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Pearson's Federal Taxation 2026: Comprehensive, 39e **(Franklin/Richardson)**
Chapter I13: Property Transactions: Sec. 1231 and Recapture

LO1: Overview of Basic Tax Treatment for Sec. 1231

1) Mark owns an unincorporated business and has $20,000 of Sec. 1231 gains and $22,000 of Sec. 1231 losses. He must report a net capital loss of $2,000 on his tax return.
Answer: FALSE
Explanation: If the netting of Sec. 1231 gains and losses at the end of the year results in a net loss, the Sec. 1231 gains and losses are treated as ordinary gains and losses.
Page Ref.: I:13-3; Example I:13-3
Objective: 1

2) A net Sec. 1231 gain is treated as ordinary income to the extent of any nonrecaptured net Sec. 1231 losses for the preceding five years.
Answer: TRUE
Explanation: Net Sec. 1231 losses are deducted as ordinary losses when incurred, but they cause net Sec. 1231 gains within the following five years to be recaptured as ordinary income rather than LTCG.
Page Ref.: I:13-3
Objective: 1

3) Thomas, a single taxpayer who has taxable income of $25,000, sells land that is Sec. 1231 property at a gain of $4,000. This is the first time Thomas has ever sold a Sec. 1231 asset. If he has no other 1231 transactions or capital asset transactions, Thomas will pay no tax on the $4,000 gain.
Answer: TRUE
Explanation: The Sec. 1231 gain will be treated as a LTCG. The LTCG rate for single taxpayers with a taxable income up to $48,350 is zero for 2025.
Page Ref.: I:13-4; Example I:13-8
Objective: 1

4) Why did Congress establish favorable treatment for 1231 assets?
A) to encourage the mobility of capital
B) to allow a larger deduction for losses
C) to help business owners replace assets which had declined in value
D) All of the above.
Answer: D
Explanation: Responses A - C all provide accurate reasons for the adoption of IRC Sec. 1231.
Page Ref.: I:13-2
Objective: 1

5) Aamir has $25,000 of net Sec. 1231 gains this year on business assets. In addition, he incurred $18,000 of loss on the sale of stock held six months. Aamir will include in his AGI
A) $3,000 short-term capital loss and $25,000 ordinary gain.
B) $22,000 net capital gain.
C) $7,000 net capital gain.
D) $7,000 short-term capital gain.
Answer: C
Explanation: The $25,000 net Sec. 1231 gain is treated as LTCG which will be netted with the $18,000 STCL, resulting in $7,000 net capital gain.
Page Ref.: I:13-3; Example I:13-2
Objective: 1

6) Jeremy has $18,000 of Sec. 1231 gains and $23,000 of Sec. 1231 losses. The gains and losses are characterized as
A)

Capital Gain	Capital Loss	Ordinary Income	Ordinary Loss
		$18,000	$23,000

B)

Capital Gain	Capital Loss	Ordinary Income	Ordinary Loss
$18,000			$23,000

C)

Capital Gain	Capital Loss	Ordinary Income	Ordinary Loss
$18,000	$23,000		

D)

Capital Gain	Capital Loss	Ordinary Income	Ordinary Loss
$18,000	$3,000		$20,000

Answer: A
Explanation: If, when netted, Sec. 1231 losses exceed Sec. 1231 gains, both are treated as ordinary.
Page Ref.: I:13-3; Example I:13-3
Objective: 1

7) Pierce has a $16,000 Sec. 1231 loss, a $12,000 Sec. 1231 gain, and a salary of $50,000. What is the treatment of these items in Pierce's AGI?
A) Pierce has a LTCG of $12,000 and a net ordinary income of $34,000.
B) The 1231 gains and losses are treated as ordinary gains and losses making Pierce's AGI for the year $46,000.
C) Pierce has a $3,000 LTCL which is deductible for AGI making AGI $47,000. He also has a $1,000 LTCL carryover.
D) Pierce has net LTCG of $9,000 and $37,000 of net ordinary income.
Answer: B
Explanation: If, when netted, Sec. 1231 losses exceed Sec. 1231 gains, both are treated as ordinary. Therefore, AGI is $50,000 + ($12,000 - $16,000) = $46,000.
Page Ref.: I:13-3; Example I:13-4
Objective: 1

8) Daniel recognizes $35,000 of Sec. 1231 gains and $25,000 of Sec. 1231 losses during the current year. The only other Sec. 1231 item was a $4,000 loss three years ago. This year, Daniel must report

A)

NLTCG	**Ordinary Income**
$10,000	$0

B)

NLTCG	**Ordinary Income**
$6,000	$4,000

C)

NLTCG	**Ordinary Income**
$4,000	$6,000

D)

NLTCG	**Ordinary Income**
$4,000	$10,000

Answer: B
Explanation: The $4,000 is considered a nonrecaptured net Sec. 1231 loss. Thus, of the net Sec. 1231 gain of $10,000 ($35,000 - $25,000), $4,000 is ordinary income.
Page Ref.: I:13-3; Example I:13-5
Objective: 1

9) During the current year, Danika recognizes a $30,000 Sec. 1231 gain and a $22,000 Sec. 1231 loss. Prior to this, Danika's only Sec. 1231 item was a $15,000 loss two years ago. Danika must report a(n)
A) $8,000 net LTCG.
B) $8,000 ordinary income.
C) $15,000 ordinary income.
D) $8,000 ordinary income and $7,000 net LTCG.
Answer: B
Explanation: In general, net 1231 gains are treated as LTCGs. However, $8,000 (from the total $15,000) of the non-recaptured Sec. 1231 loss is recaptured as ordinary income.
Page Ref.: I:13-3; Example I:13-5
Objective: 1

10) During the current year, George recognizes a $30,000 Sec. 1231 gain on sale of land and a $18,000 Sec. 1231 loss on the sale of land. Prior to this, George's only Sec. 1231 item was a $14,000 loss six years ago. George must report a
A) $12,000 net LTCG.
B) $12,000 ordinary income.
C) $14,000 ordinary income.
D) $10,000 ordinary income and $2,000 net LTCG.
Answer: A
Explanation: The lookback rule does not apply because the last 1231 loss was six years ago. Thus, the net Sec. 1231 gain is $12,000 ($30,000 - $18,000) to be treated as long-term capital gain.
Page Ref.: I:13-4
Objective: 1

11) During the current year, Kayla recognizes a $40,000 Sec. 1231 gain on sale of land and a $22,000 Sec. 1231 loss on the sale of land. Prior to this, Kayla's only Sec. 1231 item was a $10,000 loss six years ago. Kayla has $120,000 of taxable income. The amount of tax resulting from these transactions is
A) $2,700.
B) $3,600.
C) $4,000.
D) $5,040.
Answer: A
Explanation: The lookback rule does not apply because the last 1231 loss was six years ago. Therefore, the entire amount ($40,000 - $22,000) is LTCG and is taxed at 15%. 15% × $18,000 = $2,700.
Page Ref.: I:13-4; Example I:13-6
Objective: 1

12) Blair, who has $120,000 of taxable income, sells one tract of land at a gain of $29,000 and another tract of land at a gain of $11,000. Both tracts of land are Sec. 1231 property. She has never had any other Sec. 1231 transactions. How are the gains taxed?
A) ordinary income of $40,000 taxed at 28%
B) a net capital gain of $40,000 which is not taxed
C) a net capital gain of $40,000 taxed at 15%
D) ordinary income of $40,000 taxed at 25%
Answer: C
Explanation: The 1231 gains are treated as LTCG taxed at a maximum of 15%. ($29,000 + $11,000 = $40,000). Capital gains rates for single taxpayers with ordinary income greater than $40,400 and less than $445,850 are taxed at 15%.
Page Ref.: I:13-4; Example I:13-6
Objective: 1

13) Jaiyoun sells Sec. 1231 property in 2025, resulting in a $4,000 gain. This is the first time he has disposed of any Sec. 1231 property. Jaiyoun's taxable income is $30,000. His tax on the Sec. 1231 gain will be
A) $0.
B) $400.
C) $600.
D) $1,120.
Answer: A
Explanation: The Sec. 1231 gain will be treated as net capital gain, and because her taxable income does not exceed $48,350, the NCG rate that applies to the gain is 0%.
Page Ref.: I:13-4; Example I:13-8
Objective: 1

14) Yelenis reports taxable income of $200,000. She sells one Sec. 1231 asset this year, resulting in a $50,000 gain. Included in the $50,000 Sec. 1231 gain is $30,000 of unrecaptured Sec. 1250 gain. A review of Yelenis tax files for the past five years indicates one prior Sec. 1231 sale which resulted in a $14,000 loss. The gain will be taxed as
A)

15%	25%	32%
$20,000	$16,000	$0

B)

15%	25%	32%
$20,000	$16,000	$14,000

C)

15%	25%	32%
$6,000	$30,000	$0

D)

15%	25%	32%
$6,000	$30,000	$14,000

Answer: B
Explanation: $14,000 of the gain will be recharacterized as ordinary income due to the five-year lookback rule. The recharacterization is first applied to the net Sec. 1231 gain in the 25% group (unrecaptured Sec. 1250 gain).
Page Ref.: I:13-4; Example I:13-9
Objective: 1

15) Lucy, a noncorporate taxpayer, experienced the following Sec. 1231 gains and losses during the years 2020 through 2025. Her first disposition of a Sec. 1231 asset occurred in 2020. Assuming Lucy had no capital gains and losses during that time period, what is the tax treatment in each of the years listed?

	Sec. 1231 Gains	*Sec. 1231 Losses*
2020	$10,000	$ 8,000
2021	$18,000	$23,000
2022	$ 9,000	$13,000
2023	$22,000	$16,000
2024	$25,000	$17,000
2025	$11,000	$18,000

Answer:
2020 $2,000 LTCG
2021 $5,000 Ordinary loss
2022 $4,000 Ordinary loss
2023 $6,000 Ordinary income due to Sec. 1231 recapture; leaves $3,000 available for later recapture
2024 $8,000 Net gain—recapture $3,000 as ordinary income; $5,000 balance will be LTCG
2025 $7,000 Ordinary loss
Page Ref.: I:13-3
Objective: 1

16) Jillian, a single taxpayer, had the following sales of Sec. 1231 property this year:

Sale of land A at a gain of $15,000
Sale of land B at a gain of $12,000
Sale of land C at a loss of $8,000

a. Assume Jillian has taxable income from other sources exceeding $600,000. What is the amount of her resulting tax liability on the property sales?
b. Assume instead that Jillian's taxable income from other sources is less than $15,000. What is the amount of her resulting tax liability on the property sales?
c. Assume instead that Jillian's taxable income from other sources of $100,000. What is the amount of her resulting tax liability on the property sales?
Answer:
a. The net 1231 gain is $15,000 + $12,000 - $8,000 = $19,000. At Jillian's level of taxable income, the Sec. 1231 gain is taxed at 20%. Thus, the tax is $19,000 × .20 = $3,800.
b. There is no tax on capital gains for taxpayers with taxable income below $48,350.
c. Because Jillian's taxable income is between $48,350 and $533,400, it is taxed at 15%. Thus, the tax is $19,000 × .15 = $2,850.
Page Ref.: I:13-4; Example I:13-7 and I:13-8
Objective: 1

17) Hilton, a single taxpayer, reports $120,000 of taxable income. He has $16,000 of nonrecaptured net Sec. 1231 losses at the beginning of a year in which he had the following transactions:

-Sale of Asset A at a $10,000 1231 gain, all of which is unrecaptured Sec. 1250 gain
-Sale of Asset B at a $13,000 1231 gain

How are the items reported this year and at which rate(s) are the amounts taxed?
Answer: Asset A- The entire gain from the sale of Asset A is ordinary income due to the five-year lookback. The full $10,000 gain will be taxed at 24%.

Asset B- As a result of the five-year lookback rule, $6,000 of the gain on the sale of Asset B is ordinary income ($16,000 nonrecaptured losses less $10,000 ordinary income on sale of asset A) taxed at 24%; the remaining $7,000 1231 gain is taxed at 15%.
Page Ref.: I:13-4; Example I:13-9
Objective: 1

LO2: Sec. 1231 Property

1) Sec. 1231 property must satisfy a holding period of more than one year.
Answer: TRUE
Explanation: A holding period of more than one year is required of property that otherwise meets the criteria of Sec. 1231.
Page Ref.: I:13-5
Objective: 2

2) Depreciable property placed in service nine months earlier is considered Sec. 1231 property.
Answer: FALSE
Explanation: The property must be held more than one year.
Page Ref.: I:13-5
Objective: 2

3) Any gain or loss resulting from the sale or disposition of depreciable property used in trade or business and held one year or less is considered ordinary.
Answer: TRUE
Explanation: Unless the holding period is satisfied, the gain or loss on otherwise qualifying property will be ordinary.
Page Ref.: I:13-5
Objective: 2

4) The sale of inventory results in ordinary gain or loss.
Answer: TRUE
Explanation: Inventory does not qualify as Sec. 1231 property.
Page Ref.: I:13-5
Objective: 2

5) Gains and losses from involuntary conversions of property used in a trade or business generally are classified as capital gains and losses.
Answer: FALSE
Explanation: They are classified as Sec. 1231 gains and losses.
Page Ref.: I:13-6
Objective: 2

6) Gains and losses resulting from condemnations of Sec. 1231 property and capital assets held more than one year are classified as ordinary gains and losses.
Answer: FALSE
Explanation: Such gains and losses are classified as Sec. 1231 gains and losses.
Page Ref.: I:13-6
Objective: 2

7) If the recognized losses resulting from involuntary conversions arising from casualty or theft exceed the recognized gains from such events (i.e., a net loss from the casualty), all of the involuntary conversions are treated as ordinary gains and losses.
Answer: TRUE
Explanation: There is a special carveout of the normal Sec. 1231 netting process for gains and losses resulting from involuntary conversions due to casualty or theft.
Page Ref.: I:13-7
Objective: 2

8) For a business, Sec. 1231 property does not include
A) timber, coal, or domestic iron ore.
B) inventory purchased 24 months ago.
C) an office building purchased five years ago.
D) land used in the business that was purchased two years ago.
Answer: B
Explanation: Inventory is not considered Sec. 1231 property.
Page Ref.: I:13-5
Objective: 2

9) Which of the following assets is 1231 property?
A) a machine used in the company's manufacturing operations
B) an investment in corporate stock
C) land held for investment
D) items held for resale by a retailer
Answer: A
Explanation: Corporate stock and land held for investment are capital assets, while inventory is an ordinary asset. Only machinery used in a business will qualify under Sec. 1231.
Page Ref.: I:13-5
Objective: 2

10) Sec. 1231 property will generally have all the following characteristics <u>except</u>
A) real or depreciable property.
B) used in trade or business.
C) held for sale to customers.
D) held for more than one year.
Answer: C
Explanation: Inventory is not considered Sec. 1231 property.
Page Ref.: I:13-5
Objective: 2

11) A corporation owns many acres of timber, which it acquired three years ago, and which has a $120,000 basis. The timber was cut last year for use in the corporation's business. The FMV of the timber on the first day of last year was $270,000. The corporation made the appropriate election to treat the cutting as a sale or exchange. The timber is sold for $300,000 this year. The tax result this year is
A) recognition of capital gain of $30,000.
B) recognition of Sec. 1231 gain of $30,000.
C) recognition of ordinary income of $30,000.
D) no income recognized since all recognition occurs in the year of the cutting of the timber.
Answer: C
Explanation: $270,000 - $120,000 = $150,000 of Sec. 1231 gain was recognized last year under the timber election provided by Sec. 631. This year, the taxpayers recognizes the difference between the selling price of $300,000 and $270,000 = $30,000 as ordinary income.
Page Ref.: I:13-5 and I:13-6; Example I:13-13
Objective: 2

12) A corporation owns many acres of timber, which it acquired three years ago, and which has a $150,000 basis for depletion. The timber is cut during the current year for use in the corporation's business. The FMV of the timber on the first day of the current year is $280,000. If the corporation makes the appropriate election, the tax result is
A) recognition of a Sec. 1231 gain of $130,000.
B) no recognition of gain or loss since the timber is used in the business.
C) recognition of a gain at the time of sale if the timber is later sold with the gain equal to the sales price less the basis in the timber.
D) recognition of a gain if the timber is later sold with the gain equal to the sales price less $280,000 (FMV on the first day of the year of the cutting).
Answer: A
Explanation: Sec. 631 provides an election to recognize the Sec. 1231 gain when the timber is cut. $280,000 - $150,000 = $130,000
Page Ref.: I:13-5 and I:13-6; Example I:13-13
Objective: 2

13) In order to be considered Sec. 1231 property, all of the following livestock must be held for 12 months or more from date of acquisition <u>except</u>

A) goats.
B) hogs.
C) sheep.
D) cattle.
Answer: D
Explanation: Cattle must be held for 24 months or more from date of acquisition.
Page Ref.: I:13-6
Objective: 2

14) For livestock to be considered Sec. 1231 property

A) the livestock must be held for draft, breeding or dairy purposes, but not for sport.
B) cattle and horses must be held for at least 12 months from the date of acquisition.
C) cattle and horses must be held for at least 24 months from the date of acquisition.
D) livestock other than cattle and horses must be held for at least 24 months from the date of acquisition.
Answer: C
Explanation: The first answer choice is incorrect because the livestock may be held for sport. The second answer choice is incorrect and the third answer choice is correct because cattle and horses must be held for at least 24 months. The fourth answer choice is incorrect because other livestock must be held for at least 12 months.
Page Ref.: I:13-6
Objective: 2

15) If Sec. 1231 applies to the sale or exchange of an unharvested crop sold with land, the costs of producing the crop are

A) capitalized.
B) deducted as an expense of operations when incurred and also deducted from the sales price at the time of the sale.
C) deducted when incurred if the land is sold but capitalized if the land is exchanged.
D) deducted as an expense of operations when incurred.
Answer: A
Explanation: Costs of producing the crop must be capitalized.
Page Ref.: I:13-6
Objective: 2

16) Dinah owned land with a FMV of $130,000 (adjusted basis $120,000) which is investment property (a capital asset). Dinah owned a second tract of land, a 1231 asset, with a FMV of $46,000 (adjusted basis $50,000). Both tracts were acquired in 2001 and condemned by the state this year. The state paid an amount equal to FMV. If there are no other transactions involving capital assets or 1231 assets, Dinah must report on her current year return
A) $6,000 net ordinary income.
B) $6,000 net Sec. 1231 gain treated as a net capital gain.
C) a LTCG of $10,000 and a 1231 loss of $4,000.
D) a LTCG of $10,000 and a nondeductible loss of $4,000.
Answer: B
Explanation: The $10,000 gain on the condemnation of the land held for investment is considered a Sec. 1231 gain and the $4,000 loss due to the condemnation of the business land is a Sec. 1231 loss. Since the 1231 gains exceed the 1231 losses, both are treated as capital gains and losses.
Page Ref.: I:13-6 and I:13-7; Example I:13-14
Objective: 2

17) Emma owns a small building ($120,000 basis and $123,000 FMV) and equipment ($35,000 adjusted basis and $22,000 FMV). Both assets were acquired three years ago and are used in Emma's business. Both are destroyed by fire. Insurance proceeds were equal to their FMVs. Only one other transfer of an asset occurs during the year, and a $3,000 LTCL is recognized. After considering all transactions, the tax result to Emma is a
A) $13,000 NLTCL.
B) $13,000 ordinary loss.
C) $3,000 LTCG; $3,000 LTCL; and $13,000 ordinary loss.
D) $10,000 net ordinary loss and a $3,000 NLTCL.
Answer: D
Explanation: If the losses from involuntary conversion arising from fire exceed the gains, the gains and losses are treated as ordinary gains and losses which is the case in this problem. $123,000 - $120,000 = $3,000 gain; $22,000 - $35,000 = $13,000 loss. The casualty results in an ordinary net loss of $10,000.
Page Ref.: I:13-7; Example I:13-15
Objective: 2

18) Cassie owns equipment ($45,000 basis and $30,000 FMV) and a building ($152,000 basis and $158,000 FMV), which are used in Cassie's business. Both assets were acquired two years ago. The equipment and the building are destroyed in a fire, and Cassie collects insurance proceeds equal to the assets' FMV. The tax result to Cassie for this transaction is a
A) $15,000 Sec. 1231 loss and a $6,000 ordinary gain.
B) $15,000 ordinary loss and a $6,000 ordinary gain.
C) $15,000 ordinary loss and a $6,000 Sec. 1231 gain.
D) $15,000 Sec. 1231 loss and a $6,000 Sec. 1231 gain.
Answer: B
Explanation: If the losses from involuntary conversion arising from fire exceed the gains, the gains and losses are treated as ordinary gains and losses which is the case in this problem. $30,000 - $45,000 = $15,000 loss; $158,000 - $152,000 = $6,000 gain.
Page Ref.: I:13-7; Example I:13-15
Objective: 2

19) Indicate whether each of the following assets are capital assets, Sec. 1231 assets, or ordinary income property (property which, if sold, results in ordinary income). Assume that all of the property is held for more than one year.
a. XYZ Corporation owns land used as an employee parking lot. How is the parking lot classified for tax purposes?
b. Montana Corporation owns land held as an investment. How is the land classified for tax purposes?
c. John, a self-employed electrician, owns an automobile he uses strictly for personal use. How is the automobile classified for tax purposes?
d. Jan, a self-employed contractor, owns a truck she uses exclusively in her trade or business. How is the truck classified for tax purposes?
e. Leslie owns an office building where her accounting practice is located. What is the classification of the building?
f. Yvonne owns a computer for use in her job as a sales representative. She does not use the computer for personal purposes. How is the computer classified for tax purposes?
Answer:
a. Sec. 1231 property
b. Capital asset
c. Capital asset (although a loss cannot be recognized)
d. Sec. 1231 property
e. Sec. 1231 property
f. Sec. 1231 property
Page Ref.: I:13-5; Example I:13-10 and I:13-11
Objective: 2

20) Sarah owned land with a FMV of $150,000 (adjusted basis $135,000) which is investment property (a capital asset). Sarah owned a second tract of land, a 1231 asset, with a FMV of $38,000 (adjusted basis $55,000). Both tracts were acquired in 2010 and condemned by the state this year. The state paid an amount equal to FMV. If there are no other transactions involving capital assets or 1231 assets, what is the amount that Sarah must report on her current year return?
Answer: The $15,000 gain ($150,000 - $135,000) on the condemnation of the land held for investment is treated as a Sec. 1231 gain, and the $17,000 ($38,000 - $55,000) loss due to the condemnation of the business land is a Sec. 1231 loss. Since the 1231 losses exceed the 1231 gains, both are treated as ordinary gains and losses.
Page Ref.: I:13-6 and I:13-7; Example I:13-14
Objective: 2