Timing is Everything

TAX PLANNING FOR CAPITAL ASSET DISPOSAL IS COMPLEX YET NECESSARY.

One issue in an array of decisions involving capital assets is taxes. How to treat those gains and losses is likely your most important tax issue for capital asset investment planning regarding disposal decisions and the maximization of cash inflows over time. Complex and constantly changing tax rules significantly shape capital asset planning. And, as the adage goes, timing is everything.

Managing a company’s assets involves constant review and planning. To help you with your planning, we’ll look at how you can determine the timing of capital asset disposal for the beneficial treatment of gains and losses. We’ll also offer a variety of tax-planning suggestions to help you seize the moment and start disposal planning.

THE CHALLENGES

Capital assets, which are generally referred to as Section 1231 assets, affect how a business produces its products or services, meets customer demand, and competes in the marketplace. In addition to committing significant organizational resources, replacing capital assets impacts your strategy and operations for a significant period of time.
Since tax rules dealing with Section 1231 assets have grown in both number and complexity, you often have to carefully research transactions on an asset-by-asset basis to achieve optimal tax benefits.

To make matters worse, guidelines for determining when you should sell capital asset investments aren't well established. Further, the tax impact on the buyer’s and seller’s after-tax cash flows aren’t typically symmetrical, and the disposition’s tax treatment can have a significant financial impact on the seller. Finally, tax provisions that vary by entity type can affect an asset’s rate of return over time.

If your goal is to maximize cash flows, the treatment of gains and losses affects your choice of useful life and depreciation method and encourages the continual critical evaluation of the investment during its useful life.

Varying tax rules and tax rates have a huge impact on the following factors:
- The difference between before- and after-tax values,
- The rate of return over time,
- The form of asset ownership, and
- The type of assets in which to invest.

These factors determine the disposal date critical to maximizing cash flows over time.

**PROPERTY TRANSACTIONS**

If you sell an asset, you first determine the gain or loss by comparing the amount realized to the asset’s adjusted basis (cost minus accumulated depreciation). Once you determine the recognized gain or loss, you classify it by determining the property’s tax status and its holding period, which is either short term at one year or less or long term at more than one year.

Our tax law includes three tax statuses—capital, Section 1231, and ordinary:
- Capital assets are generally investments like stocks and bonds.
- Section 1231 assets are depreciable business assets or real estate used in business and held for more than one year.
- Ordinary assets are inventories and “inventory-like” assets such as copyrights, patents, etc., and accounts and notes receivable from the sale of inventory or services.

These classifications are necessary because Congress taxes capital assets uniquely. Depending on the taxpayer, capital gains are taxed at preferential rates, and the deductibility of capital losses is limited. At present, corporate taxpayers don’t have a special capital gains tax rate and can only deduct capital losses up to the amount of capital gains. Disallowed capital losses, which are in excess of capital gains during a taxable year, may be carried back three years and carried forward five years to offset capital gains during those periods.

The general tax effects of gain and loss recognition would suggest that you avoid or defer gains and capture and possibly accelerate losses. But tax rules don’t consistently encourage or discourage deferring or accelerating asset disposal. As a general tax planning strategy, corporations benefit from timing asset disposal to maximize the offset between capital gains and losses.

**SECTION 1231 ASSETS**

Depreciable property and real property (e.g., land and land improvements) used in business are commonly referred to as capital assets. As we discussed earlier, a capital asset in the tax law is generally defined as an investment (e.g., stocks or bonds). Since business assets don’t meet the tax law definition of capital assets, absent some other tax provision, the gains and losses from the disposition of these assets would generate ordinary gains and losses (i.e., fully taxable). As a result, Congress created Section 1231 to provide special treatment for most assets used in business. In general, Section 1231 assets are depreciable or real property used in a business and held for more than one year. Other Section 1231 assets include timber, coal, domestic iron ore, and certain livestock and unharvested crops.

During a taxable year, you can net together gains and losses from Section 1231 assets. If the net result is a gain, you can treat it as a long-term capital gain with the potential for a reduced tax rate. If the net result is a loss, you treat the net loss as an ordinary loss. Since there are no limits on ordinary income and losses, the net result is a deductible loss, which isn’t subject to the capital loss limitations. As a result, Section 1231 provides the best of both worlds: A net gain is treated as a long-term capital gain, while a net loss is treated as an ordinary loss.

**SECTION 1231 COMPLICATIONS**

Because of the favorable treatment in Section 1231, you might expect taxpayers to take full advantage of these rules. And they have. In response, Congress enacted rules to limit the beneficial tax treatment of Section 1231 through depreciation recapture and lookback recapture. Let’s look at these rules.

**Depreciation Recapture**

The Internal Revenue Code contains two major deprecia-
tion recapture provisions—Section 1245 and Section 1250—that cause recognized gain from the disposition of business assets (Section 1231 assets) to be treated as ordinary gain.

Section 1245 applies to nonrealty depreciable assets, such as machinery and equipment. Under this provision, you treat the gain as ordinary income up to the amount of the asset's accumulated depreciation or amortization, including any amounts immediately expensed under tax provisions. The depreciation method, such as accelerated or straight-line, doesn't matter. All depreciation taken is subject to "recapture" and is often referred to as full recapture. Your gain in excess of the accumulated depreciation or amortization receives Section 1231 treatment.

Let's look at an example. Assume that your company is planning to sell a tangible asset. It purchased the asset several years ago for $100,000 and has accumulated $40,000 of depreciation through the date of sale. As a result, its adjusted basis in the asset is $60,000. If your company sells the asset for $85,000, it recognizes a $25,000 gain ($85,000 amount realized minus the $60,000 adjusted basis). Because the gain ($25,000) is less than the accumulated depreciation deductions ($40,000), the entire gain is "recaptured" as ordinary income, so the entire gain is attributable to previous years' depreciation deductions.

The current tax depreciation system, MACRS, which stands for Modified Accelerated Cost Recovery System, uses accelerated depreciation methods over lives shorter than the economic life for these assets. In addition, an immediate expense election (Section 179) may also apply where small businesses may immediately expense up to $100,000 per year of assets in 2003 and 2004. Finally, all businesses—not just small businesses—may claim an additional first-year depreciation deduction of 50% of most tangible property's initial tax basis in 2003 and 2004. The combination of these tax depreciation provisions, in concert with Section 1245 recapture, would generally discourage early disposal of business assets.

Section 1250 generally applies to depreciable real property (e.g., buildings and their structural components). Section 1250 recapture is much less punitive than Section 1245 because only depreciation claimed in excess of straight-line depreciation is recast as ordinary income. Since MACRS requires the use of straight-line depreciation for these assets, there won't be any Section 1250 recapture on these assets. As a result, Section 1250 will only affect depreciable realty placed in service before MACRS became effective in 1987 on which accelerated tax depreciation is claimed.

Corporations must contend with a special recapture rule (Section 291 Recapture) when depreciable realty is sold at a gain. In general, corporations must compare the Section 1250 recapture amount, which is normally zero, to the recapture that would have occurred if the Section 1245 recapture rules applied (full recapture). Twenty percent of this difference must be recaptured as ordinary income. For example, assume that NB Corporation purchased a building 10 years ago for $1 million. Over the years, NB claimed $256,400 of tax depreciation using the straight-line method. As a result, the adjusted basis of the building is $743,600. If NB sells the building for $1.2 million, its recognized gain is $456,400 ($1.2 million minus $743,600). Since buildings are covered by Section 1250 depreciation recapture and straight-line depreciation was used, there is no recapture under Section 1250. Yet because NB is a corporation, Section 291 recapture comes into play. Of the $456,400 gain, $51,280 ($256,400 times 20%) is recaptured as ordinary income under Section 291. The balance of the gain ($405,120) is treated as a Section 1231 gain. Noncorporate entities aren't subject to this special recapture provision.

Although Section 1245 and Section 1250 recapture provisions may recast much of the gain from business property disposals as ordinary income, sometimes the remaining Section 1231 gain is substantial. If you have substantial capital losses that would otherwise not be deductible, Section 1231 allows you to recognize gains at only the tax cost related to depreciation recapture. If the Section 1231 assets sold include realty, the tax costs will be limited because generally there will be no depreciation recapture under Section 1250.

On the other hand, if you're considering the sale of an asset (or assets) that will generate large net Section 1231 losses, you should postpone, if possible, disposing of other assets generating Section 1231 gains. Such a strategy will allow all the Section 1231 losses to offset other forms of income as ordinary deductions, reducing taxable income in the current year and the related tax liability. As we'll show, these losses will transform subsequent net Section 1231 gains to ordinary income. Corporate taxpayers don't have a preferential capital gains tax rate at present, so this strategy is appropriate from a time-value-of-money perspective. Yet this strategy may not be appropriate for noncorporate taxpayers.

Since depreciation recapture isn't usually triggered until the property is sold, you may possibly plan for recapture in low-tax-bracket or loss years. If you have net
operating loss carryovers that are about to expire, recognizing ordinary income from recapture may absorb them.

Finally, it’s possible to postpone the depreciation recapture provisions if you acquire a new asset in a like-kind exchange, which we’ll discuss later. In this situation, you can carry over the depreciation recapture potential to the newly acquired asset, provided the gain isn’t typically recognized.

Lookback Recapture
You could maximize Section 1231’s benefits by timing all losses to fall in one year and all gains in another. This strategy would allow you to treat all gains as long-term capital gains in one year and all losses as ordinary losses in another. From a time-value-of-money perspective, you would probably take losses in an earlier year, using the deduction to reduce taxable income and the related tax liability, and defer gains to the next year by paying the tax on the gains at potentially preferential rates.

To apparently prevent such use of Section 1231, Congress enacted a special recapture rule that imposes a limitation on Section 1231’s benefits. If a net Section 1231 gain remains after applying the depreciation recapture provisions, you must “look back” to the previous five tax years and determine whether any “unrecaptured Section 1231 losses” exist. To the extent of these losses, net Section 1231 gains are converted to ordinary income.

Unrecaptured Section 1231 losses are the sum of net Section 1231 losses that haven’t been used to convert net Section 1231 gains to ordinary income in prior years. For example, if you have a net Section 1231 gain of $10,000 in 2003, the gain would normally become a long-term capital gain. But if you had net Section 1231 losses of $4,000 in 2002 and $2,000 in 1999 (and no other Section 1231 activity), $6,000 of the 2003 Section 1231 gain of $10,000 would be treated as ordinary income. The $4,000 balance would be treated as a long-term capital gain.

For corporate taxpayers, remember that there’s currently no preferential tax rate on capital gains. So this lookback recapture provision, although increasing reporting complexity, does nothing to inhibit the time-value-of-money aspects of selling loss assets in an earlier year and gain assets in a later year. If a corporate taxpayer is considering selling a large number of business assets and can time their disposition around their year-end, selling loss assets in the earlier year and gain assets in the following year will normally provide positive after-tax net cash flows.

Individual and other noncorporate business taxpayers can plan around these provisions by recognizing gain assets in an earlier year, taking advantage of the preferential capital gains tax rate, and selling loss assets in a subsequent year. But taxpayers following this strategy are effectively reducing the benefits of Section 1231 for the five-year period subsequent to the year when losses are reported.

BEYOND PROPERTY DISPOSITIONS
Other tax provisions with planning consequences include constructed assets, passive investments, like-kind exchanges, and tax credits.

Constructed Assets
Typically, a manufacturing taxpayer constructs or produces a product in order to sell it for an immediate profit. For corporate taxpayers, all labor costs (including shareholder labor) are imbedded in the product’s cost. In the case of a proprietorship or partnership, however, labor provided by the proprietor or partner doesn’t impact the product’s basis for tax purposes. As a result, when the product is sold, the related profit is greater than if a corporation had sold the same product. Further, the proprietorship or partnership could choose to use the product as a fixed asset (i.e., to make other products or otherwise generate income) rather than sell the item as inventory. For example, a construction contractor could build an apartment building and then rent the separate apartments. If the rental period is for a sufficient time, the apartment building will become a Section 1231 asset, and, when this occurs, any profit on disposition will receive favorable capital gain treatment in lieu of ordinary income.

Passive Investments
The passive-loss rules don’t allow deducting losses from business activities in which the taxpaying individual didn’t substantially participate, but taxpayers may carry forward any disallowed losses until they have passive income against which to offset losses. These rules can impact the optimality of many decisions in different ways. For example, some taxpayers may opt to continue passive activities that generate profits to offset against losses from other passive activities. Other taxpayers may opt to sell passive activities to recognize economic losses that exist so that any losses can offset active business income. Still others may opt to sell passive activities to taxpayers that stand to benefit from tax losses more than the seller would.

To prevent individuals from incorporating to avoid the
passive-loss limitations, special rules apply to closely held corporations—those that if at any time during the taxable year more than 50% of the outstanding stock value is owned, directly or indirectly, by five or fewer individuals. Closely held C corporations may use passive losses to offset income from other business activities, but passive losses may not be used to offset “portfolio” income (e.g., interest and dividends).

Installment Sales
Tax rules provide alternatives to cash sales that let you defer taxation on a transaction until a later date. One example is installment sales. Under the installment sales provisions, you can generally defer income recognition until cash payments are actually received. Under the installment sales rules, though, the entire amount of Section 1245 depreciation recapture is taxable in the year of the sale, regardless of the amount received. For example, a taxpayer sells a line of machinery with an adjusted basis of $75,000 on an installment sale for $250,000 and receives a $50,000 down payment. If the machinery had originally cost more than $250,000, then all of the gain would be Section 1245 depreciation recapture. The gain of $175,000 ($250,000 sale price minus $75,000 basis) is included as ordinary income, taxable in the year of sale even though only $50,000 was received.

Under the installment-sale rules, debt obligations can’t be marketable securities, and the rules require recognizing income if you use the installment sale’s debt obligations as security for loans. Consequently, the seller can’t obtain immediate cash from the sale without incurring a tax liability. An alternative “disposition” method in this setting is to lease the property rather than sell it, but you must make sure the lease’s structure doesn’t take on the characteristics of a sale. In contrast to the installment-sale method, the lessor assumes the risk or benefit of unforeseen decreases or increases resulting from the change in the asset’s value over its economic life.

Like-Kind Exchanges
If a taxpayer exchanges an asset for a similar one, the like-kind-exchange rules of Section 1031 may apply. This provision allows the gain or loss on the asset given up to be deferred or postponed until the acquired property is sold. The words “like-kind” refer to the nature of the property, not to its grade or quality. In general, to qualify for like-kind-exchange treatment, realty must be exchanged for other realty, or nonrealty must be exchanged for other nonrealty. (Nonrealty is like-kind only if it is exchanged for property within the same MACRS class, such as a five-year MACRS asset being exchanged for another five-year MACRS asset). If you meet the requirements, the adjusted basis of the asset given up attaches to the basis of the acquired asset, and you’ve effectively postponed the gain or loss.

Taxpayers considering the disposition of nonrealty business assets often find like-kind exchanges desirable from a cost/benefit perspective. As we discussed, the sale of these assets typically will generate gains because of rapid tax depreciation deductions, but by using the like-kind-exchange provisions you can defer the recognition of these gains. The “cost” is lower depreciation deductions in the future because of the carryover basis, and any depreciation recapture potential attaches to the new asset. The like-kind-exchange provisions, however, allow you to update your productive facilities without recognizing income.

Tax Credits
Tax credits are available when certain long-term assets are purchased (e.g., low-income housing), historic buildings are rehabilitated, or energy-conserving properties are purchased. These tax credits effectively reduce the cost of the assets. But if the property isn’t held for a specified length of time, a portion of the credit must be returned to the government. During this time, the asset’s cost varies, and taxpayers are more likely to hold these assets until the tax credits are fully qualified. Once this time has expired, other taxpayers might be able to take advantage of tax credits on the property, which will likely lead to disposition before the end of the asset’s useful life.

RESEARCH TRANSACTIONS CAREFULLY
Managing the assets of a business involves constant review and planning. The number of tax rules, and the constant changes that affect those rules, makes it very difficult to generalize advice on the disposal of business assets. Each situation will likely require research into how current tax law relates to the specific details of that transaction.

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