

A's computation of this net operating loss is a deduction arising under section 1244 for a loss on small business stock. A had no taxable income in 1977, 1978, or 1979. Assume that A can carry over the entire \$15,000 loss under the rules of section 172. In 1981 A has gross income of \$75,000 and again sustains a loss on section 1244 stock. The amount of A's 1981 loss on section 1244 stock is \$50,000. A may deduct the full \$50,000 as an ordinary loss under section 1244 and the full \$15,000 as a net operating loss carryover in 1981.

[T.D. 7779, 46 FR 29473, June 2, 1981]

**§ 1.1244(e)-1 Records to be kept.**

(a) *By the corporation*—(1) *Mandatory records.* A plan to issue pre-November 1978 stock must appear upon the records of the corporation. Any designation of post-November 1978 stock under § 1.1244(c)-2(b)(2) also must appear upon the records of the corporation.

(2) *Discretionary records.* In order to substantiate an ordinary loss deduction claimed by its shareholders, the corporation should maintain records showing the following:

(i) The persons to whom stock was issued, the date of issuance to these persons, and a description of the amount and type of consideration received from each;

(ii) If the consideration received is property, the basis in the hands of the shareholder and the fair market value of the property when received by the corporation;

(iii) The amount of money and the basis in the hands of the corporation of other property received for its stock, as a contribution to capital, and as paid-in surplus;

(iv) Financial statements of the corporation, such as its income tax returns, that identify the source of the gross receipt of the corporation for the period consisting of the five most recent taxable years of the corporation, or, if the corporation has not been in existence for 5 taxable years, for the period of the corporation's existence;

(v) Information relating to any tax-free stock dividend made with respect to section 1244 stock and any reorganization in which stock is transferred by the corporation in exchange for section 1244 stock; and

(vi) With respect to pre-November 1978 stock;

(A) Which certificates represent stock issued under the plan;

(B) The amount of money and the basis in the hands of the corporation of other property received after June 30, 1958, and before the adoption of the plan, for its stock, as a contribution to capital, and as paid-in surplus; and

(C) The equity capital of the corporation on the date of adoption of the plan.

(b) *By the taxpayer.* A person who claims an ordinary loss with respect to stock under section 1244 must have records sufficient to establish that the taxpayer is entitled to the loss and satisfies the requirements of section 1244. See also section 6001, requiring records to be maintained.

In addition, a person who owns section 1244 stock in a corporation shall maintain records sufficient to distinguish such stock from any other stock he may own in the corporation.

[T.D. 6495, 25 FR 9681, Oct. 8, 1960, as amended by T.D. 7779, 46 FR 29473, June 2, 1981; 46 FR 31881, June 18, 1981; T.D. 8594, 60 FR 20898, Apr. 28, 1995]

**§ 1.1245-1 General rule for treatment of gain from dispositions of certain depreciable property.**

(a) *General.* (1) In general, section 1245(a)(1) provides that, upon a disposition of an item of section 1245 property, the amount by which the lower of (i) the *recomputed basis* of the property, or (ii) the amount realized on a sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition), exceeds the adjusted basis of the property shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of such gain shall be determined separately for each item of section 1245 property. In general, the term *recomputed basis* means the adjusted basis of property plus all adjustments reflected in such adjusted basis on account of depreciation allowed or allowable for all periods after December 31, 1961. See section 1245(a)(2) and § 1.1245-2. Generally, the ordinary income treatment applies even though in the absence of

section 1245 no gain would be recognized under the Code. For example, if a corporation distributes section 1245 property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 1245, section 311(a) would preclude any recognition of gain to the corporation. For the definition of *section 1245 property*, see section 1245(a)(3) and § 1.1245-3. For exceptions and limitations to the application of section 1245(a)(1), see section 1245(b) and § 1.1245-4.

(2) Section 1245(a)(1) applies to dispositions of section 1245 property in taxable years beginning after December 31, 1962, except that:

(i) In respect of section 1245 property which is an elevator or escalator, section 1245(a)(1) applies to dispositions after December 31, 1963, and

(ii) In respect of section 1245 property which is livestock (described in subparagraph (4) of § 1.1245-3(a)), section 1245(a)(1) applies to dispositions made in taxable years beginning after December 31, 1969, and

(iii) [Reserved].

(3) For purposes of this section and §§ 1.1245-2 through 1.1245-6, the term *disposition* includes a sale in a sale-and-leaseback transaction and a transfer upon the foreclosure of a security interest, but such term does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest. Thus, for example, a disposition occurs upon a sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security but a disposition does not occur when the seller ultimately gives up his security interest following payment by the purchaser.

(4) For purposes of applying section 1245, the facts and circumstances of each disposition shall be considered in determining what is the appropriate item of section 1245 property. A taxpayer may treat any number of units of section 1245 property in any particular depreciation account (as defined in § 1.167(a)-7) as one item of section 1245 property as long as it is reasonably clear, from the best estimates obtainable on the basis of all the facts and

circumstances, that the amount of gain to which section 1245(a)(1) applies is not less than the total of the gain under section 1245(a)(1) which would be computed separately for each unit. Thus, for example, if 50 units of section 1245 property X, 25 units of section 1245 property Y, and other property are accounted for in one depreciation account, and if each such unit is sold at a gain in one transaction in which the total gain realized on the sale exceeds the sum of the adjustments reflected in the adjusted basis (as defined in paragraph (a)(2) of § 1.1245-2) of each such unit on account of depreciation allowed or allowable for periods after December 31, 1961, all 75 units may be treated as one item of section 1245 property. If, however, 5 such units of section 1245 property Y were sold at a loss, then only 70 of such units (50 of X plus the 20 of Y sold at a gain) may be treated as one item of section 1245 property.

(5) In case of a sale, exchange, or involuntary conversion of section 1245 and non-section 1245 property in one transaction, the total amount realized upon the disposition shall be allocated between the section 1245 property and the non-section 1245 property in proportion to their respective fair market values. In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the section 1245 property and the non-section 1245 property, any arm's length agreement between the buyer and the seller will establish the allocation. In the absence of such an agreement, the allocation shall be made by taking into account the appropriate facts and circumstances. Some of the facts and circumstances which shall be taken into account to the extent appropriate include, but are not limited to, a comparison between the section 1245 property and all the property disposed of in such transaction of (i) the original cost and reproduction cost of construction, erection, or production, (ii) the remaining economic useful life, (iii) state of obsolescence, and (iv) anticipated expenditures to maintain, renovate, or to modernize.

(b) *Sale, exchange, or involuntary conversion.* (1) In the case of a sale, exchange, or involuntary conversion of section 1245 property, the gain to which

section 1245(a)(1) applies is the amount by which (i) the lower of the amount realized upon the disposition of the property or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property.

(2) The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* On January 1, 1964, Brown purchases section 1245 property for use in his manufacturing business. The property has a basis for depreciation of \$3,300. After taking depreciation deductions of \$1,300 (the amount allowable), Brown realizes after selling expenses the amount of \$2,900 upon sale of the property on January 1, 1969. Brown's gain is \$900 (\$2,900 amount realized minus \$2,000 adjusted basis). Since the amount realized upon disposition of the property (\$2,900) is lower than its recomputed basis (\$3,300, i.e., \$2,000 adjusted basis plus \$1,300 in depreciation deductions), the entire gain is treated as ordinary income under section 1245(a)(1) and not as gain from the sale or exchange of property described in section 1231.

*Example 2.* Assume the same facts as in example (1) except that Brown exchanges the section 1245 property for land which has a fair market value of \$3,700, thereby realizing a gain of \$1,700 (\$3,700 amount realized minus \$2,000 adjusted basis). Since the recomputed basis of the property (\$3,300) is lower than the amount realized upon its disposition (\$3,700), the excess of recomputed basis over adjusted basis, or \$1,300, is treated as ordinary income under section 1245(a)(1). The remaining \$400 of the gain may be treated as gain from the sale or exchange of property described in section 1231.

(c) *Other dispositions.* (1) In the case of a disposition of section 1245 property other than by way of a sale, exchange, or involuntary conversion, the gain to which section 1245(a)(1) applies is the amount by which (i) the lower of the fair market value of the property on the date of disposition or the recomputed basis of the property, exceeds (ii) the adjusted basis of the property. If property is transferred by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange, for purposes of applying section 1245 such transfer shall be treated as a disposition other than by way of a sale, exchange, or involuntary conversion.

(2) The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* X Corporation distributes section 1245 property to its shareholders as a dividend. The property has an adjusted basis of \$2,000 to the corporation, a recomputed basis of \$3,300, and a fair market value of \$3,100. Since the fair market value of the property (\$3,100) is lower than its recomputed basis (\$3,300), the excess of fair market value over adjusted basis, or \$1,100, is treated under section 1245(a)(1) as ordinary income to the corporation even though, in the absence of section 1245, section 311(a) would preclude recognition of gain to the corporation.

*Example 2.* Assume the same facts as in example (1) except that X Corporation distributes the section 1245 property to its shareholders in complete liquidation of the corporation. Assume further that section 1245(b)(3) does not apply and that the fair market value of the property is \$3,800 at the time of the distribution. Since the recomputed basis of the property (\$3,300) is lower than its fair market value (\$3,800), the excess of recomputed basis over adjusted basis, or \$1,300, is treated under section 1245(a)(1) as ordinary income to the corporation even though, in the absence of section 1245, section 336 would preclude recognition of gain to the corporation.

(d) *Losses.* Section 1245(a)(1) does not apply to losses. Thus, section 1245(a)(1) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of property, all of which is considered section 1245 property, nor does the section apply to a disposition of such property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(e) *Treatment of partnership and partners.* (1) The manner of determining the amount of gain recognized under section 1245(a)(1) to a partnership may be illustrated by the following example:

*Example:* A partnership sells for \$63 section 1245 property which has an adjusted basis to the partnership of \$30 and a recomputed basis to the partnership of \$60. The partnership recognizes under section 1245(a)(1) gain of \$30, i.e., the lower of the amount realized (\$63) or recomputed basis (\$60), minus adjusted basis (\$30). This result would not be changed if one or more partners had, in respect of the property, a special basis adjustment described in section 743(b) or had taken depreciation deductions in respect of such special basis adjustment.

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section

1245(a)(1) by the partnership is equal to the lesser of the partner's share of total gain from the disposition of the property (gain limitation) or the partner's share of depreciation or amortization with respect to the property (as determined under paragraph (e)(2)(ii) of this section). Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph (e)(2)(i) (excess depreciation recapture) is allocated among the partners whose shares of total gain from the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Excess depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property that is allocated to the partners who are not subject to the gain limitation. See *Example 2* of paragraph (e)(2)(iii) of this section.

(ii)(A) Subject to the adjustments described in paragraphs (e)(2)(ii)(B) and (e)(2)(ii)(C) of this section, a partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.

(B) If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(C)(1) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property is contributed.

(2) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any curative allocations. (See § 1.704-3(c) for a description of the traditional method with curative allocations.)

The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partners with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner's share of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partner with respect to that property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations. See *Example 3(iii)* of paragraph (e)(2)(iii) of this section.

(3) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any remedial allocations. (See § 1.704-3(d) for a description of the remedial allocation method.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of income to the contributing partner with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to that property. See *Example 3(iv)* of paragraph (e)(2)(iii) of this section.

(4) If, under paragraphs (e)(2)(ii)(C)(2) and (e)(2)(ii)(C)(3) of this section, the partners' shares of depreciation or amortization with respect to a contributed property exceed the adjustments reflected in the adjusted basis of the

property under §1.1245-2(a) at the partnership level, then the partnership's gain recognized under section 1245(a)(1) with respect to that property is allocated among the partners in proportion to their relative shares of depreciation or amortization (subject to any gain limitation that might apply).

(5) This paragraph (e)(2)(ii)(C) also applies in determining a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704-1(b)(2)(iv)(f).

(iii) *Examples.* The application of this paragraph (e)(2) may be illustrated by the following examples:

*Example 1. Recapture allocations.* (i) *Facts.* A and B each contribute \$5,000 cash to form AB, a general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for \$5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation). (To simplify this example, AB's depreciation deductions are determined without regard to any first-year depreciation conventions.)

(ii) *Year 1.* In its first year of operations, AB has \$1,000 of depreciation from the partnership equipment. In accordance with the partnership agreement, AB allocates 90 percent (\$900) of the depreciation to A and 10 percent (\$100) of the depreciation to B. At the end of the year, AB sells the equipment for \$5,200, recognizing \$1,200 of gain (\$5,200 amount realized less \$4,000 adjusted tax basis). In accordance with the partnership agreement, the first \$800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining \$400 of gain is allocated \$200 to A and \$200 to B.

(iii) *Recapture allocations.* \$1,000 of the gain from the sale of the equipment is treated as section 1245(a)(1) gain. Under paragraph (e)(2)(i) of this section, each partner's share of the section 1245(a)(1) gain is equal to the lesser of the partner's share of total gain recognized on the sale of the equipment or the partner's share of total depreciation with respect to the equipment. Thus, A's share of the section 1245(a)(1) gain is \$900 (the lesser of A's share of the total gain (\$1,000) and A's

share of depreciation (\$900)). B's share of the section 1245(a)(1) gain is \$100 (the lesser of B's share of the total gain (\$200) and B's share of depreciation (\$100)). Accordingly, \$900 of the \$1,000 of total gain allocated to A is treated as ordinary income and \$100 of the \$200 of total gain allocated to B is treated as ordinary income.

*Example 2. Recapture allocation subject to gain limitation.* (i) *Facts.* A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75 percent to A and 25 percent to B. ABC purchases depreciable personal property for \$300 and subsequently allocates \$100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to \$0. ABC then sells the property for \$440. ABC allocates \$330 of the gain to A (75 percent of \$440) and allocates \$110 of the gain to B (25 percent of \$440). No gain is allocated to C.

(ii) *Application of gain limitation.* Each partner's share of depreciation with respect to the property is \$100. C's share of the total gain from the disposition of the property, however, is \$0. As a result, under the gain limitation provision in paragraph (e)(2)(i) of this section, C's share of section 1245(a)(1) gain is limited to \$0.

(iii) *Excess depreciation recapture.* Under paragraph (e)(2)(i) of this section, the \$100 of section 1245(a)(1) gain that cannot be allocated to C under the gain limitation provision (excess depreciation recapture) is allocated to A and B (the partners not subject to the gain limitation at the time of the allocation) in proportion to their relative shares of total gain from the disposition of the property. A's relative share of the total gain allocated to A and B is 75 percent (\$330 of \$440 total gain). B's relative share of the total gain allocated to A and B is 25 percent (\$110 of \$440 total gain). However, under the gain limitation provision of paragraph (e)(2)(i) of this section, B cannot be allocated 25 percent of the excess depreciation recapture (\$25) because that would result in a total allocation of \$125 of depreciation recapture to B (a \$100 allocation equal to B's share of depreciation plus a \$25 allocation of excess depreciation recapture), which is in excess of B's share of the total gain from the disposition of the property (\$110). Therefore, only \$10 of excess depreciation recapture is allocated to B and the remaining \$90 of excess depreciation recapture is allocated to A. A is not subject to the gain limitation because A's share of the total gain (\$330) still exceeds A's share of section 1245(a)(1) gain (\$190). Accordingly, all \$110 of the total gain allocated to B is treated as ordinary income (\$100 share of depreciation allocated to B plus \$10 of excess depreciation recapture) and \$190 of the total

gain allocated to A is treated as ordinary income (\$100 share of depreciation allocated to A plus \$90 of excess depreciation recapture).

*Example 3. Determination of partners' shares of depreciation with respect to contributed property.* (i) *Facts.* C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of \$800 and a fair market value of \$2,800. Prior to the contribution, C claimed \$200 of depreciation from C1. At the time of the contribution, C1 is depreciable under the straight-line method and has four years remaining on its 5-year recovery period. D contributes \$2,800 cash, which CD uses to purchase depreciable personal property D1, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions.)

(ii) *Traditional method.* C1 generates \$700 of book depreciation ( $\frac{1}{4}$  of \$2,800 book value) and \$200 of tax depreciation ( $\frac{1}{4}$  of \$800 adjusted tax basis) each year. C and D will each be allocated \$350 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, D will be allocated the entire \$200 of tax depreciation from C1 in year 1. D1 generates \$400 of book and tax depreciation each year ( $\frac{1}{2}$  of \$2,800 book value and adjusted tax basis). C and D will each be allocated \$200 of book and tax depreciation from D1 in year 1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is \$200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is \$200 (the amount of tax depreciation allocated to D). C and D each have a \$200 share of depreciation with respect to D1. At the end of four years, C's share of depreciation with respect to C1 will be \$200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 will be \$800 (four years of \$200 depreciation per year). At the end of four years, C and D will each have an \$800 share of depreciation with respect to D1 (four years of \$200 depreciation per year).

(iii) *Effect of curative allocations.* (A) *Year 1.* If the partnership elects to make curative allocations under § 1.704-3(c) using depreciation from D1, the results will be the same as under the traditional method, except that \$150 of the \$200 of tax depreciation from D1 that would be allocated to C under the traditional method will be allocated to D as additional depreciation with respect to C1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 will be reduced to \$50 (the total depreciation taken by C prior to contribution (\$200) decreased by the amount of the curative allocation to D (\$150)). D's share of depreciation with respect to C1 will be \$350 (the depreciation allocated to D under the

traditional method (\$200) increased by the amount of the curative allocation to D (\$150)). C and D will each have a \$200 share of depreciation with respect to D1.

(B) *Year 4.* At the end of four years, C's share of depreciation with respect to C1 will be reduced to \$0 (the total depreciation taken by C prior to contribution (\$200) decreased, but not below zero, by the amount of the curative allocations to D (\$600)), and D's share of depreciation with respect to C1 will be \$1,400 (the total depreciation allocated to D under the traditional method (\$800) increased by the amount of the curative allocations to D (\$600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than \$1,000 (CD's tax depreciation (\$800) plus C's tax depreciation prior to contribution (\$200)). Under paragraph (e)(2)(ii)(C)(4) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is \$0, and D's share of depreciation with respect to C1 is \$1,400, all of CD's \$1,000 of section 1245(a)(1) gain will be allocated to D. At the end of four years, C and D will each have an \$800 share of depreciation with respect to D1 (four years of \$200 depreciation per year).

(iv) *Effect of remedial allocations.* (A) *Year 1.* If the partnership elects to make remedial allocations under § 1.704-3(d), there will be \$600 of book depreciation from C1 in year 1. (Under the remedial allocation method, the amount by which C1's book basis (\$2,800) exceeds its tax basis (\$800) is depreciated over a 5-year life, rather than a 4-year life.) C and D will each be allocated one-half (\$300) of the total book depreciation. As under the traditional method, D will be allocated all \$200 of tax depreciation from C1. Because the ceiling rule would cause a disparity of \$100 between D's book and tax allocations of depreciation, D will also receive a \$100 remedial allocation of depreciation with respect to C1, and C will receive a \$100 remedial allocation of income with respect to C1. As a result, after the first year of partnership operations, D's share of depreciation with respect to C1 is \$300 (the depreciation allocated to D under the traditional method (\$200) increased by the amount of the remedial allocation (\$100)). C's share of depreciation with respect to C1 is \$100 (the total depreciation taken by C prior to contribution (\$200) decreased by the amount of the remedial allocation of income (\$100)). C and D will each have a \$200 share of depreciation with respect to D1.

(B) *Year 5.* At the end of five years, C's share of depreciation with respect to C1 will be \$0 (the total depreciation taken by C prior to contribution (\$200) decreased, but not

below zero, by the total amount of the remedial allocations of income to C (\$600). D's share of depreciation with respect to C1 will be \$1,400 (the total depreciation allocated to D under the traditional method (\$800) increased by the total amount of the remedial allocations of depreciation to D (\$600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than \$1,000 (CD's tax depreciation (\$800) plus C's tax depreciation prior to contribution (\$200)). Under paragraph (e)(2)(ii)(C)(4) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is \$0, and D's share of depreciation with respect to C1 is \$1,400, all of CD's \$1,000 of section 1245(a)(1) gain will be allocated to D. At the end of five years, C and D will each have a \$1,000 share of depreciation with respect to D1 (five years of \$200 depreciation per year).

(iv) *Effective date.* This paragraph (e)(2) is effective for properties acquired by a partnership on or after August 20, 1997. However, partnerships may rely on this paragraph (e)(2) for properties acquired before August 20, 1997 and disposed of on or after August 20, 1997.

(3)(i) If (a) a partner had a special basis adjustment under section 743(b) in respect of section 1245 property, or (b) on the date he acquired his partnership interest by way of a sale or exchange (or upon death of another partner) the partnership owned section 1245 property and an election under section 754 (relating to optional adjustment to basis of partnership property) was in effect with respect to the partnership, then the amount of gain recognized under section 1245(a)(1) by him upon a disposition by the partnership of such property shall be determined under this subparagraph.

(ii) There shall be allocated to such partner, in the same proportion as the partnership's total gain is allocated to him as his distributive share under section 704, a portion of (a) the common partnership adjusted basis for the property, and (b) the amount realized by the partnership upon the disposition, or, if nothing is realized, the fair market value of the property. There shall also be allocated to him, in the same proportion as the partnership's gain recognized under section 1245(a)(1) is

allocated under subparagraph (2) of this paragraph as his distributive share of such gain, a portion of *the adjustments reflected in the adjusted basis* (as defined in paragraph (a)(2) of § 1.1245-2) of such property. If on the date he acquired his partnership interest by way of a sale or exchange the partnership owned such property and an election under section 754 was in effect, then for purposes of the preceding sentence the amount of the adjustments reflected in the adjusted basis of such property on such date shall be deemed to be zero. For special rules relating to the amount of adjustments reflected in the adjusted basis of property after partnership transactions, see paragraph (c)(6) of § 1.1245-2.

(iii) The partner's adjusted basis in respect of the property shall be deemed to be (a) the portion of the partnership's adjusted basis for the property allocated to the partner under subdivision (ii) of this subparagraph, (b) increased by the amount of any special basis adjustment described in section 743(b)(1) (or decreased by the amount of any special basis adjustment described in section 743(b)(2) which the partner may have in respect of the property on the date the partnership disposed of the property.

(iv) The partner's recomputed basis in respect of the property shall be deemed to be (a) the sum of the partner's adjusted basis for the property, as determined in subdivision (iii) of this subparagraph, plus the amount of *the adjustments reflected in the adjusted basis* (as defined in paragraph (a)(2) of § 1.1245-2) for the property allocated to the partner under subdivision (ii) of this subparagraph, (b) increased by the amount by which any special basis adjustment described in section 743(b)(1) (or decreased by the amount by which any special basis adjustment described in section 743(b)(2)) in respect of the property was reduced, but only to the extent such amount was applied to adjust the amount of the deductions allowed or allowable to the partner for depreciation or amortization of section 1245 property attributable to periods referred to in paragraph (a)(2) of § 1.1245-2. The terms *allowed or allowable, depreciation or amortization, and attributable to periods* shall have the

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meanings assigned to these terms in paragraph (a) of § 1.1245-2.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

*Example:* A, B, and C each hold a one-third interest in calendar year partnership ABC. On December 31, 1962, the firm holds section 1245 property which has an adjusted basis of \$30,000 and a recomputed basis of \$33,000. Depreciation deductions in respect of the property for 1962 were \$3,000. On January 1, 1963, when D purchases C's partnership interest, the election under section 754 is in effect and a \$5,000 special basis adjustment is made in respect of D to his one-third share of the common partnership adjusted basis for the property. For 1963 and 1964 the partnership deducts \$6,000 as depreciation in respect of the property, thereby reducing its adjusted basis to \$24,000, and D deducts \$2,800, i.e., his distributive share of partnership depreciation (\$2,000) plus depreciation in respect of his special basis adjustment (\$800). On March 15, 1965, the partnership sells the property for \$48,000. Since the partnership's recomputed basis for the property (\$33,000, i.e., \$24,000 adjusted basis plus \$9,000 in depreciation deductions) is lower than the amount realized upon the sale (\$48,000), the excess of recomputed basis over adjusted basis, or \$9,000, is treated as partnership gain under section 1245(a)(1). D's distributive share of such gain is \$3,000 (1/3 of \$9,000). However, the amount of gain recognized by D under section 1245 (a)(1) is only \$2,800, determined as follows:

|  |         |          |
|--|---------|----------|
| (1) Adjusted basis:  |         |          |
| D's portion of partnership adjusted basis (1/3 of \$24,000)  | \$8,000 |          |
| D's special basis adjustment as of December 31, 1964 (\$5,000 minus \$800)   | 4,200   |          |
| D's adjusted basis   |         | \$12,200 |
| (2) Recomputed basis:  |         |          |
| D's adjusted basis   | 12,200  |          |
| D's portion of partnership depreciation for 1963 and 1964, i.e., for periods after he acquired his partnership interest (1/3 of \$6,000) | 2,000   |          |
| Depreciation for 1963 and 1964 in respect of D's special basis adjustment  | 800     |          |
| D's recomputed basis   |         | 15,000   |
| (3) D's portion of amount realized by partnership (1/3 of \$48,000)  |         | 16,000   |
| (4) Gain recognized to D under section 1245(a)(1), i.e., the lower of (2) or (3), minus (1)  |         | 2,800    |

[T.D. 6832, 30 FR 8576, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7141, 36 FR 18793, Sept. 22, 1971; T.D. 8730, 62 FR 44216, Aug. 20, 1997]

§ 1.1245-2 Definition of recomputed basis.

(a) *General rule*—(1) *Recomputed basis defined.* The term *recomputed basis* means, with respect to any property, an amount equal to the sum of:

(i) The adjusted basis of the property, as defined in section 1011, plus

(ii) The amount of the adjustments reflected in the adjusted basis.

(2) *Definition of adjustments reflected in adjusted basis.* The term *adjustments reflected in the adjusted basis* means:

(i) With respect to any property other than property described in subdivision (ii), (iii), or (iv) of this subparagraph, the amount of the adjustments attributable to periods after December 31, 1961,

(ii) With respect to an elevator or escalator, the amount of the adjustments attributable to periods after June 30, 1963,

(iii) With respect to livestock (described in subparagraph (4) of § 1.1245-3(a)), the amount of the adjustments attributable to periods after December 31, 1969, or

(iv) [Reserved]

which are reflected in the adjusted basis of such property on account of deductions allowed or allowable for depreciation or amortization (within the meaning of subparagraph (3) of this paragraph). For cases where the taxpayer can establish that the amount allowed for any period was less than the amount allowable, see subparagraph (7) of this paragraph. For determination of adjusted basis of property in a multiple asset account, see paragraph (c)(3) of § 1.167(a)-8.

(3) *Meaning of depreciation or amortization.* (i) For purposes of subparagraph (2) of this paragraph, the term *depreciation or amortization* includes allowances (and amounts treated as allowances) for depreciation (or amortization in lieu thereof), and deductions for amortization of emergency facilities under section 168. Thus, for example, such term includes a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) under section 167, an expense allowance (additional first-year depreciation allowance for property placed in service before January 1, 1981), under section 179, an expenditure treated as