Chapter 1: Form 4797

Form 4797, Sales of Business Property, was first introduced for use in preparing 1971 income tax returns. It has remained largely unchanged since then. However, it remains one of the most misunderstood forms by many tax professionals. Form 4797 is used to report the following activity.1

1. The sale or exchange of:
   a. Property used in a trade or business;
   b. Depreciable and amortizable property;
   c. Oil, gas, geothermal, or other mineral properties; and
   d. Cost-sharing payment property described in IRC §126.

2. The involuntary conversion (from other than casualty or theft) of property used in a trade or business and capital assets held in connection with a trade or business or a transaction entered into for profit

3. The disposition of noncapital assets (other than inventory or property primarily held for sale to customers)

4. The disposition of capital assets not reported on Schedule D, Capital Gains and Losses

5. The gain or loss for partners and S corporation shareholders from certain IRC §179 property dispositions by partnerships and S corporations

6. The computation of recapture amounts under IRC §§179 and 280F(b)(2) when the business use decreases to 50% or less

One of the reasons that preparers have problems completing Form 4797 is that the form refers to Code sections without defining the assets covered by the sections and without explaining what the tax consequences are being classified under a particular section. Therefore, this chapter begins with a brief explanation of the three most common Code sections used to classify assets whose disposition is reported on Form 4797.

IRC §1231 TRANSACTIONS

IRC §1231 generally covers the sale of land, buildings, and equipment that are used in a business. Depending on the circumstances, gains from the disposition of such property may be treated as ordinary income or as long-term capital gains.

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1 Instructions for Form 4797.
If the disposition of property results in a net loss, it is treated as an ordinary loss under §1231. As such, the loss is fully deductible for purposes of determining adjusted gross income (AGI) on Form 1040. Therefore, §1231 generally provides the most advantageous tax treatment for the taxpayer because net gains may be treated as long-term capital gains and net losses are treated as ordinary losses (subject to the 5-year recapture rule, which is explained later in this chapter).

The following are §1231 transactions.²

1. Sales or exchanges of real or depreciable property used in a trade or business and held for more than one year
2. Cutting of timber that the taxpayer elects to treat as a sale or exchange under §631(a)
3. Disposal of timber with a retained economic interest that is treated as a sale under §631(b)
4. Disposal of coal or domestic iron ore with a retained economic interest that is treated as a sale under §631(c)
5. Sales or exchanges of cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes and held for 24 months or more
6. Sales or exchanges of other livestock used in a trade or business for draft, breeding, dairy, or sporting purposes and held for 12 months or more
7. Sales or exchanges of unharvested crops that are:
   a. On land used in the trade or business and held for more than one year, and
   b. Sold or exchanged at the same time and to the same person as the land
8. Involuntary conversions of:
   a. Trade or business property, or
   b. Capital assets held more than one year in connection with a trade or business or a transaction entered into for profit

Excluded Transactions

IRC §1231 transactions do not include sales or exchanges of the following types of property.³

1. Inventory or property held primarily for sale to customers
2. A copyright; a literary, musical, or artistic composition; or a letter, memorandum, or similar property that was:
   a. Created by the taxpayer’s personal efforts;
   b. Prepared or produced for the taxpayer (in the case of a letter, memorandum, or similar property); or
   c. Acquired from a person described in (a) or (b) in a transaction that gave the taxpayer a carryover basis in the property
3. A U.S. government publication that the taxpayer received from the U.S. government at the price it is offered to the public and that is held by:
   a. The taxpayer who received the publication, or
   b. A taxpayer who acquired the property from a person who received the publication in a transaction that gave the taxpayer a carryover basis in the property

² Instructions for Form 4797.
³ IRC §1231(b)(1).
RECAPTURE PROVISIONS

The gain or losses on assets that qualify as §1231 assets may also be subject to special rules under IRC §§1245 and 1250. For example, the recapture provisions discussed later may cause some or all of the gain on an asset held long term to be taxed as ordinary income instead of as long-term capital gains.

IRC §1245 Property

In general, §1245 property is property that is subject to an allowance for depreciation and is one of the following.

1. Personal property
2. Single-purpose agricultural and horticultural structures
3. Other tangible property (not including a building or its structural components) that is used:
   a. As an integral part of production, manufacturing, or extraction; or
   b. For furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services
4. Storage facilities (not including a building or its structural components) used in connection with the distribution of petroleum or petroleum products
5. Railroad grading or tunnel bore

In addition, IRC §197 intangibles (e.g., goodwill, patents, copyrights, and noncompete agreements) are treated as §1245 property. If the taxpayer disposes of more than one amortizable §197 intangible in a transaction or series of related transactions, all of the intangibles are considered as one asset. This provision does not apply if the adjusted basis of a §197 intangible exceeds its fair market value (FMV).

IRC §1245 requires the lesser of the gain realized or the depreciation allowed or allowable to be recaptured as ordinary income upon the sale or other transfer of §1245 property. Thus, all gain on §1245 property is treated as ordinary gain unless the amount received on the disposition of the property is more than its original cost. The portion of the sales price that exceeds the original cost, if any, is §1231 gain. If property is disposed of at a loss, the §1245 recapture rules do not apply; instead, the loss is generally a §1231 loss unless the form of disposition is a casualty.

For purposes of §1245, the following are treated as depreciation.

1. Deductions allowed or allowable for depreciation (including bonus depreciation), amortization, depletion, or preproductive expenses
2. The amount claimed as a deduction under §179

Note. Any §179 expense claimed but not allowed due to income limitations at the entity level is not considered depreciation allowed or allowable for purposes of §1245 depreciation recapture.

3. The commercial revitalization deduction for buildings placed in service before 2010
4. The basis reduction for claiming the IRC §50(c) investment credit
5. The deduction for qualified clean-fuel vehicle property or refueling property

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4. IRC §1245(b)(8).
5. Instructions for Form 4797.