PacificCPE

COURSE
30503A

Section 1231 Property, Depreciation Recapture, and Reporting

Business asset sales come with their own set of rules—and getting them wrong can be costly. This course walks through Section 1231 gains and losses, depreciation recapture under the tax code, and how to accurately report everything on Schedule D, Form 8949, and Form 4797. Whether you're preparing returns for sole proprietors, partnerships, or corporations, understanding these rules is essential for correctly characterizing gains and losses and completing the right forms.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify what section 1231 gains and losses are.
- Recognize how to account for depreciation recapture.
- Recognize how to report capital and ordinary gains and losses from sales, exchanges, and other dispositions of property.

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Chapter 1: ORDINARY OR CAPITAL GAIN OR LOSS FOR BUSINESS PROPERTY

Chapter Objective

After completing this chapter, you should be able to:

- Identify what section 1231 gains and losses are.
- Recognize how to account for depreciation recapture.

I. INTRODUCTION

When you dispose of business property, your taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary or capital is determined under the rules for section 1231 transactions.

When you dispose of depreciable property (section 1245 property or section 1250 property) at a gain, you may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any remaining gain is a section 1231 gain.

This chapter discusses:

- Section 1231 gains and losses
- Depreciation recapture

II. SECTION 1231 GAINS AND LOSSES

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions (discussed later). Their treatment as ordinary or capital depends on whether you have a net gain or a net loss from all your section 1231 transactions.

Caution!

If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account as section 1231 gain.

Caution!

Only gain in excess of the recapture amount is considered section 1231 gain.

Section 1231 transactions. The following transactions result in gain or loss subject to section 1231 treatment.

- **Sales or exchanges of real property or depreciable personal property.** This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. This property must also be either real property or of a kind that is subject to depreciation under section 167 of the Internal Revenue Code. Depreciable personal property includes amortizable section 197 intangibles (described in Chapter 2 of course 30502N under Other Dispositions).
- **Sales or exchanges of leaseholds.** The leasehold must be used in a trade or business and held longer than 1 year.
- **Sales or exchanges of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 2 years or longer.
- **Sales or exchanges of other livestock.** This livestock does not include poultry. It must be held for draft, breeding, dairy, or sporting purposes and held for 1 year or longer.
- **Sales or exchanges of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person and the land must be held longer than 1 year. You cannot keep any right or option to directly or indirectly reacquire the land (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a lease on the land, though sold to the same person in the same transaction, are not included.
- **Cutting of timber or disposal of timber, coal, or iron ore.** The cutting or disposal must be treated as a sale, as described in Chapter 2 of course 30502N under Timber and Coal and Iron Ore.
- **Condemnations.** The condemned property must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.

- **Casualties and thefts.** The casualty or theft must have affected business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). You must have held the property longer than 1 year. However, if your casualty or theft losses are more than your casualty or theft gains, neither the gains nor the losses are taken into account in the section 1231 computation.

Property for sale to customers. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is not a section 1231 transaction. If you will get back all, or nearly all, of your investment in the property by selling it rather than by using it up in your business, it is property held mainly for sale to customers.

Example

You manufacture and sell steel cable, which you deliver on returnable reels that are depreciable property. Customers make deposits on the reels, which you refund if the reels are returned within a year. If they are not returned, you keep each deposit as the agreed-upon sales price. Most reels are returned within the 1-year period. You keep adequate records showing depreciation and other charges to the capitalized cost of the reels. Under these conditions, the reels are not property held for sale to customers in the ordinary course of your business. Any gain or loss resulting from their not being returned may be capital or ordinary, depending on your section 1231 transactions.

Patents and copyrights. The sale of a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, or similar property is not a section 1231 transaction if your personal efforts created the property, or if you acquired the property in a way that entitled you to the basis of the previous owner whose personal efforts created it (for example, if you receive the property as a gift). The sale of such property results in ordinary income and generally is reported in Part II of Form 4797.

Property deducted under the de minimis safe harbor for tangible property. If you deducted the costs of a property under the de minimis safe harbor for tangible property (currently $2,500 or less), then upon its sale or disposition, this property is not treated as property used in the trade or business under section 1231. Generally any gain on the disposition of this property is treated as ordinary income and is reported on Part II of Form 4797.

Example

In 2025 you paid $1,000 for a machine that you used in your business. you deducted the $1,000 cost of the machine on your 2025 income tax return under the de minimis safe harbor for tangible property. In 2027, you sold the machine for $1,500. Because you deducted the cost of the machine under the de minimis safe harbor, this property is not treated as property used in the trade or business under section 1231. Upon sale of the machine, you must report the $1,500 as ordinary gain on line 10 of Form 4797.

Treatment as ordinary or capital. To determine the treatment of section 1231 gains and losses, combine all your section 1231 gains and losses for the year.

- If you have a net section 1231 loss, it is ordinary loss.
- If you have a net section 1231 gain, it is ordinary income up to the amount of your nonrecaptured section 1231 losses from previous years. The rest, if any, is long-term capital gain.

Nonrecaptured section 1231 losses. Your nonrecaptured section 1231 losses are your net section 1231 losses for the previous five years that have not been applied against a net section 1231 gain. Therefore, if in any of your five preceding tax years you had section 1231 losses, a net gain for the current year from the sale of section 1231 assets is ordinary gain to the extent of your prior losses. These losses are applied against your net section 1231 gain beginning with the earliest loss in the five-year period.

Example

In 2025, Ben has a $2,000 net section 1231 gain. To figure how much he has to report as ordinary income and long-term capital gain, he must first determine his section 1231 gains and losses from the previous 5-year period. From 2020 through 2024 he had the following section 1231 gains and losses.

Year	Amount
2020	-0-
2021	-0-
2022	($2,500)
2023	-0-
2024	$1,800

Ben uses this information to figure how to report his net section 1231 gain for 2025, as shown below.

1) Net section 1231 gain (2025)		$2,000
2) Net section 1231 loss (2022)	($2,500)	
3) Net section 1231 gain (2024)	1,800	
4) Remaining net section 1231 loss from prior 5 years	($700)	
5) Gain treated as ordinary income		$700
6) Gain treated as long-term capital gain		**$1,300**

III. DEPRECIATION RECAPTURE

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income.

Records. To figure any gain that must be reported as ordinary income, you must keep permanent records of the facts necessary to figure the depreciation or amortization allowed or allowable on your property. This includes the date and manner of

acquisition, cost or other basis, depreciation or amortization, and all other adjustments that affect basis.

On property you acquired in a nontaxable exchange or as a gift, your records also must indicate the following information.

- Whether the adjusted basis was figured using depreciation or amortization you claimed on other property.
- Whether the adjusted basis was figured using depreciation or amortization another person claimed.

General asset accounts. Different rules apply to dispositions of property you depreciated using a general asset account.

Special rules for qualified section 179 real property. If you sold or otherwise disposed of qualified real property for which you elected under section 179 of the Internal Revenue Code to treat the cost of such property as an expense, special rules apply. This includes special rules for determining gain or loss and determining if the basis of the property is treated as section 1245 or 1250 property.

SECTION 1245 PROPERTY

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property.

Any gain recognized that is more than the part that is ordinary income from depreciation is a section 1231 gain. See Treatment as ordinary or capital under *Section 1231 Gains and Losses*, earlier.

Section 1245 property defined. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property.

1. Personal property (either tangible or intangible).
2. Other tangible property (except buildings and their structural components) used as any of the following.
   a) An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   b) A research facility in any of the activities in (a).
   c) A facility in any of the activities in (a) for the bulk storage of fungible commodities.

3. Where applicable, that part of real property (not included in (2)) with an adjusted basis that was reduced by (but not limited to) the following.
   a) Amortization of certified pollution control facilities.
   b) The section 179 expense deduction.
   c) Deduction for qualified clean-fuel vehicles. The termination of qualified clean-fuel vehicles expired on September 30, 2025. Deduction for certain refueling property (as in effect before repeal by P.L. 113-295).
   d) Deduction for capital costs incurred in complying with Environmental Protection Agency sulfur regulations.
   e) Deduction for certain qualified refinery property if in effect before the repeal by the Tax Increase Prevention Act of 2014. (Repealed by Public Law 113-295, section 221(a)(34)(A), except with regard to deductions made prior to December 19, 2014.)
   f) Any applicable deduction for qualified energy efficient commercial building property. See section 179D.
   g) Amortization of railroad grading and tunnel bores, if in effect before the repeal by the revenue Reconciliation Act of 1990. (Repealed by Public Law 99-514, Tax Reform Act of 1986, section 242(a)).
   h) Certain expenditures for child care facilities if in effect before repeal by the Omnibus Budget Act of 1990, Public Law 101-508, section 11801(a)(13) (except with regards to deductions made prior to November 5, 1990).
   i) Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
   j) Deduction for qualified tertiary injectant expenses.
   k) Certain reforestation expenditures.
   l) Deduction for election to expense qualified advanced mine safety equipment property.
   m) Any deduction for qualified film, television, or live theatrical productions under section 181 of the Internal Revenue Code, as amended by P.L. 119–21. Also, any deduction for qualified sound recording productions beginning in taxable years ending after July 4, 2025.
4. Single purpose agricultural (livestock) or horticultural structures.
5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.
6. Any railroad grading or tunnel bore.
7. Any qualified production property (as defined in section 168(n)(2)).