

# THEME: DISPOSING OF ASSETS

By John W. Day, MBA

## ACCOUNTING TERMS: Gain/Loss

**Gain:** When the sales price of a fixed asset *exceeds* the fixed asset's book value.

**Loss:** When the sales price of a fixed asset is *lower* than the fixed asset's book value.

## FEATURE ARTICLE: Figuring Gain/Loss When Selling Assets.

How would you feel if you sold one of your fixed assets in your business for \$2500, deposited that amount in your bank account, recorded it as revenue, paid taxes on the profit, and then, found out you only needed to report \$500 not \$2500? Perhaps slightly foolish? It happens all the time, because people don't know how to figure the gain or loss from the disposition of their assets.

Knowing how to write the proper adjusting journal entries that will record all the parts of a sale or trade of your fixed assets is a little complicated, especially when it comes to trades, and not possible to explain entirely in this newsletter. The subject matter is thoroughly discussed my Real Life Accounting course. However, I can demonstrate some of the mechanics involved so that you will be aware that, when you sell an asset, there is more to consider than meets the eye.

For example, let's assume that you bought a desk for \$2500 and depreciated it using the Double-Declining method with a one-half year convention. In the U.S. this is called MACRS (pronounced "makers") or Modified Asset Cost Recovery System. The MACRS system requires a desk to be depreciated over seven years. Three years later, you decide the desk size is too small, so you sell it for \$1800. The first step in determining the gain or loss on the sale is to figure out what the book value of the desk is. This is fairly easy to do if you have maintained a depreciation schedule for the desk. Set up a format such as this:

Original Cost - Date of Purchase		\$2,500.00
Depreciation:		
Year One	\$357.25	
Year Two	612.25	
Year Three	<u>218.63</u>	
Total Accumulated Depreciation		<u>&lt;1,183.13&gt;</u>
Book Value		\$1,316.87

Sales Price of the Desk	<u>1,800.00</u>
Gain on the Sale of the Desk	\$ 483.13 =====

Why is it a gain? Review the above definition. The sale price exceeds the book value. All this may seem like  $2+2=4$  to the experienced person, but for newbies it may be helpful to review the underlying concepts. In my course, I like to encourage students to think of these accounting events in terms of what actually took place physically. For instance, you bought a desk and used it for three years. You did not deduct the entire desk the first year you bought it. As a matter of fact, you only deducted an expense of \$357.25. During the next two years you only deducted \$830.88. Therefore, your fixed asset, called a desk, has a remaining cost basis of \$1,316.87. Since you sold that asset for more than your cost basis, you incurred a gain. In the U.S., the Internal Revenue Service requires that that gain be reported as income and taxed accordingly.

On the other hand, had the sales price been only \$800, then you would have incurred a loss of \$516.87. This makes sense, because your cost basis was \$1,316.87 and you only received \$800.00 when you sold it. Therefore, the money you lost on the sale is a cost of doing business, and according to U.S. tax law, a deductible item.

So be careful when selling an asset. You don't want to report more income than is necessary, nor do you want to lose the benefit of a deduction. That is, unless you don't mind paying extra taxes to the government.

### **QUESTION: What About Trade-Ins?**

When you trade in an asset, rather than sell or discard it outright, the process is similar for figuring the gain or the loss. The difference is that instead of using sale price to book value, use trade-in value to book value to determine gain or loss. For instance:

Book Value of the Desk	\$1,316.87
Trade-in Value	<u>1,800.00</u>
Gain on Trade	\$ 483.13

Instead of reporting the gain or loss as additional income, or a deduction against income, the gain or loss is rolled (transferred) into the cost of the new asset. Let's say you bought your new desk for \$2800.00. You paid for it by trading in the old desk for \$1,800.00 and paying the difference in cash of \$1,000.00. Since you had a gain of \$483.13, your new cost basis in the new desk is \$2,316.87 not \$2,800.00. This is because when you have a gain on a trade it reduces your cost basis of the new asset.

Why? Remember the facts. You have already received the benefit of \$1,183.13 in depreciation deductions for the first desk. But, you received an \$1,800 value on the trade resulting in a \$483.13 gain. Instead of reporting the gain, you are postponing reporting the gain by putting it into the new desk. By lowering the book value of the new desk by the gain, you are creating a lower cost basis in the desk. Therefore, when you sell the new desk, your gain will be higher than it would have been by \$483.13. Or, conversely, your loss on the sale would be less than it would have been.

You may recall just a few years ago, how, if you sold your home and had a gain, you could roll the gain over into the purchase of a new house if you bought it within two years of the sale date. (This law is no longer in effect.) The purchase price of the new home had to be equal to or greater than the sale price of the old home to roll over the full amount of the gain. This is the same concept; only here we are using business assets.

It works the same when you have a loss on the trade, except that a loss adds to the cost basis of the new asset. This makes sense because when you sell the new asset, your gain will be less, or your loss will be more. You were not able to take advantage of the loss you incurred as a deductible item when you traded in your old asset. When you sell the new asset, you are able take advantage of it.

The bottom line is that you are simply deferring or postponing the gain or loss that is incurred on the trade until a future date when you sell the new asset. Or, perhaps you may continue to do trades indefinitely. If you always have gains on your trades, then it's a great tax strategy. If you incur losses, then it may not be such a great tax strategy.

### **TIP: Maintain A Fixed Asset Schedule.**

It is so nice, when you sell an asset, simply to walk over to the file cabinet, pull out a folder that has all the basic information in it you need to figure the gain or loss on the disposed asset. I recommend maintaining a fixed asset schedule no matter how small your business. Usually you will want to group your fixed assets into categories such as Furniture & Fixtures, Office Equipment, Shop Equipment, Vehicles, Buildings, Land, Leasehold Improvements, and the like. Set up a manila folder for each of these categories that is appropriate for your business. Two-hole punch the folders and use Acco fasteners to secure your documents inside. On the inside of the folder, on the right hand side, fasten the invoices of your purchases and any other invoices that add to the cost of the asset, such as installation fees, etc. Fasten a three columnar page that remains on top and title the columns as follows:

#### **Furniture & Fixtures**

## **Purchase &**

### **Dispose Date    Asset # & Description    Additions    Deletions    Balance**

7/1/02	(1) Oak Desk	\$2,500.00		\$2,500.00
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Keep a running balance of the total Furniture & Fixtures you have “placed in service”. In other words, are actually in use. The IRS does not allow you to deduct the cost of an item until it is in use. Place a tag on the actual asset that relates to this schedule. For instance, F&F #1. When you dispose of an asset, record the date, description, and original purchase price in the Deletions column and update the running balance. Remove the disposed item’s invoice and fasten on the left side of the folder.

The total of this schedule should match the total of the Furniture & Fixtures account listed on your balance sheet. This is a sure-fire method for proving your balances. If you look at the Furniture & Fixtures number on the balance sheet and wonder what all is included, you will know exactly where to go to find out.

There are more benefits to be derived from maintaining this schedule. You may not keep a depreciation schedule separate from your tax return, but in either case the depreciation schedule’s list of assets should be exactly the same as on your fixed assets list. Sometimes those depreciation schedules get old and parts of the list become out of date. Assets may have fallen into disuse, been discarded, or perhaps sold and traded and never recorded. This system keeps your list of assets fresh and up-to-date. Furthermore, in some states, such as California, all counties collect what is called a “business property tax”. Business property taxes are figured on your fixed assets (accept for automobiles since they are already taxed via the Department of Motor Vehicles) so it is important to maintain a current list. You don’t want to pay taxes on fixed assets you are no longer using, and in case of an audit, you don’t want to receive a penalty for underpaying.

Running a business, small or large, is a matter of controlling various systems that make up an enterprise. Maintaining a schedule, whether it is manual or computerized, is the most effective and efficient way you can manage your fixed assets

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