

The tax aspects of disposing of business assets

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This fact sheet will help you understand various Internal Revenue Service regulations and publications as they apply to your marine business. It is not a substitute for IRS regulations and publications, or for expert counsel you may obtain from the IRS or professional tax practitioners.

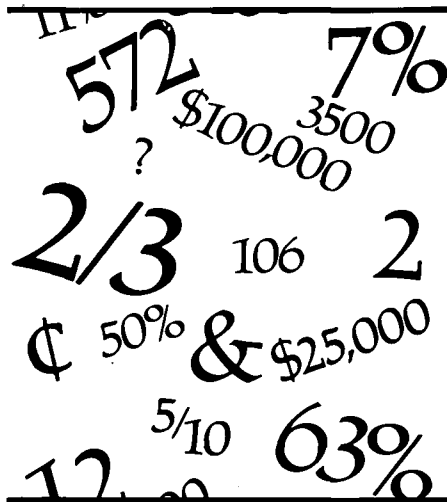
Tax treatment of disposed business assets may be one of the commonest yet most confusing sections of the IRS Code with which you must deal. There are a number of different ways in which an asset may leave the firm. An asset may be sold, exchanged, or lost through fire, disaster, theft, or other casualty situations.

For the tax treatment of these transactions, you must take these factors into consideration:

1. adjusted basis of the asset at the time of disposition;
2. the amount of depreciation which you have taken on the asset since it was acquired;
3. the proceeds you received in exchange for the asset;
4. the length of time the asset was in service in the firm;
5. whether "like property" or "unlike property" was received in exchange or purchased within certain time limits;
6. whether the asset is considered a capital asset or a noncapital (ordinary) asset; and
7. which of several tax options you choose to take in a specific instance.

Sales

The sale of a business asset is the simplest transaction. However, not all transactions involving money are sales. Insurance payments usually involve money, but when they are paid to you for an asset, they are treated as involuntary exchanges.



Exchanges

An exchange is a transfer of property for other property not money, and is usually taxed in the same way as a sale, except for nontaxable exchanges. A transaction is ordinarily an exchange if when you sell property used in your trade or business, you immediately buy similar property to replace it, and the sale and purchase are mutually related transactions with the same party. Whether or not a sale (followed by a purchase) is an exchange, depends upon the facts of the exchange.

Example. You used a pickup truck in your business for four years. Its depreciated basis is \$500 and its trade-in value is \$1,000. You are interested in a new truck that has a cash price of \$3,500. Ordinarily, you would trade your old truck for the new one and pay the dealer an additional \$2,500. Your basis for depreciation for the new truck would then be \$3,000 (\$2,500 cash paid plus \$500 basis for the old truck). However, you arrange to sell your old truck to the dealer for \$1,000 cash and buy the new truck for \$3,500 cash from the same dealer. You will still be considered to have exchanged your old truck for the new one, because the sale and purchase were reciprocal and mutually dependent. Your basis for depreciation for the new truck will be \$3,000, as if you traded the old truck.

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Nontaxable exchanges

The exchange of property for like property is the commonest type of transaction in which there is no gain or loss recognized. However, certain strict conditions must be met. These include:

1. The exchange must be for business or investment property (neither can be for personal use).
2. It must be like property (personal property cannot be exchanged for real estate).
3. It must not be property held for sale (must not be merchandise to be sold to customers).

These rules do not apply to exchanges of stocks, bonds, and the like.

Gain from certain exchanges of property is not taxed, nor is loss deductible, at the time of exchange. The new property is treated, substantially, as a continuation of the old, unliquidated investment. Taxation of the gain or deduction of the loss of such an exchange is postponed until you dispose of the property received in the exchange.

Example 1: You trade an old fishing vessel for a new one. The new one costs \$9,800. You are allowed \$1,000 for the old fishing vessel, and you pay \$8,800 cash. You have no taxable gain or deductible loss on the transaction regardless of the adjusted basis of the old vessel. If you had sold the old fishing vessel to a third party for \$1,000 and then purchased a new one, you would have had a recognized gain or loss on the sale of the old vessel measured by the difference between the amount realized and the adjusted basis of the old fishing vessel.

Example 2: You exchange real estate held by you for investment, having an



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adjusted basis of \$8,800, for other real estate to be held for investment. The real estate you receive has a fair market value of \$10,000, and you also receive \$1,000 in cash. Although the total gain realized on the transaction is \$3,000, the portion of gain to be included in income is limited to the \$1,000 cash received.

Example 3: Suppose, in the preceding example, that the property you transfer is subject to a \$3,000 mortgage. The gain realized and the amount of gain to be taxed are as follows:

Fair market value of like property received	\$10,000
Cash	1,000
Mortgage	3,000
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Total consideration received	14,000
Less: Adjusted basis of property you transferred	8,000
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Gain realized	\$ 6,000

The gain realized is taxed only to the extent of \$4,000, the sum of the cash (\$1,000) and the \$3,000 mortgage. Basis of the new property in such cases is discussed in IRS Publication 595.

Types of gains and losses

There are different types of gains and losses that arise from different situations. Part of the differences depend upon whether or not the asset is properly called a capital asset, a noncapital (ordinary) asset, or one that may be treated as either of these two under certain circumstances. Potential gains and losses include:

1. ordinary gain on the disposition of depreciable property,
2. casualty gains and losses, and
3. capital or ordinary gains and losses.

For income tax purposes, all property you own and use for personal purposes, pleasure, or investment is a *capital asset*. An intangible property right may also be a capital asset. Examples of capital assets would include: a dwelling that you and your family own and occupy; household furnishings that you and your family use; an automobile used for pleasure; stocks and bonds when held by individuals for investment. You will find additional information on this subject in IRS Publication 550.

An asset is a *noncapital (ordinary) asset* if it is excluded from the term *capital assets*. A list of properties, excluded from the term *capital assets* by the law, appears in the Schedule D instructions (IRS Publication 544). This means that most of the property or assets used in a business are considered noncapital or ordinary assets. Examples include trucks, plant equipment, and commercial fishing vessels.

Ordinary gains on the disposition of depreciable property

Depreciation allowed, including additional first-year depreciation, may cause the gain on a disposition of depreciable personal property to be treated as ordinary income. There is an important distinction between *real property* and *personal property*.

If you computed depreciation on real property with a method that produces a greater depreciation deduction than that produced by the straight-line method, all or part of the gain on real property held longer than one year may be treated as ordinary income rather than capital gain. For more details, see IRS Publication 544.

With *personal property*, any gain to the full extent of the depreciation is ordinary income. Any gain above the extent of the depreciation is treated as "Section 1231 gain" (see below).

Casualty gains and losses

A casualty is the complete or partial destruction or accidental and irretrievable loss of property resulting from an identifiable event of a sudden, unexpected, or unusual nature, such as an automobile collision, fire, flood, storm, hurricane, or other similar event. Insurance payments or other proceeds received in compensation for casualty losses may result in gains or losses. You may postpone the tax on gains from "involuntary exchanges" (casualties). However, similar property must be received (or purchased) within two years after the close of the year in which the involuntary exchange occurred.

Capital gains and losses, Sections 1231, 1245, and 1250

Capital gain is the gain on the sale of capital assets, and also the gain treated as such under Section 1231 of the IRS Code. Special benefits apply in that only half the net gain is considered taxable.

Capital loss is the loss from the sale of capital assets only. Only half the loss is deductible from other income on the same tax return, and the maximum deduction each year is \$1,000.

Section 1231 gain involves special rules that allow you to treat a net gain from the sale or involuntary exchange of assets (described in Section 1231) as if it were a capital gain even though the

assets that you sold were not capital assets. Qualifying assets (under Section 1231) are property used in trade or business and held for more than six months. Limitations on the amount so treated are described in Sections 1245 and 1250 of the IRS Code:

Section 1245 provides that any gain on tangible personal property attributable to depreciation must be treated as ordinary gain.

Section 1250 provides that all or part of the gain attributable to depreciation *in excess of* straight-line must be treated as ordinary gain (depending upon the length of time the property was held).

Reference materials

Ball, John L., *The Basics of Depreciation*, Oregon State University Extension Service, Sea Grant Marine Advisory Program Publication SG 36 (Corvallis, 1976).

IRS Publication 544, *Sales and Other Dispositions of Assets*.

IRS Publication 550, *Tax Information on Investment Income and Expenses*.

IRS Publication 595, *Tax Guide for Commercial Fishermen*.

Glossary of terms

Basis—The original cost or purchase price of assets or property. If the property was acquired by gift or inheritance, or in some other manner, *basis other than cost* must be used.

Adjusted basis—Your original cost or other basis plus certain additions, such as improvements which you are required to capitalize, and minus certain deductions, such as depreciation and casualty losses.

Fair market value—The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

Gain—The excess of the amount you realize from a sale or exchange over the adjusted basis of the property you transfer.

Capital gain—The gain on the sale of capital assets; *also* gain treated as such under Section 1231 of the IRS Code.

Capital loss—The loss from the sale of capital assets only.

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