

## § 1.1245-4

(1) Tangible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of *section 38 property* for purposes of the investment credit), and

(2) Intangible personal property.

(c) *Property described in section 1245(a)(3)(B)*. (1) The term *property described in section 1245(a)(3)(B)* means tangible property of the requisite depreciable character other than personal property (and other than a building and its structural components), but only if there are adjustments reflected in the adjusted basis of the property (within the meaning of paragraph (a)(2) of § 1.1245-2) for a period during which such property (or other property):

(i) Was used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or

(ii) Constituted a research or storage facility used in connection with any of the foregoing activities.

Thus, even though during the period immediately preceding its disposition the property is not used as an integral part of an activity specified in subdivision (i) of this subparagraph and does not constitute a facility specified in subdivision (ii) of this subparagraph, such property is nevertheless property described in section 1245(a)(3)(B) if, for example, there are adjustments reflected in the adjusted basis of the property for a period during which the property was used as an integral part of manufacturing by the taxpayer or another taxpayer, or for a period during which other property (which was involuntarily converted into, or exchanged in a like kind exchange for, the property) was so used by the taxpayer or another taxpayer. For rules applicable to involuntary conversions and like kind exchanges, see paragraph (d)(3) of § 1.1245-4.

(2) The language used in subparagraph (1) (i) and (ii) of this paragraph shall have the same meaning as when used in paragraph (a) of § 1.48-1, and the terms *building* and *structural components* shall have the meanings assigned

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to those terms in paragraph (e) of § 1.48-1.

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### § 1.1245-4 Exceptions and limitations.

(a) *Exception for gifts*—(1) *General rule*. Section 1245(b)(1) provides that no gain shall be recognized under section 1245(a)(1) upon a disposition by gift. For purposes of this paragraph, the term *gift* means, except to the extent that subparagraph (3) of this paragraph applies, a transfer of property which, in the hands of the transferee, has a basis determined under the provisions of section 1015 (a) or (d) (relating to basis of property acquired by gifts). For reduction in amount of charitable contribution in case of a gift of section 1245 property, see section 170(e) and the regulations thereunder.

(2) *Examples*. The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example 1*. A places section 1245 property in trust to pay the income from the property to B for his life, and after B's death to distribute the property to C. If the basis of the property to the fiduciary and to C is determined under the uniform basis rules prescribed in paragraph (b) of § 1.1015-1, and under paragraph (c) of § 1.1015-1 the time the fiduciary and C acquire their interests in the property is the time the donor relinquished dominion over the property, then section 1245(a)(1) does not apply to the transfer by A to the trust or to the distribution to C.

*Example 2*. Assume the same facts as in example (1), except that the fiduciary sells the section 1245 property and reinvests the proceeds in other section 1245 property which is distributed to C upon B's death. Assume further that under paragraph (f) of § 1.1015-1 C's basis for the distributed property is the cost or other basis to the fiduciary. Section 1245(a)(1) applies to the sale but not to the distribution.

(3) *Disposition in part a sale or exchange and in part a gift*. Where a disposition of property is in part a sale or exchange and in part a gift, 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. For determination of the recomputed basis of the

property in the hands of the transferee, see paragraph (c)(2) of § 1.1245-2.

(4) *Example.* The provisions of subparagraph (3) of this paragraph may be illustrated by the following example:

*Example:* (i) Smith transfers section 1245 property, which he has held in excess of 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), to his son for \$60,000. Immediately before the transfer the property in the hands of Smith has an adjusted basis of \$30,000, a fair market value of \$90,000, and a recomputed basis of \$110,000. Since the amount realized upon disposition of the property (\$60,000) is lower than its recomputed basis (\$110,000), the excess of the amount realized over adjusted basis, or \$30,000, 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. Smith has made a gift of \$30,000 (\$90,000 fair market value minus \$60,000 amount realized) to which section 1245(a)(1) does not apply.

(ii) Immediately before the transfer, the amount of adjustments reflected in the adjusted basis of the property was \$80,000. Under paragraph (c)(2) of § 1.1245-2, \$50,000 of adjustments are reflected in the adjusted basis of the property immediately after the transfer, that is, \$80,000 of such adjustments immediately before the transfer, minus \$30,000 gain taken into account under section 1245(a)(1) upon the transfer. Thus, the recomputed basis of the property in the hands of the son is \$110,000.

(b) *Exception for transfers at death—(1) General rule.* Section 1245(b)(2) provides that, except as provided in section 691 (relating to income in respect of a decedent), no gain shall be recognized under section 1245(a)(1) upon a transfer at death. For purposes of this paragraph, the term *transfer at death* means a transfer of property which, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor. For recomputed basis of property acquired in a transfer at death, see paragraph (c)(1)(iv) of § 1.1245-2.

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

*Example 1.* Smith owns section 1245 property which, upon Smith's death, is inherited by his son. Since the property is described in section 1014(b)(1), its basis in the hands of the son is determined under the provisions of

section 1014(a). Therefore, section 1245(a)(1) does not apply to the transfer at Smith's death.

*Example 2.* H purchases section 1245 property which he conveys to himself and W, his wife, as tenants by the entirety. Upon H's death in 1970 the property (including W's share) is included in his gross estate. Since the entire property is described in section 1014(b) (1) and (9), its basis in the hands of W is determined under the provisions of section 1014(a). Therefore, section 1245(a)(1) does not apply to the transfer at H's death. For determination of the recomputed basis of the property in the hands of W, see paragraph (c)(3) of § 1.1245-2.

*Example 3.* Green's will provides for the bequest of section 1245 property to trustees to pay the income from the property to his wife for her lifetime, and upon her death to distribute the property to his son. If under paragraph (a)(2) of § 1.1014-4 the son's unadjusted basis for the property is its fair market value at the time the decedent died, section 1245(a)(1) does not apply to the distribution of the property to the son.

*Example 4.* The trustee of a trust created by will transfers section 1245 property to a beneficiary in satisfaction of a specific bequest of \$10,000. If under the principles of paragraph (a)(3) of § 1.1014-4 the trust realizes a taxable gain upon the transfer, section 1245(a)(1) applies to the transfer.

(c) *Limitation for certain tax-free transactions—(1) Limitation on amount of gain.* Section 1245(b)(3) provides that upon a transfer of property described in subparagraph (2) of this paragraph, the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 1245). For purposes of this subparagraph, in case of a transfer of both section 1245 property and non-section 1245 property in one transaction, the amount realized from the disposition of the section 1245 property (as determined under paragraph (a)(5) of § 1.1245-1) shall be deemed to consist of that portion of the fair market value of each property acquired which bears the same ratio to the fair market value of such acquired property as the amount realized from the disposition of the section 1245 property bears to the total amount realized. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard

to section 1245) which shall be recognized as ordinary income under section 1245(a)(1). For determination of the recomputed basis of the section 1245 property in the hands of the transferee, see paragraph (c)(2) of § 1.1245-2. Section 1245(b)(3) does not apply to a disposition of property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(2) *Transfers covered.* The transfers referred to in subparagraph (1) of this paragraph are transfers of property in which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(i) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). See subparagraph (3) of this paragraph.

(ii) Section 351 (relating to transfer to a corporation controlled by transferor).

(iii) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(iv) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(v) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(vi) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(vii) Section 731 (relating to distributions by a partnership to a partner). For special carryover basis rule, see section 1245(b)(6)(A) and paragraph (f)(1) of this section.

(3) *Complete liquidation of subsidiary.* In the case of a distribution in complete liquidation of an 80-percent-or-more controlled subsidiary to which section 332 applies, the limitation provided in section 1245(b)(3) is confined to instances in which the basis of the property in the hands of the transferee is determined, under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation of section 1245(b)(3) may apply in respect of a liquidating distribution of section 1245 property by an 80-percent-or-more controlled corpora-

tion to the parent corporation, but does not apply in respect of a liquidating distribution of section 1245 property to a minority shareholder. Section 1245(b)(3) does not apply to a liquidating distribution of property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis for the stock of the subsidiary.

(4) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* Section 1245 property, which is owned by Smith, has a fair market value of \$10,000, a recomputed basis of \$8,000, and an adjusted basis of \$4,000. Smith transfers the property to a corporation in exchange for stock in the corporation worth \$9,000 plus \$1,000 in cash in a transaction qualifying under section 351. Without regard to section 1245, Smith would recognize \$1,000 gain under section 351(b), and the corporation's basis for the property would be determined under section 362(a) by reference to its basis in the hands of Smith. Since the recomputed basis of the property disposed of (\$8,000) is lower than the amount realized (\$10,000), the excess of recomputed basis over adjusted basis (\$4,000), or \$4,000, would be treated as ordinary income under section 1245(a)(1) if the provisions of section 1245(b)(3) did not apply. However, section 1245(b)(3) limits the gain taken into account by Smith under section 1245(a)(1) to \$1,000. If, instead, Smith transferred the property to the corporation solely in exchange for stock of the corporation worth \$10,000, then, because of the application of section 1245(b)(3), Smith would not take any gain into account under section 1245(a)(1). If, however, Smith transferred the property to the corporation for stock worth \$5,000 and \$5,000 cash, only \$4,000 of the \$5,000 gain under section 351(b) would be treated as ordinary income under section 1245(a)(1).

*Example 2.* Assume the same facts as in example (1) except that Smith contributes the property to a new partnership in which he has a one-half interest. Since, without regard to section 1245, no gain would be recognized to Smith under section 721, and by reason of the application of section 721 the partnership's basis for the property would be determined under section 723 by reference to its basis in the hands of Smith, the application of section 1245(b)(3) results in no gain being taken into account by Smith under section 1245(a)(1).

*Example 3.* Assume the same facts as in example (2) except that the property is subject to a \$9,000 mortgage. Since under section

752(b) (relating to decrease in partner's liabilities) Smith is treated as receiving a distribution in money of \$4,500 (one-half of liability assumed by partnership), and since the basis of Smith's partnership interest is \$4,000 (the adjusted basis of the contributed property), the \$4,500 distribution results in his realizing \$500 gain under section 731(a) (relating to distributions by a partnership), determined without regard to section 1245. Accordingly, the application of section 1245(b)(3) limits the gain taken into account by Smith under section 1245(a)(1) to \$500.

(d) *Limitation for like kind exchanges and involuntary conversions*—(1) *General rule.* Section 1245(b)(4) provides that if property is disposed of and gain (determined without regard to section 1245) is not recognized in whole or in part under section 1031 (relating to like kind exchanges) or section 1033 (relating to involuntary conversions), then the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the sum of:

(i) The amount of gain recognized on such disposition (determined without regard to section 1245), plus

(ii) The fair market value of property acquired which is not section 1245 property and which is not taken into account under subdivision (i) of this subparagraph (that is, the fair market value of non-section 1245 property acquired which is qualifying property under section 1031 or 1033, as the case may be).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

*Example 1.* Smith exchanges machine A for machine B in a like kind exchange as to which no gain is recognized under section 1031(a). Both machines are section 1245 property. No gain is recognized under section 1245(a)(1) because of the limitation contained in section 1245(b)(4). The result would be the same if machine A were involuntarily converted into machine B in a transaction as to which no gain is recognized under section 1033(a)(1).

*Example 2.* Jones owns property A, which is section 1245 property, with an adjusted basis of \$100,000 and a recomputed basis of \$116,000. The property is destroyed by fire and Jones receives \$117,000 of insurance proceeds. Thus, the amount of gain under section 1245(a)(1), determined without regard to section 1245(b)(4), would be \$16,000. He uses \$105,000 of the proceeds to purchase section 1245 property similar or related in service or use to property A, and \$9,000 of the proceeds to pur-

chase stock in the acquisition of control of a corporation owning property similar or related in service or use to property A. Both acquisitions qualify under section 1033(a)(3)(A). Jones properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the amount by which the amount realized from the conversion exceeds the cost of the stock and other property acquired to replace the converted property. Since \$3,000 of the gain is recognized (without regard to section 1245) under section 1033(a)(3) (that is, \$117,000 minus \$114,000), and since the stock purchased for \$9,000 is not section 1245 property and was not taken into account in determining the gain under section 1033, section 1245(b)(4) limits the amount of the gain taken into account under section 1245(a)(1) to \$12,000 (that is, \$3,000 plus \$9,000). If, instead of purchasing \$9,000 in stock, Jones purchases \$9,000 worth of property which is section 1245 property similar or related in use to the destroyed property, section 1245(b)(4) would limit the amount of gain taken into account under section 1245(a)(1) to \$3,000.

(3) *Certain tangible property.* If:

(i) A person disposes of section 1245 property in a transaction to which section 1245(b)(4) applies,

(ii) Adjustments are reflected in the adjusted basis (within the meaning of paragraph (a)(2) of § 1.1245-2) of such property which are attributable to the use of such property (or other property) as an integral part of an activity, or as a facility, specified in section 1245(a)(3)(B) (i) or (ii), and

(iii) Property is acquired in the transaction which would be considered as section 1245 property described in section 1245(a)(3)(B) if such person used the acquired property as an integral part of such an activity, or as such a facility, then (regardless of the use of the acquired property) the acquired property shall be considered as section 1245 property described in section 1245(a)(3)(B). For definition of property described in section 1245(a)(3)(B), see paragraph (c) of § 1.1245-3. Thus, for example, if a person's section 1245 property (which is personal property) is involuntarily converted into property A which would qualify as section 1245 property only if it were devoted to a specified use, and if the person had so devoted the section 1245 property disposed of, then the acquired property is considered as section 1245 property described in section 1245(a)(3)(B) and

therefore its fair market value is not taken into account under subparagraph (1)(ii) of this paragraph. For recomputed basis of property A, see paragraph (a)(5) of § 1.1245-2. Moreover, if property A is not devoted to a specified use and is subsequently involuntarily converted into property B which would qualify as section 1245 property only if it were so devoted, then property B is also considered as section 1245 property described in section 1245(a)(3)(B).

(4) *Application to disposition of section 1245 property and nonsection 1245 property in one transaction.* For purposes of this paragraph, if both section 1245 property and nonsection 1245 property are acquired as the result of one disposition in which both section 1245 property and nonsection 1245 property are disposed of, then except as provided in subparagraph (7) of this paragraph:

(i) The total amount realized upon the disposition shall be allocated (in a manner consistent with the principles of paragraph (a)(5) of § 1.1245-1) between the section 1245 property and the non-section 1245 property disposed of in proportion to their respective fair market values.

(ii) The amount realized upon the disposition of the section 1245 property shall be deemed to consist of so much of the fair market value of the section 1245 property acquired as is not in excess of the amount realized from the section 1245 property disposed of, and the remaining portion (if any) of the amount realized upon the disposition of the section 1245 property shall be deemed to consist of so much of the fair market value of the non-section 1245 property acquired as is not in excess of the amount of such remaining portion, and

(iii) The amount realized upon the disposition of the non-section 1245 property shall be deemed to consist of so much of the fair market value of all the property acquired which was not taken into account in subdivision (ii) of this subparagraph.

(5) *Example.* The provisions of subparagraph (4) of this paragraph may be illustrated by the following example:

*Example:* (i) Smith owns section 1245 property A with a fair market value of \$30,000, and non-section 1245 property X with a fair market value of \$20,000. Properties A and X

are destroyed by fire and Smith receives insurance proceeds of \$40,000. He uses all the proceeds, plus additional cash of \$10,000, to purchase in a single transaction properties B and Y which qualify under section 1033(a)(3)(A), and he properly elects under section 1033(a)(3)(A) and the regulations thereunder to limit recognition of gain to the excess of the amount realized from the conversion over the costs of the qualifying properties acquired. Thus no gain would be recognized (without regard to section 1245) under section 1033(a)(3)(A). Property B is section 1245 property with a fair market value of \$15,000, and property Y is non-section 1245 property with a fair market value of \$35,000.

(ii) The amount realized upon the disposition of A and X (\$40,000) is allocated between A and X in proportion to their respective fair market values. Thus, the amount considered realized in respect of A is \$24,000 (that is,  $\frac{30}{50}$  of \$40,000). (The amount considered realized in respect of X is \$16,000 (that is,  $\frac{20}{50}$  of \$40,000).)

(iii) The \$24,000 realized upon the disposition of A is deemed to consist of the fair market value of B (\$15,000) and \$9,000 of the fair market value of Y. (The \$16,000 realized upon the disposition of X is deemed to consist of \$16,000 of the fair market value of Y. Also, \$10,000 of the fair market value of Y is attributable to the additional cash of \$10,000.)

(iv) Assume that A has an adjusted basis of \$5,000, and a recomputed basis of \$40,000. Since the amount considered realized upon the disposition of A (\$24,000) is lower than its recomputed basis (\$40,000), the amount of gain which would be recognized under section 1245(a)(1), determined without regard to section 1245(b)(4), is \$19,000, that is, the amount realized (\$24,000) minus the adjusted basis (\$5,000). Since no gain is recognized (without regard to section 1245) under section 1033(a)(3), and since \$9,000 of the property acquired in exchange for section 1245 property A is non-section 1245 property Y, section 1245(b)(4) limits the amount of gain taken into account under section 1245(a)(1) to \$9,000.

(6) *Cross references.* For the manner of determining the recomputed basis of property acquired in a transaction to which section 1245(b)(4) applies, see paragraph (c)(4) of § 1.1245-2. For the manner of determining the basis of such property, see paragraph (a) of § 1.1245-5.

(7) *Coordination with section 1250.* For purposes of this paragraph, if section 1245 property and section 1250 property are disposed of in one transaction in which the property acquired includes section 1250 property, the allocation

rules of paragraph (d)(6) of § 1.1250-3 shall apply.

(e) *Limitation for section 1071 and 1081 transactions*—(1) *Section 1071 and 1081(b) transactions.* If property is disposed of and gain (determined without regard to section 1245) is not recognized in whole or in part because of the application of section 1071 (relating to gain from sale or exchange to effectuate policies of F.C.C.) or section 1081(b) (relating to gain from sale or exchange in obedience to order of S.E.C.), then the amount of gain taken into account by the transferor under section 1245(a)(1) shall not exceed the sum of:

(i) The amount of gain recognized on such disposition (determined without regard to section 1245),

(ii) In the case of a transaction to which section 1071 applies, the fair market value of property acquired which is not section 1245 property and which is not taken into account under subdivision (i) of this subparagraph, plus

(iii) The amount by which the basis of property, other than section 1245 property, is reduced (pursuant to an election under section 1071 or pursuant to the application of section 1082(a)(2)), and which is not taken into account under subdivision (i) or (ii) of this subparagraph.

(2) *Section 1081(d)(1)(A) transaction.* No gain shall be recognized under section 1245(a)(1) upon an exchange of property as to which gain would not be recognized (without regard to section 1245) because of the application of section 1081(d)(1)(A) (relating to transfers within system group). For recomputed basis of property acquired in a transaction referred to in this subparagraph, see paragraph (c)(2) of § 1.1245-2.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* Corporation X elects under section 1071 to treat a sale of section 1245 property for \$100,000 as an involuntary conversion subject to the provisions of section 1033, but does not elect to reduce the basis of depreciable property pursuant to an election under section 1071. The corporation uses \$35,000 of the proceeds to purchase section 1245 property and \$40,000 to purchase other property. Both properties qualify as replacement property under section 1033. Assuming that the amount of gain under section

1245(a)(1) (determined without regard to this paragraph) would be \$70,000, and that \$25,000 of gain would be recognized (without regard to section 1245) upon the application of section 1071, the amount of gain taken into account under section 1245(a)(1) is \$65,000 (\$25,000 plus \$40,000).

*Example 2.* (i) Assume the same facts as in example (1) except that the corporation elects under section 1071 to reduce its basis for property of a character subject to the allowance for depreciation under section 167 by the amount of gain which would be recognized without regard to the application of section 1245, that is, by \$25,000. Assume further that under section 1071 the corporation may reduce the basis of depreciable property consisting of property A, which is section 1245 property with an adjusted basis of \$30,000, and property B, which is property other than section 1245 property with an adjusted basis of \$20,000. Under paragraph (a)(2) of § 1.1071-3, the \$25,000 of unrecognized gain is applied to reduce the basis of property A by \$15,000 (30,000/50,000 of \$25,000) and the basis of property B by \$10,000 (20,000/50,000 of \$25,000).

(ii) The amount of gain which would be recognized (determined without regard to section 1245) under section 1071 is zero, i.e., the amount determined in example (1) (\$25,000), minus the amount of the reduction in basis of depreciable property pursuant to the election (\$25,000). The amount of gain taken into account under section 1245(a)(1) is \$50,000, i.e., the sum of (a) the gain which would be recognized without regard to section 1245 (zero), (b) the cost of property acquired which is not section 1245 property (\$40,000), plus (c) the amount by which the basis of property B is reduced (\$10,000). For method of increasing basis of property B, see paragraph (b)(2) of § 1.1245-5, and for recomputed basis of property A, see paragraph (c)(5) of § 1.1245-2.

(f) *Limitation for property distributed by a partnership*—(1) *In general.* For purposes of section 1245(b)(3) (relating to certain tax-free transactions), the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(2) *Adjustments reflected in the adjusted basis.* If section 1245 property is distributed by a partnership to a partner, then, for purposes of determining the recomputed basis of the property in the hands of the distributee, the amount of the adjustments reflected in the adjusted basis of the property immediately after the distribution shall be an amount equal to:

(i) The potential section 1245 income (as defined in paragraph (c)(4) of § 1.751-1) of the partnership in respect of the property immediately before the distribution, reduced by

(ii) The portion of such potential section 1245 income which is recognized as ordinary income to the partnership under paragraph (b)(2)(ii) of § 1.751-1.

(3) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* (i) A machine, which is section 1245 property owned by partnership ABC, has an adjusted basis of \$9,000, a recomputed basis of \$18,000, and a fair market value of \$15,000. Since the fair market value of the machine is lower than its recomputed basis, the potential section 1245 income in respect of the machine is the excess of fair market value over adjusted basis, or \$6,000. The partnership distributes the machine to C in a complete liquidation of his partnership interest to which section 736(a) does not apply. C, who had originally contributed the machine to the partnership, has a basis for his partnership interest of \$10,000. Since section 751(b)(2)(A) provides that section 751(b)(1) does not apply to a distribution of property to the partner who contributed the property, no gain would be recognized to the partnership under section 731(b) (without regard to the application of section 1245). By reason of the application of section 731, C's basis for the property would, under section 732(b), be equal to his basis for his interest in the partnership, or \$10,000.

(ii) Since section 731 applies to the distribution, and since subparagraph (1) of this paragraph provides that, for purposes of section 1245(b)(3), C's basis for the property is deemed to be determined by reference to the adjusted basis of the property to the partnership, the gain taken into account under section 1245(a)(1) by the partnership is limited by section 1245(b)(3) so as not to exceed the amount of gain which would be recognized to the partnership if section 1245 did not apply. Accordingly, the partnership does not recognize any gain under section 1245(a)(1) upon the distribution.

(iii) Immediately after the distribution, the amount of the adjustments reflected in the adjusted basis of the property is equal to \$6,000 (that is, the potential section 1245 income of the partnership in respect of the property before the distribution, \$6,000, minus the gain recognized by the partnership under section 751(b), zero). Accordingly, C's recomputed basis for the property is \$16,000 (that is, adjusted basis, \$10,000, plus adjustments reflected in the adjusted basis, \$6,000).

*Example 2.* Assume the same facts as in example (1) except that the machine had been purchased by the partnership. Assume fur-

ther that upon the distribution, the partnership recognizes \$4,000 gain as ordinary income under section 751(b). Under section 1245(b)(3), gain to be taken into account under section 1245(a)(1) by the partnership is limited to \$4,000. Immediately after the distribution, the amount of adjustments reflected in the adjusted basis of the property is \$2,000 (that is, potential section 1245 income of the partnership, \$6,000, minus gain recognized to the partnership under section 751(b), \$4,000). Thus, if the adjusted basis of the machine in the hands of C were \$11,333 (see, for example, the computation in paragraph (d)(2) of example (6) of paragraph (g) of § 1.751-1), the recomputed basis of the machine would be \$13,333 (\$11,333 plus \$2,000).

(g) [Reserved]

(h) *Timber property subject to amortization under section 194—(1) In general.* For purposes of section 1245(a)(2), in determining the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, a taxpayer shall not take into account amortization deductions claimed under section 194 to the extent such deductions are attributable to the amortizable basis (within the meaning of section 194(c)(2)) of the taxpayer acquired before the tenth taxable year preceding the taxable year in which gain with respect to the property is recognized.

(2) *Example.* The principles of paragraph (h)(1) of this section are illustrated by the following example:

*Example:* Assume A owns qualified timber property (as defined in section 194(c)(1)) with a basis of \$30,000. In 1981, A incurs \$12,000 of qualifying reforestation expenditures and elects to amortize the maximum \$10,000 of such expenses under section 194. The \$10,000 of deductions are taken during the 8-year period from 1981 to 1988. If A sells the property in 1990 for \$60,000 a gain of \$28,000 (\$60,000—adjusted basis of \$32,000) is recognized on the sale. Since the sale took place within 10 years of the taxable year in which the reforestation expenditures were made, \$10,000 of the gain is treated as ordinary income, and the remaining \$18,000 of gain would be capital gain, if it otherwise qualifies for capital gain treatment. In order to avoid ordinary income treatment of the gain attributable to the reforestation expenditures incurred in 1981, A would have to wait until 1992 to dispose of the property.

[T.D. 6832, 30 FR 8581, July 7, 1965, as amended by T.D. 7084, 36 FR 268, Jan. 8, 1971; T.D. 7207, 37 FR 20799, Oct. 14, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7927, 48 FR 55851, Dec. 16, 1983]