain how the gain would be reported on its tax return. Write a memo to Fernando LLC explaining your answer and requesting any additional information you may need.

### Solution

#### Memo to Client

Dear Fernando LLC,

I am responding to your inquiry concerning the potential sale of your land in Arkansas. You have held the land for more than one year, which qualifies it as long-term. The amount of your gain from a sale would be \$130,000 (\$230,000 realized – \$100,000 adjusted basis). But the way that gain is treated on your tax return depends on how you have used the land, so I will need to know that information.

There are three possibilities:

- The LLC is a real estate dealer and holds this land as inventory along with other parcels of land for sale,
- The LLC has been using the land in a trade or business, *or*
- The LLC has held the land for investment planning for it to appreciate.

If the LLC held the land as inventory, then the gain will be ordinary gain and taxed at the members' marginal tax rate for ordinary income, possibly as high as 37%. If the land was used in a trade or business, the gain will be a Section 1231 gain. If the land is the only Section 1231 asset sold this year, then the gain will be a long-term capital gain and receive a preferential tax rate, not to exceed 20%. If the LLC held the land for investment, then it is a capital asset resulting in a long-term capital gain with a preferential tax rate, not to exceed 20%.

Please provide further information regarding the use of the land, and we can determine the gain's character and how it will be treated on your tax return.

Sincerely,

Carnes & Youngberg, CPAs

## Ethics and Professional Responsibilities Application

**Ethics**

### Correcting Errors

**(LO1)** Tommy “The Tattoo King” Tinker has a tattoo parlor in Tennessee operating as an S corporation. He has asked you to look at his online QuickBooks file and prepare his current-year tax return. While reviewing the file, you find some suspicious expenses. When you dig deeper, you realize that Tommy is paying his ex-wife’s alimony, home mortgage interest expense, home real estate taxes, and various other personal expenses from his S corporation business checking account.

Tommy says that because his business supports his wife’s alimony and his other personal expenses, they should all be deductible. How should you respond to Tommy?

In addition to the chapter content, see *Statements on Standards for Tax Services* at [www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services](http://www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services), *Circular 230* at [www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230](http://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230), and Chapter 2, LO4, Tax Professional Responsibilities.

### Solution

Deductions related to the taxpayer’s personal life are not deductible as a business expense. Under IRC §162(a), expenses deductible for the business must be ordinary, necessary, and reasonable for the carrying on of that trade or business. As Tommy’s tax accountant, per the AICPA *Statement on Standards for Tax Services* No. 1.2, Knowledge of Errors, you should advise him of the potential consequences of the error and recommend what corrective measures he should take. SSTS No. 1.2.6 states that a CPA “should promptly inform a taxpayer upon becoming aware of a taxpayer’s failure to file a required return, an error in a previously filed return, [or] an error in a return that is the subject of an administrative proceeding.” The CPA may provide the recommendation either orally or in writing. §10.21 of *Circular 230* imposes similar obligations on tax professionals.

You should tell Tommy that you will correct the QuickBooks file and the current-year tax return to properly reflect the expenses for the business.

### Five-Year Lookback Rule

**(LO4)** Hogan Inc. is a C corporation and is a new client this year. The company has provided you with its tax returns from the last three years to help you prepare its current year’s return. In the current year, Hogan Inc. sold several business assets, resulting in a net Section 1231 gain of \$17,000. When you review the prior returns, you notice that your client has had net Section 1231 gains and losses in which the five-year lookback rule was not followed. You realize this will affect your preparation of the current year’s return. Should you

inform Hogan Inc. that you need to amend the previous returns, or leave them as filed because you have been hired to prepare only the current year’s return?

In addition to the chapter content, see *Statements on Standards for Tax Services* at [www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services](http://www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services), *Circular 230* at [www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230](http://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230), and Chapter 2, LO4, Tax Professional Responsibilities.

### Solution

Under AICPA *Statements on Standards for Tax Services* No. 1.2.6, Knowledge of Errors, “A member should promptly inform a taxpayer upon becoming aware of the taxpayer’s failure to file a required return, [or] an error in a previously filed return.” Therefore, you must inform Hogan Inc. of the earlier error before preparing the current year’s return. Also, per *Circular 230* §10.21, if a practitioner has knowledge of an omission or error in a previously filed tax return, then the practitioner must notify the client of the noncompliance and offer suggestions to remedy the situation. If Hogan Inc. does not agree to amend the prior year’s returns, you should consider walking away from the engagement. It is the CPA’s professional responsibility to advise the client of appropriate treatment, but the CPA cannot inform the Internal Revenue Service of earlier errors and must keep the information confidential.

## Key Terms

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## End-of-Chapter Assessment

### Discussion Questions

- (LO1)** Describe the entity theory.
- (LO1)** Explain the difference between an operating distribution and a liquidating distribution.
- (LO2)** What is the due date for partnerships and S corporations to file their income tax returns?
- (LO2)** Define *statute of limitations* and explain how it applies to tax assessment and refunds.
- (LO2)** Describe the failure to pay penalty and the failure to file a tax return penalty.
- (LO2)** What is meant by the term *substantial authority*?
- (LO2)** Provide two examples of an accuracy-related penalty.
- (LO3)** What does the tax law include in *amount realized*?
- (LO3)** What is the difference between *realized gain or loss* and *recognized gain or loss*?
- (LO3)** Provide two reasons why realized gain might be deferred for tax purposes.
- (LO3)** Provide a definition for *boot*.
- (LO3)** How does a tax-deferred transaction impact the holding period of an asset?
- (LO3)** Define *related-party transaction*.
- (LO3)** Does the related-party loss disallowance rule apply even when the selling price is equal to the fair market value and can be substantiated by a qualified appraisal?
- (LO3)** Why is it important to differentiate among ordinary assets, Section 1231 assets, and capital assets?
- (LO3)** Distinguish between *realty* and *personalty*.
- (LO3)** When is an asset deemed long-term for holding-period purposes? Why is this important?
- (LO4)** If a business-use asset held long-term is sold at a loss, and it is the only business-use asset sold during the year, what is the character of that loss?
- (LO4)** Explain the five-year lookback rule regarding Section 1231 net gains.
- (LO4)** Does the lookback rule apply to both net Section 1231 gains and losses generated in the current year?
- (LO4)** What is a Section 1245 asset?
- (LO4)** If Section 197 intangible assets are purchased as part of an acquisition of a business, how are they treated when they are sold?
- (LO4)** What is a Section 1250 asset?
- (LO4)** What is unrecaptured Section 1250 gain?
- (LO4)** On what tax form does a taxpayer report the sale of business-use assets?
- (LO4)** Provide some examples where the recapture rules do not apply.
- (LO5)** What is a specified service business activity?

## Multiple Choice Questions

1. **(LO1)** A C corporation files which tax form to report its income, expenses, and credits?
  - a. Form 1120
  - b. Form 1040
  - c. Form 1065
  - d. Form 1120-S
2. **(LO1)** Form 1041 is used to file a tax return for which entity?
  - a. Corporation
  - b. Partnership
  - c. Trust
  - d. Limited liability company
3. **(LO2)** On what day, in general, is Form 1120 due for a calendar year-end corporation, not including extensions and without incurring a possible penalty?
  - a. March 15
  - b. April 1
  - c. April 15
  - d. June 30
4. **(LO2)** If Burger Inc. (a calendar year-end corporation) filed its Year 3 tax return on February 14, Year 4, when does the statute of limitations expire for assessing additional tax?
  - a. February 14, Year 6
  - b. April 15, Year 6
  - c. February 14, Year 7
  - d. April 15, Year 7
5. **(LO2)** Heather Inc. inadvertently failed to e-file its Year 10 tax return on April 15, Year 11, but it did pay its balance due of \$1,500 on time. Heather Inc. e-filed on June 3, Year 11. What late filing penalty does Heather Inc. incur?
  - a. \$0
  - b. \$150
  - c. \$215
  - d. \$500
6. **(LO3)** Rico Inc. sells a parcel of investment real estate and receives \$120,000 cash and stock with a fair market value of \$100,000 and basis of \$60,000. Additionally, the \$50,000 mortgage on the property is assumed by the buyer. Rico Inc. paid an attorney \$1,000 to execute the sale. The week before the sale, Rico paid \$75 to have a fence repaired on the property. The basis in the parcel of investment real estate is \$200,000. What is Rico Inc.'s amount realized from selling the property?
  - a. \$219,000
  - b. \$268,925
  - c. \$269,000
  - d. \$270,000
7. **(LO3)** Which of the following fall under the related-party relationship rules for loss disallowance on sale of an asset? Select all that apply.
  - a. Two cousins
  - b. A shareholder who owns 60% of a corporation's stock
  - c. Brother and sister
  - d. Mother-in-law and daughter-in-law
8. **(LO3)** On April 16, Year 10, Alvin Inc. sold 200 shares of Chipmunk stock to its 100% shareholder, Tang, for \$18,000. Alvin Inc. purchased the stock in Year 5 for \$23,000. Tang sold the stock to Amber, an unrelated third party, for \$30,000 on December 28, Year 10. What amount of gain from the sale of the stock to Amber should Tang report on his Year 10 income tax return?
  - a. \$0
  - b. \$2,000
  - c. \$5,000
  - d. \$7,000
9. **(LO3)** Which of the following is an ordinary asset?
  - a. Computer
  - b. Delivery truck
  - c. Accounts receivable
  - d. Equipment
10. **(LO3)** Which of the following assets would be classified as ordinary for purposes of determining the character of gain or loss?
  - I. Personal residence
  - II. Inventory
  - III. Asset sold by a business that had been owned for eight months
  - a. II
  - b. II, III
  - c. I, II
  - d. I, II, III
11. **(LO3)** Which of the following assets would be classified as capital for purposes of determining the character of gain or loss?
  - I. Equipment used in a business
  - II. Land owned by a dealer in real estate
  - III. Stock owned by a corporation
  - IV. Copyright owned by author of book
  - a. III
  - b. IV
  - c. II, III
  - d. I, II, III, IV
12. **(LO3)** Which of the following is an example of realty?
  - a. Storefront property
  - b. Land
  - c. Apartment building
  - d. Warehouse
  - e. All of these
13. **(LO4)** Wolf, Inc. had the following net Section 1231 gains/losses for its first four years of operations:
 

Year 1	\$10,000
Year 2	\$ 4,000
Year 3	\$12,000
Year 4	(\$18,000)

In Year 5, Wolf has a net Section 1231 gain of \$30,000. How will this gain be taxed according to the following classification?

	<u>Ordinary income</u>	<u>Long-term capital gain</u>
a.	\$18,000	\$12,000
b.	\$ 0	\$30,000
c.	\$30,000	\$ 0
d.	\$12,000	\$18,000

14. (LO4) On January 1, Year 8, Whitehouse Corp. placed into service five-year MACRS equipment with an initial tax basis of \$10,000. On December 31, Year 10, Whitehouse sold the property for \$8,000, after having taken \$6,000 in MACRS depreciation deductions. What amount of the gain should Whitehouse recapture as ordinary income under the Section 1245 recapture rules?

- a. \$0
- b. \$2,000
- c. \$4,000
- d. \$6,000

15. (LO4) Tanner Company purchased and placed into service seven-year furniture on March 15, Year 2. The furniture cost \$3,600 and was sold in Year 4 for \$4,000 after taking \$1,711 in MACRS depreciation deductions. What amount should Tanner recapture as ordinary income under the Section 1245 recapture rules?

- a. \$0
- b. \$1,711
- c. \$1,889
- d. \$2,111

16. (LO4) Becker Company sold a business-use computer for \$1,000 in December of the current year. Becker Company had purchased the computer several years earlier for \$2,800 and had taken \$1,500 of MACRS depreciation deductions as of the date of the sale. What amount is subject to Section 1245 depreciation recapture?

- a. \$0
- b. \$1,300
- c. \$1,500
- d. (\$300)

17. (LO4) Carmella LLC purchased a commercial building on June 1, Year 3, for \$200,000. The building was depreciated using regular MACRS straight-line depreciation. The apartment building was sold on December 31, Year 8, for \$330,000 when its adjusted tax basis was \$160,000 (assume that \$40,000 of depreciation had been claimed). How much gain from the sale of the building is subject to the 25% rate as unrecaptured Section 1250 gain, and how much gain qualifies as Section 1250 depreciation recapture?

	<u>Unrecaptured Section 1250 gain at 25% rate</u>	<u>Section 1250 recapture</u>
a.	\$ 0	\$170,000
b.	\$ 40,000	\$130,000
c.	\$ 40,000	\$ 0
d.	\$170,000	\$ 0

18. (LO4) Anthony Inc., an S corporation, purchased a rental apartment building for \$325,000 in April 1984. The corporation elected to depreciate it using the 150% declining balance method with a useful life of 50 years, resulting in accelerated depreciation taken of \$260,000. Straight-line depreciation would have been \$220,000. Anthony Inc. sold the building in November 2025, for \$400,000. What portion of the gain is subject to Section 1250 recapture?

- a. \$0
- b. \$40,000
- c. \$65,000
- d. \$335,000

19. (LO4) Section 291 recaptures applies to which of the following entity types?

- a. S corporation
- b. C corporation
- c. LLC that has not elected to be treated as a corporation
- d. Partnership

20. (LO5) Where does the QBI deduction appear on Form 1040?

- a. It is an itemized deduction taken on Schedule A of Form 1040.
- b. It is a deduction from AGI on Form 1040 taken after the deduction for the greater of itemized deductions or the standard deduction.
- c. It is a business deduction and is taken on Schedule C of Form 1040.
- d. It is a deduction that reduces self-employment income and is taken on Schedule SE of Form 1040.

21. (LO5) Abe is the sole shareholder and president of Lincoln, Inc., an S corporation that is a qualified trade or business. In 2025, Lincoln has net income of \$330,000 after deducting Abe's salary of \$75,000. What is Abe's qualified business income?

- a. \$0
- b. \$75,000
- c. \$330,000
- d. \$405,000

22. (LO5) Which of the following is not a specified service activity for the purpose of calculating the qualified business income deduction?

- a. Accounting
- b. Financial services
- c. Athletics
- d. Architecture

23. (LO5) In 2025, Cal, who is single, earns sole proprietor income of \$245,000 generated from his law practice. He does not have any employees or qualified assets. Cal's modified taxable income is \$285,000. How much is his QBI deduction?

- a. \$0
- b. \$49,000
- c. \$54,490
- d. \$57,000

## Brief Exercises

1. **(LO1)** Describe the three foundational principles for property transactions.
2. **(LO2)** TennisNow is an S corporation with a calendar year-end. TennisNow filed its Form 1120-S for 2025 on December 26, 2026. TennisNow has eight shareholders. What is TennisNow's penalty for late filing of its tax return?
3. **(LO2)** Bennett owns 100% of Garrard Corporation, which does estate planning and consulting. After completing Garrard's tax return this year, Bennett realized that Garrard owed \$24,000 in taxes. Instead of paying the taxes as owed, Bennett reduced Garrard's income by \$100,000. How would the IRS respond to this situation?
4. **(LO3)** Shane Inc. exchanged its investment land (basis \$43,000, FMV \$56,000) for farming land (basis \$44,000, FMV \$51,000) and \$5,000 cash. Assume this exchange qualifies as a tax-deferred transaction. What is Shane Inc.'s recognized gain, if any?
5. **(LO3)** Harriet owns 500 shares of Coca-Cola stock and paid \$36 per share in 2018. She sold it in the current year for \$30 per share to Ethyl Company, a partnership in which she has a capital interest of 35%. Ethyl Company later sold the stock to an unrelated third party for \$50 per share. What is Harriet's recognized gain or loss on the sale? What is Ethyl Company's recognized gain or loss on the sale?
6. **(LO3)** Harriet owns 500 shares of Coca-Cola stock and paid \$36 per share in 2018. She sold it in the current year for \$30 per share to Ethan Company, a partnership in which she has a capital interest of 65%. Ethan Company later sold the stock for \$50 per share. What is Harriet's recognized gain or loss on the sale? What is Ethan Company's recognized gain or loss on the sale?
7. **(LO3)** Tito Company purchased equipment to be used in its business on January 9 of the current year. In December, Tito is considering selling the equipment. If Tito sells in December, what is the asset's classification? If Tito sells it on January 10 of next year, what is the asset's classification?
8. **(LO4)** Daewoon Company owns a popular restaurant on Main Street. During the current year, it sold various assets, resulting in net Section 1231 gains of \$22,000 and net Section 1231 losses of \$11,000. Daewoon Company also sold stock, which generated a capital loss of \$9,000. What is the net effect of these transactions?
9. **(LO4)** Toucan owns Fit for U (FFU), an exercise facility. FFU sells weightlifting equipment for \$44,000. FFU purchased the equipment four years ago for \$75,000 and has accumulated depreciation of \$60,000. What is FFU's realized and recognized gain or loss? What is the character of the gain or loss?
10. **(LO4)** Giada received a building to expand her pizza restaurant business as a gift from her Uncle Joey. The building had a fair market value of \$225,000 and an adjusted basis of \$100,000. Is Joey subject to the recapture provisions on the gift? Is Giada subject to the recapture provisions if she decides to sell the gifted building?
11. **(LO5)** Enid operates, as a sole proprietor, an animal shelter that generates net revenue of \$88,000. Enid has also made a self-employed health insurance payment of \$6,000. What is Enid's qualified business income?
12. **(LO5)** Theo, single, is the sole shareholder of Theo's Tool and Dye, Inc., a tool and dye manufacturing company operating as an S corporation. Theo reports qualified business income of \$118,000, and he has no employees. He also has qualified dividend income of \$4,400. He has no itemized deductions and claims the standard deduction of \$15,000 on his 2025 Form 1040. What is Theo's qualified business income deduction?

## Application Problems

1. **(LO2)** Cain Inc. (a calendar year-end corporation) filed its 2025 Form 1120 on February 14, 2026.
  - a. When will the statute of limitations for its 2025 return expire?
  - b. When will the statute of limitations expire if it filed its tax return on August 15, 2026?
  - c. When will the statute of limitations expire if Cain Inc. never filed its return?
2. **(LO2)** Granite Inc. filed its 2025 tax return on May 29, 2026, and never properly extended its tax return. Granite owed \$6,400, which was paid on April 15, 2026.
  - a. How much is its failure to file penalty?
  - b. If it filed its return on December 15, 2026, what is its failure to file penalty?
3. **(LO2)** Granite Inc. filed its 2025 tax return on April 15, 2026. Granite Inc. owed \$6,400 for its 2025 tax return, which was not paid when the return was filed.
  - a. How much is Granite's failure to pay penalty if it filed its return on April 15, 2026, and paid the balance due on May 29, 2026?
  - b. If Granite filed its return on April 15, 2026, and paid the balance due on December 15, 2026, what is its failure to pay penalty?
4. **(LO2)** Granite Inc. filed its 2025 tax return late and never properly extended its tax return. Granite's failure to file its return on time was determined to be intentional and fraudulent. Granite owed \$6,400 for its 2025 tax return.
  - a. How much is its failure to file penalty if it filed its return on May 29, 2026?
  - b. If it filed its return on December 15, 2026, what is its failure to file penalty?
5. **(LO2)** Asher Inc. is a medical supply corporation with a calendar year-end. Its tax liability is \$56,000 for 2025 and \$50,000 for 2024. How much must Asher Inc. pay in estimated income taxes in 2025 to avoid an underpayment penalty for 2025? Assume the annualization exception is not beneficial to Asher.
6. **(LO2)** Decker Corporation owes \$18,500 in tax liability with its 2025 tax return due on April 15, 2026. Decker filed its return, but unfortunately, Decker was not able to pay its liability until July 1, 2026. Assume that the federal short-term interest rate is 4%. How much will the IRS assess Decker for interest and penalties?

**7. (LO2)** Enthusiasm Learning Center is a partnership with a calendar year-end. Enthusiasm filed its Form 1065 for 2025 on October 5, 2026. Enthusiasm has 24 limited partners and one general partner. What is Enthusiasm's penalty for late filing of its tax return?

**8. (LO3)** Elijah Inc. owns an apartment building that it purchased 10 years ago for \$345,000. Its current adjusted basis is \$220,000, and the outstanding mortgage is \$250,000. Elijah Inc. sells the building for cash of \$300,000 plus assumption of the mortgage. Elijah Inc. pays commissions on the sale of \$30,000, title transfer fees of \$500, and an attorney at closing \$1,000. What is Elijah Inc.'s realized and recognized gain?

**9. (LO3)** Chase Company would like to exchange land that it owns (adjusted basis \$140,000 and FMV of \$172,000) for land in a neighboring county (adjusted basis \$120,000 and FMV \$142,000) plus cash of \$30,000. Assume that the parcels of land are qualified property for treating this as a deferred transaction, and that the cash is boot.

- What is Chase's realized gain?
- What is Chase's recognized gain?
- What is Chase's deferred gain?
- What is Chase's basis in the property received?
- What is Chase's holding period in the new property?

**10. (LO3)** Evan owns investment land with an adjusted basis of \$52,000 and fair market value of \$42,000. He sells the land to Stan Corporation, an S Corporation for which he is an 80% shareholder, for \$39,000. Stan Corporation then sells the land to an unrelated third party for \$65,000.

- What is Evan's realized gain/loss and recognized gain/loss? What is Stan Corporation's basis in the land purchased?
- What is Stan Corporation's realized gain/loss and recognized gain/loss?
- Assume the same facts except Stan Corporation then sells the land to an unrelated third party for \$45,000. What is Stan Corporation's realized gain/loss and recognized gain/loss?
- Assume the same facts except Stan Corporation then sells the land to an unrelated third party for \$35,000. What is Stan's realized gain/loss and recognized gain/loss?

**11. (LO3)** Classify each of the following assets as realty, personalty (tangible), personalty (intangible asset), or natural resource.

- Extracted coal
- Covenant not to compete
- Warehouse used to store chemicals
- Trademark used to sell a product
- Dump truck used at a construction site
- Printer used in an office

**12. (LO3)** Classify each of the following assets as ordinary, Section 1231, or capital.

- Notes receivable
- One parcel of land held for investment
- Automobile used 100% for business and held for three years
- 1967 Ford Mustang owned for personal pleasure
- Desk and chair used in business and sold after three months
- Land used as a playground for a day care center

**13. (LO4)** Sven Inc. sold several business assets in the current year. The sales resulted in Section 1231 gains of \$12,000 and Section 1231 losses of \$15,000. What is the character of the Section 1231 gains and losses?

**14. (LO4)** Boris is the sole owner of a single-member LLC that reports its tax items on Schedule C. The LLC had several transactions during the year.

- Land held for investment for 13 months and sold at a gain of \$45,000
- Inventory used in the LLC and sold for a loss of \$23,000
- Casualty loss from a fire in the warehouse of \$55,000
- Parking lot adjacent to the business sold at a gain of \$20,000 after being held for more than one year

Determine the tax consequences of these transactions. Assume that the LLC had no prior Section 1231 losses in previous years and no other sales of Section 1231 assets this year.

**15. (LO4)** Daisy Company had several pieces of land that it sold in the current year:

<u>Asset</u>	<u>Sales price</u>	<u>Cost</u>	<u>Holding period</u>
Land held for Investment	\$100,000	\$ 74,000	Long-term
Land #1 used in its business	\$135,000	\$140,000	Short-term
Land #2 used in its business	\$122,000	\$115,000	Long-term

What are the tax consequences of the asset sales? Assume that Daisy Company does not have any net Section 1231 losses in prior years and that these are all the Section 1231 transactions for this year.

**16. (LO4)** Li Company started its ice cream parlor in Year 1. In Year 4, Li sold one business-use asset for a Section 1231 gain of \$5,000 and sold another business-use asset for a Section 1231 loss of \$2,200. If Li Company had a net Section 1231 loss of \$1,000 in Year 3, what is the amount and character of the assets sold in Year 4?

**17. (LO4)** Rhys Inc. sold various business-use assets in Year 10 resulting in a net Section 1231 gain of \$7,000. Rhys Inc. had the following net Section 1231 gains and losses in the previous years:

- Year 4 (\$2,000)
- Year 5 (\$1,500)
- Year 6 \$2,500
- Year 7 \$ 800
- Year 8 (\$4,500)
- Year 9 \$3,000

How is the Year 10 net Section 1231 gain of \$7,000 treated?

**18. (LO4)** Sandra Company sold land that it used in its business for \$125,000 in the current year. Sandra Company purchased the land several years ago for \$138,000.

- What is the amount and character of Sandra's recognized gain/loss?
- What if Sandra Company sold the asset for \$150,000? Assume it did not have any prior net Section 1231 losses in the past five years and that there were no other Section 1231 transactions this year.

**19. (LO4)** Sasha Inc. owns business-use equipment with an initial purchase price of \$50,000. The asset's accumulated depreciation is

\$30,000. Assume that Sasha Inc. sells the equipment for \$25,000 and that its tax rate is 21%.

- a. Compute Sasha Inc.'s tax gain or loss on the sale and the character of the gain or loss.
  - b. Compute Sasha Inc.'s after-tax cash flow from the sale.
- 20. (LO4)** Bohai owns Dig Deep Company (DDC), specializing in manufacturing colonoscopy equipment. In the current year, DDC sold a machine for \$28,000. DDC purchased the machine in 2021 for \$38,000 and deducted depreciation expense of \$23,000.
- a. What is the amount and character of the gain/loss?
  - b. What if the machine was sold for \$49,000?
  - c. What if the machine was sold for \$12,000?
- 21. (LO4)** MaryAnn Company purchased Tanger Corporation five years ago for \$780,000. As part of the purchase, MaryAnn Company acquired two patents, which had a value of \$50,000. In the current year, the company sells both patents for \$65,000. Total amortization claimed on the patents through the date of sale was \$16,800. What are the tax consequences of this sale?
- 22. (LO4)** Daisy LLC has owned an apartment building since 1985, which it purchased for \$232,000. Daisy LLC sold the apartment building in 1989 for \$248,000. Accumulated depreciation as of the date of sale was \$34,000, of which \$6,000 was in excess of straight-line depreciation. How much of the gain is considered ordinary income?
- 23. (LO4)** Eric LLC purchased a commercial building five years ago for \$365,000. In the current year, Eric LLC sold the building for \$100,000 cash and the buyer's assumption of Eric's debt on the building of \$300,000. Through the date of sale, Eric LLC deducted \$47,000 straight-line depreciation on the building. Compute Eric LLC's recognized gain on the sale and the character of the gain.
- 24. (LO4)** Delgado Corporation purchased an apartment building on August 3, 2021, for \$980,000 and sold the building on March 9, 2025, for \$1,300,000. Delgado deducted straight-line depreciation of \$127,689 for years 2021–2025. Determine the recognized gain and its character.
- 25. (LO4)** Upon her death, Latif's grandmother bequeathed him the apartment building that she had rented out for the last 12 years. He does not want the hassle of maintaining the building, so he intends to sell the building right away. What are his tax consequences based on the following information?
- Fair market value as of the date of death was \$625,000.
  - Original cost was \$400,000.
  - Straight-line depreciation taken was \$175,000 through the date of sale.
  - Latif sells the building for \$650,000.
- 26. (LO5)** Susan owns a floral shop as a sole proprietorship and has net earnings of \$100,000 on Schedule C. Susan is allowed a self-employment tax deduction for AGI of \$7,065 ( $\$100,000 \times 0.9235 \times 15.3\% \times 50\%$ ). What is her qualified business income?
- 27. (LO5)** Roger, a single taxpayer, owns and operates a video game store. He does not have any employees and reported qualified business

income of \$125,000 through a sole proprietorship in 2025. Roger has AGI of \$155,000, including \$2,000 interest income, has no itemized deductions, and claimed the standard deduction of \$15,000 on his 2025 Form 1040. His modified taxable income is \$140,000 ( $\$155,000 - \$15,000$ ). What is Roger's QBI deduction?

**28. (LO5)** Kate, a single taxpayer, owns and operates an ice cream shop. She does not have any employees and reported qualified business income of \$125,000 through a sole proprietorship in 2025. Kate has AGI of \$155,000, including \$20,000 of net capital gain, has no itemized deductions, and claimed the standard deduction of \$15,000 on her 2025 Form 1040. Her modified taxable income is \$120,000 ( $\$155,000 - \$15,000 - \$20,000$ ). What is Kate's QBI deduction?

**29. (LO5)** Jaewoo is a CPA and operates his own CPA firm as a single-member LLC. His qualified business income from his accounting firm was \$555,000 for 2025. Jaewoo paid wages of \$162,000 this year, and the unadjusted basis of the property used in the LLC was \$400,000. Jaewoo is married, and the taxable income before the QBI deduction is \$500,000 for him and his spouse. What is Jaewoo's QBI deduction?

**30. (LO5)** Lexi, a single taxpayer, owns and operates a computer repair shop. She pays one employee \$15,000 in wages and has no qualified property. Lexi reported qualified business income through a sole proprietorship of \$145,000 in 2025. She has AGI of \$285,000, has no itemized deductions, and claimed the standard deduction of \$15,000 on her 2025 Form 1040. Her modified taxable income is \$270,000 ( $\$285,000 - \$15,000$ ).

- a. What is Lexi's QBI deduction?
- b. Assume Lexi has machinery and equipment with an unadjusted basis of \$160,000. What is her QBI deduction?

**31. (LO5)** Grant, a single taxpayer, has qualified business income and the following qualified business deductions after considering the wage limitation and the specified services limitation:

Sunshine LLC	\$25,000
Monsoon S Corporation	\$18,000
Landslide LLP	\$15,000

Grant's modified taxable income is \$275,000, which includes net capital gains of \$5,000 and qualified dividend income of \$2,500. What is his allowable QBI deduction?

**32. (LO5 Advanced)** Alexander, a single taxpayer, owns and operates a fishing supply store. He pays one employee \$15,000 in wages and has qualified property with an unadjusted basis of \$160,000. He reported qualified business income through a sole proprietorship of \$145,000 in 2025. Alexander has taxable income of \$205,350, which is also his modified taxable income.

- a. What is Alexander's QBI deduction?
- b. If Alexander were a tennis professional, what would be his QBI deduction?
- c. If Alexander were a tennis professional with a taxable income of \$250,000, what would be his QBI deduction?

## Tax Planning Problems

1. **(LO3)** Benjamin owns equipment that is used 100% in his business with a fair market value of \$11,000 and an adjusted basis of \$15,000. He would like to sell the equipment and is looking for the best net after-tax cash flow. His tax rate is 35%. Would it be better to sell the equipment to his dad for \$11,000 or his best friend for \$10,000? Why?

2. **(LO4)** Your client, Dwayne, owns Dwayne's Manufacturing Company, and is looking to sell and replace his entire line of machinery and equipment, which is used to manufacture rugs. The machinery and equipment originally cost \$500,000 and is fully depreciated. Dwayne expects to sell the machinery and equipment for its fair market value of \$500,000. He has told you that he assumes he will recognize no gain because he is selling the machinery and equipment for the same amount he paid for them. Explain how the sale will be treated and why Congress created the depreciation recapture rules. Assume that Dwayne's ordinary marginal tax rate is 37% and his LTCG rate is 20%.

3. **(LO4)** Barret Company has been in business since 2014 and has never sold a Section 1231 asset. Barret has a net profit before asset sales of \$350,000 this year. Barret has owned the following assets since inception of the business but is trying to decide if it is the right time to sell the assets before the end of the year.

<u>Asset</u>	<u>Sales price</u>	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>Gain/loss</u>
Furniture	\$ 7,000	\$10,000	\$10,000	\$ 7,000
Computers	\$ 2,500	\$ 4,000	\$ 3,000	\$ 1,500
Artwork	\$ 10,000	\$12,000		(\$ 2,000)
Machinery	\$ 8,000	\$12,000	\$ 2,000	(\$ 2,000)
Building	\$100,000	\$75,000	\$ 7,500	\$32,500
Stock	\$ 60,000	\$33,000		\$27,000

What is the character of the gains/losses, and what is Barret's profit after asset sales? Is there any advice you would give him with regard to the Section 1231 assets?

4. **(LO4)** DeMarcus owns and operates a sporting goods store as a single member LLC. He is considering selling several assets (used in

the business and held long-term) and would like to know the most advantageous tax result. These would be the only Section 1231 assets sold this year. Assume DeMarcus is in a 37% tax bracket and has never sold an asset in the past. The following information will help you decide the best course of action. Should Demarcus sell the assets this year or wait until next year?

<u>Asset</u>	<u>Sales price</u>	<u>Cost</u>	<u>Depreciation</u>	<u>Gain/loss</u>
Building	\$100,000	\$75,000	\$5,000	\$ 30,000
Land	\$ 25,000	\$37,000	N/A	(\$ 12,000)

5. **(LO4)** Sanjay has asked your advice on how to treat an asset sale that he will have in the near future. Sanjay is very close to his uncle, who is critically ill. His uncle has listed several assets in his will that Sanjay will inherit upon the uncle's death. One of the assets is a warehouse that his uncle uses in his business and has owned for the last 10 years. Sanjay would like to know the tax consequences if the warehouse was gifted to him by his uncle or if he waits and receives it through inheritance. Calculate the gain, if any, and its character if Sanjay receives the gift today or if he waits until his uncle passes, based on the following information.

Fair market value today	\$500,000
Original cost	\$375,000
Straight-line depreciation claimed	\$ 96,000

Assume that the uncle dies, Sanjay sells the warehouse for \$550,000, and the fair market value as of date of death is \$500,000.

6. **(LO5)** Candy Cane, single, owns and operates the following businesses in 2025. None of these are specified service businesses.

<u>Business</u>	<u>QBI</u>	<u>W-2 wages</u>	<u>Property</u>
Treetop Decorations	\$100,000	\$12,500	\$0
Candy's Cookies	\$ 65,000	\$ 0	\$0
Candy's Snow Supplies	(\$ 45,000)	\$ 5,000	\$0

Candy's modified taxable income is \$400,000. Can she ignore the loss from Candy's Snow Supplies in calculating her QBI deduction?

## Professional Development Skills

### Communication Problem

Communication

**1. (LO4) Decision on When to Sell Business-Use Assets** Sylvia has owned her own beauty salon as a sole proprietorship in Alpharetta, Georgia, since 2017. The salon needs a makeover, and she is looking at selling her salon chairs, furniture, and pedicure basins. All of these assets have been held long-term. Sylvia has never sold any business assets in the past, and her current year AGI before the sale of assets is \$150,000. Included in her AGI is a \$10,000 short-term capital loss from the sale of stock that has been limited to \$3,000. She would like your advice as to whether the sale of these assets will help utilize her entire \$10,000 loss. She provides you with the following information:

<u>Asset</u>	<u>Cost</u>	<u>Accumulated depreciation</u>	<u>FMV</u>
Chairs	\$48,000	\$30,000	\$24,000
Furniture	\$25,000	\$15,000	\$ 8,000
Basins	\$12,000	\$ 3,000	\$13,000

If Sylvia sells the assets at their fair market value (FMV), what will be the amount of recognized gain/loss and its character? Will the sale of assets help utilize her \$10,000 short-term capital loss? Write a letter to Sylvia explaining your findings.

### Ethics and Professional Responsibilities Problem

Ethics

**1. (LO1) Underreported Income** Anthony Johnson, who owns a local bar and works as its bartender, is a new client of yours and would like to meet to discuss his financial statements and tax return for the current year. He operates the bar as an S corporation and is the sole shareholder. Anthony indicates that business has been slow; he expects a loss and feels he shouldn't owe any taxes this year. While reviewing the manual business records and Anthony's personal tax information, you see that there are very few cash receipts and no recording of tips. Anthony also has a large mortgage on his home, generating \$28,000 in mortgage interest expense, and \$25,000 in property taxes. You continue to dig through previous tax returns for the S corporation and Anthony's Form 1040 and notice very little income for the last five years. You wonder how Anthony can afford such a nice home. During your next meeting, you ask him about the cash receipts, the tips, and his large mortgage and property taxes. Anthony is vague and says no one in his line of work reports all the cash receipts and tips. What should you do?

In addition to the chapter content, see *Statements on Standards for Tax Services* at [www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services](http://www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services), *Circular 230* at [www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230](http://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230), and Chapter 2, LO4, Tax Professional Responsibilities.

**2. (LO1) Reliance on Workpapers of a Third Party** Your CPA firm, Carnes and Youngberg, has been hired to help a new client in resolving a dispute with the IRS for a prior year's tax return. Carnes and Youngberg did not prepare the return, and your client did not have the best record keeping in the past. When reviewing the correspondence from the IRS, as well as Form 4797, Form 8949, and Schedule D, you notice some discrepancies on the forms compared to the workpapers that your client did provide. You realize that the workpapers and tax return were prepared by Frank Fishy, an attorney who also prepares tax returns. With a little digging, you find out that Frank Fishy has been disbarred from practicing before the IRS, and this concerns you. May you ask for assistance from Frank or rely on his workpapers? What is your responsibility regarding representing the client before the IRS?

In addition to the chapter content, see *Statements on Standards for Tax Services* at [www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services](http://www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services), *Circular 230* at [www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230](http://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230), and Chapter 2 LO4, Tax Professional Responsibilities.

## Research Problems

### Research

**1. (LO2) Timely Filing of Tax Return** Collins Inc. is a calendar year-end C corporation owned 100% by Chase Collins. Chase was out of the country on the due date for filing the 2025 tax return, so he asked his CPA to file an extension. The CPA properly completed the extension form and queued it up to file electronically with her software. Unfortunately, the CPA never hit the submit button and did not realize the error until October 15 when she wanted to electronically file the tax return at the extension due date. As a result, the Collins Inc. tax return was not timely filed, and the IRS assessed a late filing penalty of \$83,650 against the corporation. Collins Inc. paid the penalty and have filed a case in District Court to have the penalty abated. Chase Collins states that he relied on his CPA to properly file the extension, and the corporation should not be assessed the penalty. Conduct research to determine if Collins Inc. has reasonable cause to have the penalty abated.

**2. (LO4) Potential Depreciation Recapture** Grandma Sally died on November 5 of the current year. In her will, she left her granddaughter, Sienna, several assets that Sally had used in her farming business, including:

	<u>FMV at date of death</u>	<u>Sally's basis in the asset</u>
Silo	\$335,000	\$145,000
Farming equipment	\$ 80,000	\$110,000

Sienna would like to sell the assets immediately for their FMV. Does the depreciation recapture provision apply to either Sally or Sienna?

## Excel Problems

### Technology

**1. (LO3) Related-Party Sale** Chike owns 100 shares of stock in Belvidere Corporation. He purchased the stock for \$40,000 three years ago. Chike sells the shares to Naomi Inc. in the current year for \$32,000, resulting in a realized loss of \$8,000 to Chike. Chike owns 75% of Naomi Inc. Create an Excel spreadsheet to indicate the recognized gain if Naomi Inc. sells the stock to an outside third party for:

1. \$42,000
2. \$36,000
3. \$30,000

**2. (LO4) Lookback Rule** Elonzo Corporation sold various business-use assets in Year 20, resulting in a net Section 1231 gain of \$12,000. Year 14 was the first year of operations. Elonzo Corporation had the following net Section 1231 gains and losses in the previous years:

- Year 14 \$6,500
- Year 15 (\$2,000)
- Year 16 (\$4,500)
- Year 17 \$5,000
- Year 18 (\$2,500)
- Year 19 (\$1,000)

- a. How is the Year 20 net Section 1231 gain of \$12,000 treated?
- b. How would your answer change if the Year 14 amount was (\$6,500)?
- c. Create an Excel spreadsheet that shows your results and that could also be used for the same question with different amounts.

## Tax Compliance and Reporting Problem

**Compliance**

**1. (LO4) Sale of Assets** Victor E. Husky (SSN: 123-45-6789) owns and operates Husky Ice Arena and Pro Shop as a sole proprietor. During 2025, the following transactions occurred:

1. A delivery truck used in the business was sold on January 2 for \$3,500. The truck had been purchased on January 2, 2019, for \$6,000. The asset was fully depreciated.
2. Unimproved land (which is considered a business-use asset) adjacent to the Ice Arena was sold for \$15,000 on February 1. This land had been purchased on November 28, 2003, for \$40,000.
3. Victor sold a rowing machine used by the hockey players at the ice arena on June 5 for \$4,900. The rowing machine was purchased on July 29, 2016, for \$5,200. The asset was fully depreciated.
4. Victor sold an apartment building on September 1 for \$300,000. The rental property had been purchased on September 1, 2022, for \$150,000. As of the date of the sale, the adjusted basis was \$133,637.
5. A Zamboni used in the business was sold on October 10 for \$85,000. The Zamboni had been purchased on October 10, 2023, for \$100,000. As of the date of sale, the accumulated depreciation was \$61,600.
6. Ice equipment used in the business was sold on October 14 for \$5,000. The ice equipment had been purchased on October 16, 2022, for \$35,000. As of the date of the sale, accumulated depreciation was \$26,936.

Victor does not have any unrecovered Section 1231 lookback losses. Victor needs help completing his tax return in regard to these asset sales. Please complete Form 4797. The 2024 Form 4797 is used because it was the most recent form available at the time of publication.

## CPA Exam Preparation: Task-Based Simulation

**1. (LO3) Calculation of Realized Gain** Hall Inc. is selling its current warehouse and purchasing another larger warehouse for its growing business. You will review a list of improvements provided by Hall Inc., as well as the settlement statements for purchase and sale, and determine the amount realized, adjusted basis, and realized gain on the sale.

*Go to Wiley's book companion site to complete the Task-Based Simulation.*

**2. (LO4) Calculating Gain/Loss and Character on Sale of Assets** Harry Clarke and Russell Addison own Nutty for U (NFU), a partnership located on Waverly Avenue in Windy City, Illinois. NFU is a very popular store for nuts, popcorn, and candy, but its owners would like to move their location closer to a popular ballpark. NFU will be selling some of its assets and would like to know the tax implications of each sale. You will calculate the gain or loss for assets like inventory, equipment, and real estate, and determine the character of each gain or loss.

*Go to Wiley's book companion site to complete the Task-Based Simulation.*

**3. (LO5) Saenz—Qualified Business Income** Javier and Maria Saenz, married filing jointly, have several business investments. Their adjusted gross income and taxable income for 2025 is \$300,000 and \$275,000, respectively, before any qualified business income deduction.

Referencing information from two Schedule K-1 forms and one Schedule C form, you will calculate their qualified business income deduction for three different deduction scenarios.

*Go to Wiley's book companion site to complete the Task-Based Simulation.*