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Sales and Other Dispositions of Assets

For use in preparing
2003 Returns



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Important Changes for 2003

New 50% special depreciation allowance. You can claim a 50% special depreciation allowance for qualified property acquired after May 5, 2003, and placed in service before January 1, 2005. The 30% or the 50% additional first-year depreciation allowance is subject to depreciation recapture. See *Depreciation Recapture* in chapter 3.

Reduced capital gains tax rates. The maximum tax rate on net capital gain has been reduced for individual taxpayers for sales, exchanges, or conversions of assets after May 5, 2003. The lower rates (from 20% to 15% and from 10% to 5%) apply to assets held more than one year (and installment payments received after that date). See *Capital Gains Tax Rates* in chapter 4.

Qualified 5-year gain eliminated. The 8% maximum tax rate for qualified 5-year gain has been eliminated for sales and other dispositions after May 5, 2003 (and installment payments

received after that date). See *Qualified 5-Year Gain* in chapter 4.

Important Reminders

Investing in DC Zone assets. Beginning in 2003, investments in District of Columbia Enterprise Zone (DC Zone) assets held more than 5 years will qualify for a special tax benefit. If you sell or exchange a DC Zone asset at a gain, you will not have to include any qualified capital gain in your gross income. This exclusion applies to an interest in, or property of, certain businesses operating in the District of Columbia. For more information, see Publication 954, *Tax Incentives for Distressed Communities*.

Renewal community capital gain. Beginning in 2007, the sale of an interest in, or property of, certain businesses operating in a renewal community may qualify for a special tax benefit. If you sell qualified community assets held more than 5 years, you will not have to include any qualified capital gain in your gross income. This exclusion applies to any qualified community stock, partnership interest, and business property acquired after 2001. For more information, see Publication 954.

Dispositions of U.S. real property interests by foreign persons. If you are a foreign person or firm and you sell or otherwise dispose of a U.S. real property interest, the buyer (or other transferee) may have to withhold income tax on the amount you receive for the property (including cash, the fair market value of other property, and any assumed liability). Corporations, partnerships, trusts, and estates also may have to withhold on certain U.S. real property interests they distribute to you. You must report these dispositions and distributions and any income tax withheld on your U.S. income tax return.

For more information on dispositions of U.S. real property interests, see Publication 519, *U.S. Tax Guide for Aliens*.

Foreign source income. If you are a U.S. citizen with income from dispositions of property outside the United States (foreign income), you must report all such income on your tax return unless it is exempt from U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payor.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

Introduction

This publication explains the tax rules that apply when you dispose of property. It discusses the following topics.

- How to figure a gain or loss.

- Whether your gain or loss is ordinary or capital.
- How to treat your gain or loss when you dispose of business property.
- How to report a gain or loss.

This publication also explains whether your gain is taxable or your loss is deductible.

This publication does **not** discuss certain transactions covered in other IRS publications. These include the following.

- Most transactions involving stocks, bonds, options, forward and futures contracts, and similar investments, discussed in chapter 4 of Publication 550, *Investment Income and Expenses*.
- Sale of your main home, discussed in Publication 523, *Selling Your Home*.
- Installment sales, discussed in Publication 537, *Installment Sales*.
- Transfers of property at death, discussed in Publication 559, *Survivors, Executors, and Administrators*.

Disposing of property. You dispose of property when any of the following occurs.

- You sell property.
- You exchange property for other property.
- Your property is condemned or disposed of under threat of condemnation.
- Your property is repossessed.
- You abandon property.
- You give property away.

Forms to file. When you dispose of property, you usually will have to file one or more of the following forms.

- Schedule D (Form 1040), *Capital Gains and Losses*.
- Form 4797, *Sales of Business Property*.
- Form 8824, *Like-Kind Exchanges*.

Chapter 4 illustrates how to fill out Form 4797 and Form 8824.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can email us at ***taxforms@irs.gov**. Please put "Publications Comment" on the subject line.

You can write to us at the following address:

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

1.

Gain or Loss

Topics

This chapter discusses:

- Sales and exchanges
- Abandonments
- Foreclosures and repossessions
- Involuntary conversions
- Nontaxable exchanges
- Transfers to spouse
- Rollovers and exclusions for certain capital gains

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 537** Installment Sales
- 547** Casualties, Disasters, and Thefts
- 550** Investment Income and Expenses
- 551** Basis of Assets
- 908** Bankruptcy Tax Guide
- 954** Tax Incentives for Distressed Communities

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 1040** U.S. Individual Income Tax Return
- 1040X** Amended U.S. Individual Income Tax Return
- 1099-A** Acquisition or Abandonment of Secured Property
- 1099-C** Cancellation of Debt
- 4797** Sales of Business Property
- 8824** Like-Kind Exchanges

See chapter 5 for information about getting publications and forms.

Sales and Exchanges

The following discussions describe the kinds of transactions that are treated as sales or exchanges and explain how to figure gain or loss. A **sale** is a transfer of property for money or a mortgage, note, or other promise to pay money. An **exchange** is a transfer of property for other property or services.

Sale or lease. Some agreements that seem to be leases may really be conditional sales contracts. The intention of the parties to the agree-

ment can help you distinguish between a sale and a lease.

There is no test or group of tests to prove what the parties intended when they made the agreement. You should consider each agreement based on its own facts and circumstances. For more information on leases, see chapter 4 in Publication 535, *Business Expenses*.

Cancellation of a lease. Payments received by a tenant for the cancellation of a lease are treated as an amount realized from the sale of property. Payments received by a landlord (lessor) for the cancellation of a lease are essentially a substitute for rental payments and are taxed as ordinary income.

Copyright. Payments you receive for granting the exclusive use of (or right to exploit) a copyright throughout its life in a particular medium are treated as received from the sale of property. It does not matter if the payments are a fixed amount or a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or an amount based on the number of copies sold, performances given, or exhibitions made. Nor does it matter if the payments are made over the same period as that covering the grantee's use of the copyrighted work.

If the copyright was used in your trade or business and you held it longer than a year, the gain or loss may be a section 1231 gain or loss. For more information, see *Section 1231 Gains and Losses* in chapter 3.

Easement. The amount received for granting an easement is subtracted from the basis of the property. If only a specific part of the entire tract of property is affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received.

Any amount received that is more than the basis to be reduced is a taxable gain. The transaction is reported as a sale of property.

If you transfer a perpetual easement for consideration and do not keep any beneficial interest in the part of the property affected by the easement, the transaction will be treated as a sale of property. However, if you make a qualified conservation contribution of a restriction or easement granted in perpetuity, it is treated as a charitable contribution and not a sale or exchange, even though you keep a beneficial interest in the property affected by the easement.

If you grant an easement on your property (for example, a right-of-way over it) under condemnation or threat of condemnation, you are considered to have made a forced sale, even though you keep the legal title. Although you figure gain or loss on the easement in the same way as a sale of property, the gain or loss is treated as a gain or loss from a condemnation. See *Gain or Loss From Condemnations*, later.

Property transferred to satisfy debt. A transfer of property to satisfy a debt is an exchange.

Note's maturity date extended. The extension of a note's maturity date is not treated as an exchange of an outstanding note for a new and different note. Also, it is not considered a closed and completed transaction that would result in a

gain or loss. However, an extension will be treated as a taxable exchange of the outstanding note for a new and materially different note if the changes in the terms of the note are significant. Each case must be determined by its own facts.

Transfer on death. The transfer of property to an executor or administrator on the death of an individual is not a sale or exchange.

Bankruptcy. Generally, a transfer of property from a debtor to a bankruptcy estate is not treated as a sale or exchange. For more information, see *The Bankruptcy Estate* in Publication 908.

Gain or Loss From Sales and Exchanges

Gain or loss is usually realized when property is sold or exchanged. A **gain** is the amount you realize from a sale or exchange of property that is more than its adjusted basis. A **loss** is the adjusted basis of the property that is more than the amount you realize.

Table 1–1. How To Figure Whether You Have a Gain or Loss

IF your...	THEN you have a...
Adjusted basis is more than the amount realized,	Loss.
Amount realized is more than the adjusted basis,	Gain.

Basis. You must know the basis of your property to determine whether you have a gain or loss from its sale or other disposition. The basis of property you buy is usually its cost. However, if you acquired the property by gift, inheritance, or in some way other than buying it, you must use a basis other than its cost. See *Basis Other Than Cost* in Publication 551.

Adjusted basis. The adjusted basis of property is your original cost or other basis plus certain additions and minus certain deductions, such as depreciation and casualty losses. See *Adjusted Basis* in Publication 551. In determining gain or loss, the costs of transferring property to a new owner, such as selling expenses, are added to the adjusted basis of the property.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the fair market value of all property or services you receive. The amount you realize also includes any of your liabilities that were assumed by the buyer and any liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

If the liabilities relate to an exchange of multiple properties, see *Treatment of liabilities under Multiple Property Exchanges*, later.

Fair market value. Fair market value (FMV) is the price at which the property would change hands between a buyer and a seller when both have reasonable knowledge of all the necessary facts and neither has to buy or sell. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of FMV. If there is a stated price for services, this price is treated as the FMV unless there is evidence to the contrary.

Example. In your business, you used a building that cost you \$70,000. You made certain permanent improvements at a cost of \$20,000 and deducted depreciation totaling \$10,000. You sold the building for \$100,000 plus property having an FMV of \$20,000. The buyer assumed your real estate taxes of \$3,000 and a mortgage of \$17,000 on the building. The selling expenses were \$4,000. Your gain on the sale is figured as follows.

Amount realized:		
Cash	\$100,000	
FMV of property received	20,000	
Real estate taxes assumed by buyer	3,000	
Mortgage assumed by buyer	17,000	\$140,000
Adjusted basis:		
Cost of building	\$70,000	
Improvements	20,000	
Total	\$90,000	
Minus: Depreciation	10,000	
Adjusted basis	\$80,000	
Plus: Selling expenses	4,000	\$84,000
Gain on sale		\$56,000

Amount recognized. Your gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses are deductible from gross income. However, your gain or loss realized from certain exchanges of property is not recognized for tax purposes. See *Nontaxable Exchanges*, later. Also, a loss from the disposition of property held for personal use is not deductible.

Interest in property. The amount you realize from the disposition of a life interest in property, an interest in property for a set number of years, or an income interest in a trust is a recognized gain under certain circumstances. If you received the interest as a gift, inheritance, or in a transfer from a spouse or former spouse incident to a divorce, the amount realized is a recognized gain. Your basis in the property is disregarded. This rule does not apply if all interests in the property are disposed of at the same time.

Example 1. Your father dies and leaves his farm to you for life with a remainder interest to your younger brother. You decide to sell your life interest in the farm. The entire amount you receive is a recognized gain. Your basis in the farm is disregarded.

Example 2. The facts are the same as in Example 1, except that your brother joins you in selling the farm. The entire interest in the property is sold, so your basis in the farm is not disregarded. Your gain or loss is the difference between your share of the sales price and your adjusted basis in the farm.

Canceling a sale of real property. If you sell real property under a sales contract that allows the buyer to return the property for a full refund and the buyer does so, you may not have to recognize gain or loss on the sale. If the buyer returns the property in the year of sale, no gain or loss is recognized. This cancellation of the sale in the same year it occurred places both you and the buyer in the same positions you

were in before the sale. If the buyer returns the property in a later tax year, however, you must recognize gain (or loss, if allowed) in the year of the sale. When the property is returned in a later year, you acquire a new basis in the property. That basis is equal to the amount you pay to the buyer.

Bargain Sale

If you sell or exchange property for less than fair market value with the intent of making a gift, the transaction is partly a sale or exchange and partly a gift. You have a gain if the amount realized is more than your adjusted basis in the property. However, you do not have a loss if the amount realized is less than the adjusted basis of the property.

Bargain sales to charity. A bargain sale of property to a charitable organization is partly a sale or exchange and partly a charitable contribution. If a charitable deduction for the contribution is allowable, you must allocate your adjusted basis in the property between the part sold and the part contributed based on the fair market value of each. The adjusted basis of the part sold is figured as follows.

Adjusted basis of entire property	X	Amount realized (fair market value of part sold)	
		Fair market value of entire property	

Based on this allocation rule, you will have a gain even if the amount realized is not more than your adjusted basis in the property. This allocation rule does not apply if a charitable contribution deduction is not allowable.

See Publication 526, *Charitable Contributions*, for information on figuring your charitable contribution.

Example. You sold property with a fair market value of \$10,000 to a charitable organization for \$2,000 and are allowed a deduction for your contribution. Your adjusted basis in the property is \$4,000. Your gain on the sale is \$1,200, figured as follows.

Sales price	\$2,000
Minus: Adjusted basis of part sold (\$4,000 × (\$2,000 ÷ \$10,000))	800
Gain on the sale	\$1,200

Property Used Partly for Business or Rental

If you sell or exchange property you used partly for business or rental purposes and partly for personal purposes, you must figure the gain or loss on the sale or exchange as though you had sold two separate pieces of property. You must allocate the selling price, selling expenses, and the basis of the property between the business or rental part and the personal part. You must subtract depreciation you took or could have taken from the basis of the business or rental part.

Gain or loss on the business or rental part of the property may be a capital gain or loss or an ordinary gain or loss, as discussed in chapter 3 under *Section 1231 Gains and Losses*. Any gain on the personal part of the property is a capital

gain. You cannot deduct a loss on the personal part.

Example. You sold a condominium for \$57,000. You had bought the property 9 years earlier in January for \$30,000. You used two-thirds of it as your home and rented out the other third. You claimed depreciation of \$3,272 for the rented part during the time you owned the property. You made no improvements to the property. Your selling expenses for the condominium were \$3,600. You figure your gain or loss as follows.

	Rental (1/3)	Personal (2/3)
1) Selling price	\$19,000	\$38,000
2) Minus: Selling expenses	1,200	2,400
3) Amount realized (adjusted sales price)	17,800	35,600
4) Basis	10,000	20,000
5) Minus: Depreciation	3,272	
6) Adjusted basis	6,728	20,000
7) Gain (line 3 – line 6)	\$11,072	\$15,600

Property Changed to Business or Rental Use

You cannot deduct a loss on the sale of property you acquired for use as your home and used as your home until the time of sale.

You can deduct a loss on the sale of property you acquired for use as your home but changed to business or rental property and used as business or rental property at the time of sale. However, if the adjusted basis of the property at the time of the change was more than its fair market value, the loss you can deduct is limited.

Figure the loss you can deduct as follows.

- 1) Use the lesser of the property's adjusted basis or fair market value at the time of the change.
- 2) Add to (1) the cost of any improvements and other increases to basis since the change.
- 3) Subtract from (2) depreciation and any other decreases to basis since the change.
- 4) Subtract the amount you realized on the sale from the result in (3). If the amount you realized is more than the result in (3), treat this result as zero.

The result in (4) is the loss you can deduct.

Example. You changed your main home to rental property 5 years ago. At the time of the change, the adjusted basis of your home was \$75,000 and the fair market value was \$70,000. This year, you sold the property for \$55,000. You made no improvements to the property but you have depreciation expense of \$12,620 over the 5 prior years. Although your loss on the sale is \$7,380 [(\$75,000 – \$12,620) – \$55,000], the amount you can deduct as a loss is limited to \$2,380, figured as follows.

Lesser of adjusted basis or fair market value at time of the change	\$70,000
Plus: Cost of any improvements and any other additions to basis after the change	-0-
	70,000

Minus: Depreciation and any other decreases to basis after the change	12,620
	57,380

Minus: Amount you realized from the sale	55,000
Deductible loss	\$2,380

Gain. If you have a gain on the sale, you generally must recognize the full amount of the gain. You figure the gain by subtracting your adjusted basis from your amount realized, as described earlier.

You may be able to exclude all or part of the gain if you owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale. For more information, see Publication 523.

Abandonments

The abandonment of property is a disposition of property. You abandon property when you voluntarily and permanently give up possession and use of the property with the intention of ending your ownership but without passing it on to anyone else.

Loss from abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. The loss is the property's **adjusted basis** when abandoned. This rule also applies to leasehold improvements the lessor made for the lessee that were abandoned. However, if the property is later foreclosed on or repossessed, gain or loss is figured as discussed later. The abandonment loss is deducted in the tax year in which the loss is sustained.

You cannot deduct any loss from abandonment of your home or other property held for personal use.

Example. Ann abandoned her home that she bought for \$200,000. At the time she abandoned the house, her mortgage balance was \$185,000. She has a nondeductible loss of \$200,000 (the adjusted basis). If the bank later forecloses on the loan or repossesses the house, she will have to figure her gain or loss as discussed later under *Foreclosures and Repossessions*.

Cancellation of debt. If the abandoned property secures a debt for which you are personally liable and the debt is canceled, you will realize ordinary income equal to the canceled debt. This income is separate from any loss realized from abandonment of the property. Report income from cancellation of a debt related to a business or rental activity as business or rental income. Report income from cancellation of a nonbusiness debt as other income on line 21, Form 1040.

However, income from cancellation of debt is not taxed if any of the following conditions apply.

- The cancellation is intended as a gift.
- The debt is qualified farm debt (see chapter 4 of Publication 225, *Farmer's Tax Guide*).
- The debt is qualified real property business debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*).

Table 1-2. Worksheet for Foreclosures and Repossessions
(Keep for your records)



Part 1. Figure your income from cancellation of debt. (Note: If you are not personally liable for the debt, you do not have income from cancellation of debt. Skip Part 1 and go to Part 2.)	
1. Enter the amount of debt canceled by the transfer of property	_____
2. Enter the fair market value of the transferred property	_____
3. Income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero	=====
Part 2. Figure your gain or loss from foreclosure or repossession.	
4. Enter the smaller of line 1 or line 2. Also include any proceeds you received from the foreclosure sale. (If you are not personally liable for the debt, enter the amount of debt canceled by the transfer of property.)	_____
5. Enter the adjusted basis of the transferred property	_____
6. Gain or loss from foreclosure or repossession. Subtract line 5 from line 4	=====

* The income may not be taxable. See *Cancellation of debt*.

- You are insolvent or bankrupt (see Publication 908).

Forms 1099–A and 1099–C. If your abandoned property secures a loan and the lender knows the property has been abandoned, the lender should send you Form 1099–A showing information you need to figure your loss from the abandonment. However, if your debt is canceled and the lender must file Form 1099–C, the lender may include the information about the abandonment on that form instead of on Form 1099–A. The lender must file Form 1099–C and send you a copy if the amount of debt canceled is \$600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For abandonments of property and debt cancellations occurring in 2003, these forms should be sent to you by February 2, 2004.

Foreclosures and Repossessions

If you do not make payments you owe on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which you may realize gain or loss. This is true even if you voluntarily return the property to the lender. You also may realize ordinary income from cancellation of debt if the loan balance is more than the fair market value of the property.

Buyer’s (borrower’s) gain or loss. You figure and report gain or loss from a foreclosure or repossession in the same way as gain or loss from a sale or exchange. The gain or loss is the difference between your adjusted basis in the transferred property and the amount realized. See *Gain or Loss From Sales and Exchanges*, earlier.

TIP You can use Table 1–2 to figure your gain or loss from a foreclosure or repossession.

Amount realized on a nonrecourse debt. If you are not personally liable for repaying the debt (nonrecourse debt) secured by the transferred property, the amount you realize includes the full debt canceled by the transfer. The full canceled debt is included even if the fair market value of the property is less than the canceled debt.

Example 1. Chris bought a new car for \$15,000. He paid \$2,000 down and borrowed the remaining \$13,000 from the dealer’s credit company. Chris is not personally liable for the loan (nonrecourse), but pledges the new car as security. The credit company repossessed the car because he stopped making loan payments. The balance due after taking into account the payments Chris made was \$10,000. The fair market value of the car when repossessed was \$9,000. The amount Chris realized on the repossession is \$10,000. That is the debt canceled by the repossession, even though the car’s fair market value is less than \$10,000. Chris figures his gain or loss on the repossession by comparing the amount realized (\$10,000) with his adjusted basis (\$15,000). He has a \$5,000 nondeductible loss.

Example 2. Abena paid \$200,000 for her home. She paid \$15,000 down and borrowed the remaining \$185,000 from a bank. Abena is not personally liable for the loan (nonrecourse debt), but pledges the house as security. The bank foreclosed on the loan because Abena stopped making payments. When the bank foreclosed on the loan, the balance due was \$180,000, the fair market value of the house was \$170,000, and Abena’s adjusted basis was \$175,000 due to a casualty loss she had deducted. The amount Abena realized on the foreclosure is \$180,000, the debt canceled by the foreclosure. She figures her gain or loss by comparing the amount realized (\$180,000) with her adjusted basis (\$175,000). She has a \$5,000 realized gain.

Amount realized on a recourse debt. If you are personally liable for the debt (recourse debt), the amount realized on the foreclosure or repossession does not include the canceled debt that is your income from cancellation of debt. However, if the fair market value of the transferred property is less than the canceled

debt, the amount realized includes the canceled debt up to the fair market value of the property. You are treated as receiving ordinary income from the canceled debt for the part of the debt that is more than the fair market value. See *Cancellation of debt*, later.

Example 1. Assume the same facts as in the previous Example 1, except Chris is personally liable for the car loan (recourse debt). In this case, the amount he realizes is \$9,000. This is the canceled debt (\$10,000) up to the car’s fair market value (\$9,000). Chris figures his gain or loss on the repossession by comparing the amount realized (\$9,000) with his adjusted basis (\$15,000). He has a \$6,000 nondeductible loss. He also is treated as receiving ordinary income from cancellation of debt. That income is \$1,000 (\$10,000 – \$9,000). This is the part of the canceled debt not included in the amount realized.

Example 2. Assume the same facts as in the previous Example 2, except Abena is personally liable for the loan (recourse debt). In this case, the amount she realizes is \$170,000. This is the canceled debt (\$180,000) up to the fair market value of the house (\$170,000). Abena figures her gain or loss on the foreclosure by comparing the amount realized (\$170,000) with her adjusted basis (\$175,000). She has a \$5,000 nondeductible loss. She also is treated as receiving ordinary income from cancellation of debt. That income is \$10,000 (\$180,000 – \$170,000). This is the part of the canceled debt not included in the amount realized.

Seller’s (lender’s) gain or loss on repossession. If you finance a buyer’s purchase of property and later acquire an interest in it through foreclosure or repossession, you may have a gain or loss on the acquisition. For more information, see *Repossession* in Publication 537.

Cancellation of debt. If property that is repossessed or foreclosed on secures a debt for which you are personally liable (recourse debt), you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. This income is separate from any gain or loss realized from the foreclosure or repossession. Report the income from cancellation of a debt related to a business or rental activity as business or rental income. Report the income from cancellation of a nonbusiness debt as other income on line 21, Form 1040.

TIP You can use Table 1–2 to figure your income from cancellation of debt.

However, income from cancellation of debt is not taxed if any of the following conditions apply.

- The cancellation is intended as a gift.
- The debt is qualified farm debt (see chapter 4 of Publication 225, *Farmer’s Tax Guide*).
- The debt is qualified real property business debt (see chapter 5 of Publication 334, *Tax Guide for Small Business*).
- You are insolvent or bankrupt (see Publication 908).

Table 1-3. **Worksheet for Condemnations**
(Keep for your records)



Part 1. Gain from severance damages. (If you did not receive severance damages, skip Part 1 and go to Part 2.)	
1. Enter severance damages received	_____
2. Enter your expenses in getting severance damages	_____
3. Subtract line 2 from line 1. If less than zero, enter -0-	_____
4. Enter any special assessment on remaining property taken out of your award	_____
5. Net severance damages. Subtract line 4 from line 3. If less than zero, enter -0-	_____
6. Enter the adjusted basis of the remaining property	_____
7. Gain from severance damages. Subtract line 6 from line 5. If less than zero, enter -0-	_____
8. Refigured adjusted basis of the remaining property. Subtract line 5 from line 6. If less than zero, enter -0-	_____
Part 2. Gain or loss from condemnation award.	
9. Enter the condemnation award received	_____
10. Enter your expenses in getting the condemnation award	_____
11. If you completed Part 1, and line 4 is more than line 3, subtract line 3 from line 4. Otherwise, enter -0-	_____
12. Add lines 10 and 11	_____
13. Net condemnation award. Subtract line 12 from line 9	_____
14. Enter the adjusted basis of the condemned property	_____
15. Gain from condemnation award. If line 14 is more than line 13, enter -0-. Otherwise, subtract line 14 from line 13 and skip line 16	_____
16. Loss from condemnation award. Subtract line 13 from line 14	_____
<i>(Note: You cannot deduct the amount on line 16 if the condemned property was held for personal use.)</i>	
Part 3. Postponed gain from condemnation. (Complete only if line 7 or line 15 is more than zero and you bought qualifying replacement property or made expenditures to restore the usefulness of your remaining property.)	
17. If you completed Part 1, and line 7 is more than zero, enter the amount from line 5. Otherwise, enter -0-	_____
18. If line 15 is more than zero, enter the amount from line 13. Otherwise, enter -0-	_____
19. Add lines 17 and 18*	_____
20. Enter the total cost of replacement property and any expenses to restore the usefulness of your remaining property	_____
21. Subtract line 20 from line 19. If less than zero, enter -0-	_____
22. If you completed Part 1, add lines 7 and 15. Otherwise, enter the amount from line 15	_____
23. Recognized gain. Enter the smaller of line 21 or line 22.	_____
24. Postponed gain. Subtract line 23 from line 22. If less than zero, enter -0-	_____

*If the condemned property was your main home, subtract from this total the gain you excluded from your income and enter the result.

Forms 1099–A and 1099–C. A lender who acquires an interest in your property in a foreclosure or repossession should send you Form 1099–A showing the information you need to figure your gain or loss. However, if the lender also cancels part of your debt and must file Form 1099–C, the lender may include the information about the foreclosure or repossession on that form instead of on Form 1099–A. The lender must file Form 1099–C and send you a copy if the amount of debt canceled is \$600 or more and the lender is a financial institution, credit union, federal government agency, or any organization that has a significant trade or business of lending money. For foreclosures or repossessions occurring in 2003, these forms should be sent to you by February 2, 2004.

Involuntary Conversions

An involuntary conversion occurs when your property is destroyed, stolen, condemned, or disposed of under the threat of condemnation and you receive other property or money in payment, such as insurance or a condemnation award. Involuntary conversions are also called **involuntary exchanges**.

Gain or loss from an involuntary conversion of your property is usually recognized for tax purposes unless the property is your main home. You report the gain or deduct the loss on your tax return for the year you realize it. (You cannot deduct a loss from an involuntary conversion of property you held for personal use unless the loss resulted from a casualty or theft.)

However, depending on the type of property you receive, you may not have to report a gain on an involuntary conversion. You do not report the gain if you receive property that is similar or related in service or use to the converted property. Your basis for the new property is the same as your basis for the converted property. This means that the gain is deferred until a taxable sale or exchange occurs.

If you receive money or property that is not similar or related in service or use to the involuntarily converted property and you buy qualifying replacement property within a certain period of time, you can choose to postpone reporting the gain.

This publication explains the treatment of a gain or loss from a condemnation or disposition under the threat of condemnation. If you have a gain or loss from the destruction or theft of property, see Publication 547.

Condemnations

A condemnation is the process by which private property is legally taken for public use without the owner's consent. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take it. The owner receives a condemnation award (money or property) in exchange for the property taken. A condemnation is like a forced sale, the owner being the seller and the condemning authority being the buyer.

Example. A local government authorized to acquire land for public parks informed you that it wished to acquire your property. After the local government took action to condemn your property, you went to court to keep it. But, the court decided in favor of the local government, which took your property and paid you an amount fixed by the court. This is a condemnation of private property for public use.

Threat of condemnation. A threat of condemnation exists if a representative of a government body or a public official authorized to acquire property for public use informs you that the government body or official has decided to acquire your property. You must have reasonable grounds to believe that, if you do not sell voluntarily, your property will be condemned.

The sale of your property to someone other than the condemning authority qualifies as an involuntary conversion, provided you have reasonable grounds to believe that your property will be condemned. If the buyer of this property knows at the time of purchase that it will be condemned and sells it to the condemning authority, this sale also qualifies as an involuntary conversion.

Reports of condemnation. A threat of condemnation exists if you learn of a decision to acquire your property for public use through a report in a newspaper or other news medium, and this report is confirmed by a representative of the government body or public official involved. You must have reasonable grounds to believe that they will take necessary steps to condemn your property if you do not sell voluntarily. If you relied on oral statements made by a government representative or public official, the Internal Revenue Service may ask you to get written confirmation of the statements.

Example. Your property lies along public utility lines. The utility company has the authority to condemn your property. The company informs you that it intends to acquire your property by negotiation or condemnation. A threat of condemnation exists when you receive the notice.

Related property voluntarily sold. A voluntary sale of your property may be treated as a forced sale that qualifies as an involuntary conversion if the property had a substantial economic relationship to property of yours that was condemned. A **substantial economic relationship** exists if together the properties were one economic unit. You also must show that the condemned property could not reasonably or adequately be replaced. You can choose to postpone reporting the gain by buying replacement property. See *Postponement of Gain*, later.

Gain or Loss From Condemnations

If your property was condemned or disposed of under the threat of condemnation, figure your gain or loss by comparing the adjusted basis of your condemned property with your net condemnation award.

If your net condemnation award is more than the adjusted basis of the condemned property, you have a gain. You can postpone reporting gain from a condemnation if you buy replacement property. If only part of your property is condemned, you can treat the cost of restoring the remaining part to its former usefulness as the cost of replacement property. See *Postponement of Gain*, later.

If your net condemnation award is less than your adjusted basis, you have a loss. If your loss is from property you held for personal use, you cannot deduct it. You must report any deductible loss in the tax year it happened.



You can use Part 2 of Table 1–3 to figure your gain or loss from a condemnation award.

Main home condemned. If you have a gain because your main home is condemned, you generally can exclude the gain from your income as if you had sold or exchanged your home. You

may be able to exclude up to \$250,000 of the gain (up to \$500,000 if married filing jointly). For information on this exclusion, see Publication 523. If your gain is more than you can exclude but you buy replacement property, you may be able to postpone reporting the rest of the gain. See *Postponement of Gain*, later.

Condemnation award. A condemnation award is the money you are paid or the value of other property you receive for your condemned property. The award is also the amount you are paid for the sale of your property under threat of condemnation.

Payment of your debts. Amounts taken out of the award to pay your debts are considered paid to you. Amounts the government pays directly to the holder of a mortgage or lien against your property are part of your award, even if the debt attaches to the property and is not your personal liability.

Example. The state condemned your property for public use. The award was set at \$200,000. The state paid you only \$148,000 because it paid \$50,000 to your mortgage holder and \$2,000 accrued real estate taxes. You are considered to have received the entire \$200,000 as a condemnation award.

Interest on award. If the condemning authority pays you interest for its delay in paying your award, it is not part of the condemnation award. You must report the interest separately as ordinary income.

Payments to relocate. Payments you receive to relocate and replace housing because you have been displaced from your home, business, or farm as a result of federal or federally assisted programs are not part of the condemnation award. Do not include them in your income. Replacement housing payments used to buy new property are included in the property's basis as part of your cost.

Net condemnation award. A net condemnation award is the total award you received, or are considered to have received, for the condemned property minus your expenses of obtaining the award. If only a part of your property was condemned, you also must reduce the award by any special assessment levied against the part of the property you retain. This is discussed later under *Special assessment taken out of award*.

Severance damages. Severance damages are not part of the award paid for the property condemned. They are paid to you if part of your property is condemned and the value of the part you keep is decreased because of the condemnation.

For example, you may receive severance damages if your property is subject to flooding because you sell flowage easement rights (the condemned property) under threat of condemnation. Severance damages also may be given to you if, because part of your property is condemned for a highway, you must replace fences, dig new wells or ditches, or plant trees to restore your remaining property to the same usefulness it had before the condemnation.

The contracting parties should agree on the specific amount of severance damages in writing. If this is not done, all proceeds from the condemning authority are considered awarded for your condemned property.

You cannot make a completely new allocation of the total award after the transaction is completed. However, you can show how much of the award both parties intended for severance damages. The severance damages part of the award is determined from all the facts and circumstances.

Example. You sold part of your property to the state under threat of condemnation. The contract you and the condemning authority signed showed only the total purchase price. It did not specify a fixed sum for severance damages. However, at settlement, the condemning authority gave you closing papers showing clearly the part of the purchase price that was for severance damages. You may treat this part as severance damages.

Treatment of severance damages. Your net severance damages are treated as the amount realized from an involuntary conversion of the remaining part of your property. Use them to reduce the basis of the remaining property. If the amount of severance damages is based on damage to a specific part of the property you kept, reduce the basis of only that part by the net severance damages.

If your net severance damages are more than the basis of your retained property, you have a gain. You may be able to postpone reporting the gain. See *Postponement of Gain*, later.



You can use Part 1 of Table 1–3 to figure any gain from severance damages and to refigure the adjusted basis of the remaining part of your property.

Net severance damages. To figure your net severance damages, you first must reduce your severance damages by your expenses in obtaining the damages. You then reduce them by any special assessment (described later) levied against the remaining part of the property and taken out of the award by the condemning authority. The balance is your net severance damages.

Expenses of obtaining a condemnation award and severance damages. Subtract the expenses of obtaining a condemnation award, such as legal, engineering, and appraisal fees, from the total award. Also, subtract the expenses of obtaining severance damages, that may include similar expenses, from the severance damages paid to you. If you cannot determine which part of your expenses is for each part of the condemnation proceeds, you must make a proportionate allocation.

Example. You receive a condemnation award and severance damages. One-fourth of the total was designated as severance damages in your agreement with the condemning authority. You had legal expenses for the entire condemnation proceeding. You cannot determine how much of your legal expenses is for each part of the condemnation proceeds. You must allocate one-fourth of your legal expenses to the severance damages and the other three-fourths to the condemnation award.

Special assessment taken out of award. When only part of your property is condemned, a special assessment levied against the remaining property may be taken out of your condemnation award. An assessment may be levied if

the remaining part of your property benefited by the improvement resulting from the condemnation. Examples of improvements that may cause a special assessment are widening a street and installing a sewer.

To figure your net condemnation award, you generally reduce the award by the assessment taken out of the award.

Example. To widen the street in front of your home, the city condemned a 25-foot deep strip of your land. You were awarded \$5,000 for this and spent \$300 to get the award. Before paying the award, the city levied a special assessment of \$700 for the street improvement against your remaining property. The city then paid you only \$4,300. Your net award is \$4,000 (\$5,000 total award minus \$300 expenses in obtaining the award and \$700 for the special assessment taken out).

If the \$700 special assessment were not taken out of the award and you were paid \$5,000, your net award would be \$4,700 (\$5,000 – \$300). The net award would not change, even if you later paid the assessment from the amount you received.

Severance damages received. If severance damages are included in the condemnation proceeds, the special assessment taken out is first used to reduce the severance damages. Any balance of the special assessment is used to reduce the condemnation award.

Example. You were awarded \$4,000 for the condemnation of your property and \$1,000 for severance damages. You spent \$300 to obtain the severance damages. A special assessment of \$800 was taken out of the award. The \$1,000 severance damages are reduced to zero by first subtracting the \$300 expenses and then \$700 of the special assessment. Your \$4,000 condemnation award is reduced by the \$100 balance of the special assessment, leaving a \$3,900 net condemnation award.

Part business or rental. If you used part of your condemned property as your home and part as business or rental property, treat each part as a separate property. Figure your gain or loss separately because gain or loss on each part may be treated differently.

Some examples of this type of property are a building in which you live and operate a grocery, and a building in which you live on the first floor and rent out the second floor.

Example. You sold your building for \$24,000 under threat of condemnation to a public utility company that had the authority to condemn. You rented half the building and lived in the other half. You paid \$25,000 for the building and spent an additional \$1,000 for a new roof. You claimed allowable depreciation of \$4,600 on the rental half. You spent \$200 in legal expenses to obtain the condemnation award. Figure your gain or loss as follows.

	<u>Resi- dential Part</u>	<u>Busi- ness Part</u>
1) Condemnation award received	\$12,000	\$12,000
2) Minus: Legal expenses, \$200	100	100
3) Net condemnation award	\$11,900	\$11,900

4) Adjusted basis:			
1/2 of original cost,			
\$25,000 Plus: 1/2 of			
cost of roof,	\$12,500	\$12,500	
1,000	500	500	
Total	<u>\$13,000</u>	<u>\$13,000</u>	
5) Minus: Depreciation . .		4,600	
6) Adjusted basis,			
business part		<u>\$8,400</u>	
7) (Loss) on residential	<u>(\$1,100)</u>		
property			
8) Gain on business property		<u>\$3,500</u>	

The loss on the residential part of the property is not deductible.

Postponement of Gain

Do not report the gain on condemned property if you receive only property that is similar or related in service or use to the condemned property. Your basis for the new property is the same as your basis for the old.

Money or unlike property received. You ordinarily must report the gain if you receive money or unlike property. You can choose to postpone reporting the gain if you buy property that is similar or related in service or use to the condemned property within the replacement period, discussed later. You also can choose to postpone reporting the gain if you buy a controlling interest (at least 80%) in a corporation owning property that is similar or related in service or use to the condemned property. See *Controlling interest in a corporation*, later.

To postpone reporting all the gain, you must buy replacement property costing at least as much as the amount realized for the condemned property. If the cost of the replacement property is less than the amount realized, you must report the gain up to the unspent part of the amount realized.

The basis of the replacement property is its cost, reduced by the postponed gain. Also, if your replacement property is stock in a corporation that owns property similar or related in service or use, the corporation generally will reduce its basis in its assets by the amount by which you reduce your basis in the stock. See *Controlling interest in a corporation*, later.

TIP You can use Part 3 of Table 1–3 to figure the gain you must report and your postponed gain.

Postponing gain on severance damages. If you received severance damages for part of your property because another part was condemned and you buy replacement property, you can choose to postpone reporting gain. See *Treatment of severance damages*, earlier. You can postpone reporting all your gain if the replacement property costs at least as much as your net severance damages plus your net condemnation award (if resulting in gain).

You also can make this choice if you spend the severance damages, together with other money you received for the condemned property (if resulting in gain), to acquire nearby property that will allow you to continue your business. If suitable nearby property is not available and you are forced to sell the remaining property and relocate in order to continue your business, see *Postponing gain on the sale of related property*, next.

If you restore the remaining property to its former usefulness, you can treat the cost of restoring it as the cost of replacement property.

Postponing gain on the sale of related property. If you sell property that is related to the condemned property and then buy replacement property, you can choose to postpone reporting gain on the sale. You must meet the requirements explained earlier under *Related property voluntarily sold*. You can postpone reporting all your gain if the replacement property costs at least as much as the amount realized from the sale plus your net condemnation award (if resulting in gain) plus your net severance damages, if any (if resulting in gain).

Buying replacement property from a related person. Certain taxpayers cannot postpone reporting gain from a condemnation if they buy the replacement property from a related person. For information on related persons, see *Non-deductible Loss under Sales and Exchanges Between Related Persons* in chapter 2.

This rule applies to the following taxpayers.

- 1) C corporations.
- 2) Partnerships in which more than 50% of the capital or profits interest is owned by C corporations.
- 3) All others (including individuals, partnerships (other than those in (2)), and S corporations) if the total realized gain for the tax year on all involuntarily converted properties on which there are realized gains is more than \$100,000.

For taxpayers described in (3) above, gains cannot be offset with any losses when determining whether the total gain is more than \$100,000. If the property is owned by a partnership, the \$100,000 limit applies to the partnership and each partner. If the property is owned by an S corporation, the \$100,000 limit applies to the S corporation and each shareholder.

Exception. This rule does not apply if the related person acquired the property from an unrelated person within the replacement period.

Advance payment. If you pay a contractor in advance to build your replacement property, you have not bought replacement property unless it is finished before the end of the replacement period (discussed later).

Replacement property. To postpone reporting gain, you must buy replacement property for the specific purpose of replacing your condemned property. You do not have to use the actual funds from the condemnation award to acquire the replacement property. Property you acquire by gift or inheritance does not qualify as replacement property.

Similar or related in service or use. Your replacement property must be similar or related in service or use to the property it replaces.

If the condemned property is real property you held for use in your trade or business or for investment (other than property held mainly for sale), but your replacement property is not similar or related in service or use, it will be treated as such if it is like-kind property to be held for use in a trade or business or for investment. For a discussion of like-kind property, see *Like-Kind Property* under *Like-Kind Exchanges*, later.

Owner-user. If you are an owner-user, similar or related in service or use means that replacement property must function in the same way as the property it replaces.

Example. Your home was condemned and you invested the proceeds from the condemnation in a grocery store. Your replacement property is not similar or related in service or use to the condemned property. To be similar or related in service or use, your replacement property must also be used by you as your home.

Owner-investor. If you are an owner-investor, similar or related in service or use means that any replacement property must have the same relationship of services or uses to you as the property it replaces. You decide this by determining all the following information.

- Whether the properties are of similar service to you.
- The nature of the business risks connected with the properties.
- What the properties demand of you in the way of management, service, and relations to your tenants.

Example. You owned land and a building you rented to a manufacturing company. The building was condemned. During the replacement period, you had a new building built on other land you already owned. You rented out the new building for use as a wholesale grocery warehouse. The replacement property is also rental property, so the two properties are considered similar or related in service or use if there is a similarity in all the following areas.

- Your management activities.
- The amount and kind of services you provide to your tenants.
- The nature of your business risks connected with the properties.

Leasehold replaced with fee simple property. Fee simple property you will use in your trade or business or for investment can qualify as replacement property that is similar or related in service or use to a condemned leasehold if you use it in the same business and for the identical purpose as the condemned leasehold.

A **fee simple** property interest generally is a property interest that entitles the owner to the entire property with unconditional power to dispose of it during his or her lifetime. A **leasehold** is property held under a lease, usually for a term of years.

Outdoor advertising display replaced with real property. You can choose to treat an outdoor advertising display as real property. If you make this choice and you replace the display with real property in which you hold a different kind of interest, your replacement property can qualify as like-kind property. For example, real property bought to replace a destroyed billboard and leased property on which the billboard was located qualifies as property of a like kind.

You can make this choice only if you did not claim a section 179 deduction for the display. You cannot cancel this choice unless you get the consent of the Internal Revenue Service.

An outdoor advertising display is a sign or device rigidly assembled and permanently attached to the ground, a building, or any other permanent structure used to display a commercial or other advertisement to the public.

Substituting replacement property. Once you designate certain property as replacement property on your tax return, you cannot substitute other qualified property. But, if your previously designated replacement property does not qualify, you can substitute qualified property if you acquire it within the replacement period.

Controlling interest in a corporation. You can replace property by acquiring a controlling interest in a corporation that owns property similar or related in service or use to your condemned property. You have controlling interest if you own stock having at least 80% of the combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock.

Basis adjustment to corporation's property. The basis of property held by the corporation at the time you acquired control must be reduced by your postponed gain, if any. You are not required to reduce the adjusted bases of the corporation's properties below your adjusted basis in the corporation's stock (determined after reduction by your postponed gain).

Allocate this reduction to the following classes of property in the order shown below.

- 1) Property that is similar or related in service or use to the condemned property.
- 2) Depreciable property not reduced in (1).
- 3) All other property.

If two or more properties fall in the same class, allocate the reduction to each property in proportion to the adjusted bases of all the properties in that class. The reduced basis of any single property cannot be less than zero.

Main home replaced. If your gain from a condemnation of your main home is more than you can exclude from your income (see *Main home condemned* under *Gain or Loss From Condemnations*, earlier), you can postpone reporting the rest of the gain by buying replacement property that is similar or related in service or use. To postpone reporting all the gain, the replacement property must cost at least as much as the amount realized from the condemnation minus the excluded gain.

You must reduce the basis of your replacement property by the postponed gain. Also, if you postpone reporting any part of your gain under these rules, you are treated as having owned and used the replacement property as your main home for the period you owned and used the condemned property as your main home.

Replacement period. To postpone reporting your gain from a condemnation, you must buy replacement property within a certain period of time. This is the **replacement period**.

The replacement period for a condemnation begins on the earlier of the following dates.

- The date on which you disposed of the condemned property.
- The date on which the threat of condemnation began.

The replacement period ends 2 years after the end of the first tax year in which any part of the gain on the condemnation is realized.

If real property held for use in a trade or business or for investment (not including property held primarily for sale) is condemned, the replacement period ends 3 years after the end of the first tax year in which any part of the gain on the condemnation is realized. However, this 3-year replacement period cannot be used if you replace the condemned property by acquiring control of a corporation owning property that is similar or related in service or use.

New York Liberty Zone property condemned. If property in the New York Liberty Zone was condemned as a result of the September 11, 2001, terrorist attacks, the replacement period ends 5 years after the end of the first tax year in which any part of the gain on the condemnation is realized. This 5-year replacement period applies only if substantially all of the use of the replacement property is in New York City.

Determining when gain is realized. If you are a cash basis taxpayer, you realize gain when you receive payments that are more than your basis in the property. If the condemning authority makes deposits with the court, you realize gain when you withdraw (or have the right to withdraw) amounts that are more than your basis.

This applies even if the amounts received are only partial or advance payments and the full award has not yet been determined. A replacement will be too late if you wait for a final determination that does not take place in the applicable replacement period after you first realize gain.

For accrual basis taxpayers, gain (if any) accrues in the earlier year when either of the following occurs.

- All events have occurred that fix the right to the condemnation award and the amount can be determined with reasonable accuracy.
- All or part of the award is actually or constructively received.

For example, if you have an absolute right to a part of a condemnation award when it is deposited with the court, the amount deposited accrues in the year the deposit is made even though the full amount of the award is still contested.

Replacement property bought before the condemnation. If you buy your replacement property after there is a threat of condemnation but before the actual condemnation and you still hold the replacement property at the time of the condemnation, you have bought your replacement property within the replacement period. Property you acquire before there is a threat of condemnation does not qualify as replacement property acquired within the replacement period.

Example. On April 3, 2002, city authorities notified you that your property would be condemned. On June 5, 2002, you acquired property to replace the property to be condemned. You still had the new property when the city took possession of your old property on September 4, 2003. You have made a replacement within the replacement period.

Extension. You can get an extension of the replacement period if you apply to the IRS director for your area. You should apply before the end of the replacement period. Your application should contain all details of your need for an extension. You can file an application within a reasonable time after the replacement period ends if you can show reasonable cause for the delay. An extension of the replacement period will be granted if you can show reasonable cause for not making the replacement within the regular period.

Ordinarily, requests for extensions are granted near the end of the replacement period or the extended replacement period. Extensions are usually limited to a period of 1 year or less. The high market value or scarcity of replacement property is not a sufficient reason for granting an extension. If your replacement property is being built and you clearly show that the replacement or restoration cannot be made within the replacement period, you will be granted an extension of the period.

Choosing to postpone gain. Report your choice to postpone reporting your gain, along with all necessary details, on a statement attached to your return for the tax year in which you realize the gain.

If a partnership or a corporation owns the condemned property, **only the partnership or corporation** can choose to postpone reporting the gain.

Replacement property acquired after return filed. If you buy the replacement property after you file your return reporting your choice to postpone reporting the gain, attach a statement to your return for the year in which you buy the property. The statement should contain detailed information on the replacement property.

Amended return. If you choose to postpone reporting gain, you must file an amended return for the year of the gain (individuals file Form 1040X) in either of the following situations.

- You do not buy replacement property within the replacement period. On your amended return, you must report the gain and pay any additional tax due.
- The replacement property you buy costs less than the amount realized for the condemned property (minus the gain you excluded from income if the property was your main home). On your amended return, you must report the part of the gain you cannot postpone reporting and pay any additional tax due.

Time for assessing a deficiency. Any deficiency for any tax year in which part of the gain is realized may be assessed at any time before the expiration of 3 years from the date you notify the IRS director for your area that you have replaced, or intend not to replace, the condemned property within the replacement period.

Changing your mind. You can change your mind about reporting or postponing the gain at any time before the end of the replacement period.

Example. Your property was condemned and you had a gain of \$5,000. You reported the gain on your return for the year in which you realized it, and paid the tax due. You buy replacement property within the replacement pe-

riod. You used all but \$1,000 of the amount realized from the condemnation to buy the replacement property. You now change your mind and want to postpone reporting the \$4,000 of gain equal to the amount you spent for the replacement property. You should file a claim for refund on Form 1040X. Explain on Form 1040X that you previously reported the entire gain from the condemnation, but you now want to report only the part of the gain equal to the condemnation proceeds not spent for replacement property (\$1,000).

Reporting a Condemnation Gain or Loss

Generally, you report gain or loss from a condemnation on your return for the year you realize the gain or loss.

Personal-use property. Report gain from a condemnation of property you held for personal use (other than excluded gain from a condemnation of your main home or postponed gain) on Schedule D (Form 1040).

Do not report loss from a condemnation of personal-use property. But, if you received a Form 1099-S, *Proceeds From Real Estate Transactions* (for example, showing the proceeds of a sale of real estate under threat of condemnation), you must show the transaction on Schedule D even though the loss is not deductible. Complete columns (a) through (e), and enter -0- in column (f).

Business property. Report gain (other than postponed gain) or loss from a condemnation of property you held for business or profit on **Form 4797**. If you had a gain, you may have to report all or part of it as ordinary income. See *Like-Kind Exchanges and Involuntary Conversions* in chapter 3.

Nontaxable Exchanges

Certain exchanges of property are not taxable. This means any gain from the exchange is not recognized, and any loss cannot be deducted. Your gain or loss will not be recognized until you sell or otherwise dispose of the property you receive.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be both of the following.

- Qualifying property.
- Like-kind property.

These two requirements are discussed later.

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up. See *Deferred Exchange*, later.

If the like-kind exchange involves the receipt of money or unlike property or the assumption of your liabilities, you may have to recognize gain. See *Partially Nontaxable Exchanges*, later.

Multiple-party transactions. The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements described in this section.

Receipt of title from third party. If you receive property in a like-kind exchange and the other party who transfers the property to you does not give you the title, but a third party does, you still can treat this transaction as a like-kind exchange if it meets all the requirements.

Basis of property received. If you acquire property in a like-kind exchange, the basis of that property is the same as the basis of the property you transferred.

For the basis of property received in an exchange that is only partially nontaxable, see *Partially Nontaxable Exchanges*, later.

Example. You exchanged real estate held for investment with an adjusted basis of \$25,000 for other real estate held for investment. The fair market value of both properties is \$50,000. The basis of your new property is the same as the basis of the old (\$25,000).

Money paid. If, in addition to giving up like-kind property, you pay money in a like-kind exchange, you still have no recognized gain or loss. The basis of the property received is the basis of the property given up, increased by the money paid.

Example. Bill Smith trades an old cab for a new one. The new cab costs \$30,000. He is allowed \$8,000 for the old cab and pays \$22,000 cash. He has no recognized gain or loss on the transaction regardless of the adjusted basis of his old cab. If Bill sold the old cab to a third party for \$8,000 and bought a new one, he would have a recognized gain or loss on the sale of his old cab equal to the difference between the amount realized and the adjusted basis of the old cab.

Sale and purchase. If you sell property and buy similar property in two mutually dependent transactions, you may have to treat the sale and purchase as a single nontaxable exchange.

Example. You used your car in your business for 2 years. Its adjusted basis is \$3,500 and its trade-in value is \$4,500. You are interested in a new car that costs \$20,000. Ordinarily, you would trade your old car for the new one and pay the dealer \$15,500. Your basis for depreciation of the new car would then be \$19,000 (\$15,500 plus \$3,500 adjusted basis of the old car).

You want your new car to have a larger basis for depreciation, so you arrange to sell your old car to the dealer for \$4,500. You then buy the new one for \$20,000 from the same dealer. However, you are treated as having exchanged your old car for the new one because the sale and purchase are reciprocal and mutually dependent. Your basis for depreciation for the new car is \$19,000, the same as if you traded the old car.

Reporting the exchange. Report the exchange of like-kind property, even though no gain or loss is recognized, on **Form 8824**. The instructions for the form explain how to report the details of the exchange.

If you have any recognized gain because you received money or unlike property, report it on Schedule D (Form 1040) or **Form 4797**, whichever applies. See chapter 4. You may have to report the recognized gain as ordinary income from depreciation recapture. See *Like-Kind Exchanges and Involuntary Conversions* in chapter 3.

Exchange expenses. Exchange expenses are generally the closing costs you pay. They include such items as brokerage commissions, attorney fees, and deed preparation fees. Subtract these expenses from the consideration received to figure the amount realized on the exchange. Also, add them to the basis of the like-kind property received. If you receive cash or unlike property in addition to the like-kind property and realize a gain on the exchange, subtract the expenses from the cash or fair market value of the unlike property. Then, use the net amount to figure the recognized gain. See *Partially Nontaxable Exchanges*, later.

Qualifying Property

In a like-kind exchange, both the property you give up and the property you receive must be held by you for investment or for productive use in your trade or business. Machinery, buildings, land, trucks, and rental houses are examples of property that may qualify.

The rules for like-kind exchanges do not apply to exchanges of the following property.

- Property you use for personal purposes, such as your home and your family car.
- Stock in trade or other property held primarily for sale, such as inventories, raw materials, and real estate held by dealers.
- Stocks, bonds, notes, or other securities or evidences of indebtedness, such as accounts receivable.
- Partnership interests.
- Certificates of trust or beneficial interest.
- Choses in action.

However, you might have a nontaxable exchange under other rules. See *Other Nontaxable Exchanges*, later.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of one property for another property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange. However, see *Multiple Property Exchanges*, later.

Like-Kind Property

There must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like-kind property. For example, the trade of land improved with an apartment house for land improved with a store building, or a panel truck for a pickup truck, is a like-kind exchange.

An exchange of personal property for real property does not qualify as a like-kind exchange. For example, an exchange of a piece of

machinery for a store building does not qualify. Also, the exchange of livestock of different sexes does not qualify.

Real property. An exchange of city property for farm property, or improved property for unimproved property, is a like-kind exchange.

The exchange of real estate you own for a real estate lease that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

An exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange if the nature or character of the two property interests is the same.

Foreign real property exchanges. Real property located in the United States and real property located outside the United States are not considered like-kind property under the like-kind exchange rules. If you exchange foreign real property for property located in the United States, your gain or loss on the exchange is recognized. Foreign real property is real property not located in a state or the District of Columbia.

This foreign real property exchange rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind property under the rules for replacing condemned property to postpone reporting gain on the condemnation. See *Postponement of Gain* under *Involuntary Conversions*, earlier.

Personal property. Depreciable tangible personal property can be either *like kind* or *like class* to qualify for nonrecognition treatment. Like-class properties are depreciable tangible personal properties within the same General Asset Class or Product Class. Property classified in any General Asset Class may not be classified within a Product Class.

General Asset Classes. General Asset Classes describe the types of property frequently used in many businesses. They include the following property.

- 1) Office furniture, fixtures, and equipment (asset class 00.11).
- 2) Information systems, such as computers and peripheral equipment (asset class 00.12).
- 3) Data handling equipment except computers (asset class 00.13).
- 4) Airplanes (airframes and engines), except planes used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21).
- 5) Automobiles and taxis (asset class 00.22).
- 6) Buses (asset class 00.23).
- 7) Light general purpose trucks (asset class 00.241).
- 8) Heavy general purpose trucks (asset class 00.242).
- 9) Railroad cars and locomotives except those owned by railroad transportation companies (asset class 00.25).

10) Tractor units for use over the road (asset class 00.26).

11) Trailers and trailer-mounted containers (asset class 00.27).

12) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28).

13) Industrial steam and electric generation or distribution systems (asset class 00.4).

Product Classes. Product Classes include property listed in a 4-digit product class (except any ending in "9," a miscellaneous category) in Division D of the Standard Industrial Classification codes of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (SIC Manual). Copies of the manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce. To order the manual, call the National Technical Information Service at **1-800-553-NTIS (1-800-553-6847)**. The cost of the manual is \$42 plus shipping and handling and the order number is PB87-100012.

Example 1. You transfer a personal computer used in your business for a printer to be used in your business. The properties exchanged are within the same General Asset Class and are of a like class.

Example 2. Trena transfers a grader to Ron in exchange for a scraper. Both are used in a business. Neither property is within any of the General Asset Classes. Both properties, however, are within the same Product Class and are of a like class.

Intangible personal property and nondepreciable personal property. If you exchange intangible personal property or nondepreciable personal property for like-kind property, no gain or loss is recognized on the exchange. (There are no like classes for these properties.) Whether intangible personal property, such as a patent or copyright, is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved. It also depends on the nature or character of the underlying property to which those rights relate.

Example. The exchange of a copyright on a novel for a copyright on a different novel can qualify as a like-kind exchange. However, the exchange of a copyright on a novel for a copyright on a song is not a like-kind exchange.

Goodwill and going concern. The exchange of the goodwill or going concern value of a business for the goodwill or going concern value of another business is not a like-kind exchange.

Foreign personal property exchanges. Personal property used predominantly in the United States and personal property used predominantly outside the United States are not like-kind property under the like-kind exchange rules. If you exchange property used predominantly in the United States for property used predominantly outside the United States, your gain or loss on the exchange is recognized.

Predominant use. You determine the predominant use of property you gave up based on where that property was used during the 2-year period ending on the date you gave it up. You determine the predominant use of the property you acquired based on where that property was used during the 2-year period beginning on the date you acquired it.

But if you held either property less than 2 years, determine its predominant use based on where that property was used only during the period of time you (or a related person) held it. This does not apply if the exchange is part of a transaction (or series of transactions) structured to avoid having to treat property as unlike property under this rule.

However, you must treat property as used predominantly in the United States if it is used outside the United States but, under section 168(g)(4) of the Internal Revenue Code, is eligible for accelerated depreciation as though used in the United States.

Deferred Exchange

A deferred exchange is one in which you transfer property you use in business or hold for investment and later you receive like-kind property you will use in business or hold for investment. (The property you receive is replacement property.) The transaction must be an exchange (that is, property for property) rather than a transfer of property for money used to buy replacement property.

If, before you receive the replacement property, you actually or constructively receive money or unlike property in full payment for the property you transfer, the transaction will be treated as a sale rather than a deferred exchange. In that case, you must recognize gain or loss on the transaction, even if you later receive the replacement property. (It would be treated as if you bought it.)

You constructively receive money or unlike property when the money or property is credited to your account or made available to you. You also constructively receive money or unlike property when any limits or restrictions on it expire or are waived.

Whether you actually or constructively receive money or unlike property, however, is determined without regard to certain arrangements you make to ensure that the other party carries out its obligation to transfer the replacement property to you. For example, if you have that obligation secured by a mortgage or by cash or its equivalent held in a qualified escrow account or qualified trust, that arrangement will be disregarded in determining whether you actually or constructively receive money or unlike property. For more information, see section 1.1031(k)-1(g) of the regulations. Also, see *Like-Kind Exchanges Using Qualified Intermediaries*, later.

Identification requirement. You must identify the property to be received within **45 days** after the date you transfer the property given up in the exchange. This period of time is called the **identification period**. Any property received during the identification period is considered to have been identified.

If you transfer more than one property (as part of the same transaction) and the properties are transferred on different dates, the identifica-

tion period and the receipt period begin on the date of the earliest transfer.

Identifying replacement property. You must identify the replacement property in a signed written document and deliver it to the other person involved in the exchange. You must clearly describe the replacement property in the written document. For example, use the legal description or street address for real property and the make, model, and year for a car. In the same manner, you can cancel an identification of replacement property at any time before the end of the identification period.

Identifying alternative and multiple properties. You can identify more than one replacement property. Regardless of the number of properties you give up, the maximum number of replacement properties you can identify is the larger of the following.

- Three.
- Any number of properties whose total fair market value (FMV) at the end of the identification period is not more than double the total fair market value, on the date of transfer, of all properties you give up.

If, as of the end of the identification period, you have identified more properties than permitted under this rule, the only property that will be considered identified is:

- Any replacement property you received before the end of the identification period, and
- Any replacement property identified before the end of the identification period and received before the end of the receipt period, but only if the fair market value of the property is at least 95% of the total fair market value of all identified replacement properties. (Do not include any you canceled.) Fair market value is determined on the earlier of the date you received the property or the last day of the receipt period.

Disregard incidental property. Do not treat property incidental to a larger item of property as separate from the larger item when you identify replacement property. Property is incidental if it meets both the following tests.

- It is typically transferred with the larger item.
- The total fair market value of all the incidental property is not more than 15% of the total fair market value of the larger item of property.

Replacement property to be produced. Gain or loss from a deferred exchange can qualify for nonrecognition even if the replacement property is not in existence or is being produced at the time you identify it as replacement property. If you need to know the fair market value of the replacement property to identify it, estimate its fair market value as of the date you expect to receive it.

Receipt requirement. The property must be received by the earlier of the following dates.

- The 180th day after the date on which you transfer the property given up in the exchange.

- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

You must receive substantially the same property that met the identification requirement, discussed earlier.

Replacement property produced after identification. In some cases, the replacement property may have been produced after you identified it (as described earlier in *Replacement property to be produced*.) In that case, to determine whether the property you received was substantially the same property that met the identification requirement, do not take into account any variations due to usual production changes. Substantial changes in the property to be produced, however, will disqualify it.

If your replacement property is personal property that had to be produced, it must be completed by the date you receive it to qualify as substantially the same property you identified.

If your replacement property is real property that had to be produced and it is not completed by the date you receive it, it still may qualify as substantially the same property you identified. It will qualify only if, had it been completed on time, it would have been considered to be substantially the same property you identified. It is considered to be substantially the same only to the extent it is considered real property under local law. However, any additional production on the replacement property after you receive it does not qualify as like-kind property. (To this extent, the transaction is treated as a taxable exchange of property for services.)

Like-Kind Exchanges Using Qualified Intermediaries

If you transfer property through a qualified intermediary, the transfer of the property given up and receipt of like-kind property is treated as an exchange. This rule applies even if you receive money or other property directly from a party to the transaction other than the qualified intermediary.

A **qualified intermediary** is a person who enters into a written exchange agreement with you to acquire and transfer the property you give up and to acquire the replacement property and transfer it to you. This agreement must expressly limit your rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary.

Multiple-party transactions involving related persons. A taxpayer who transfers property given up to a qualified intermediary in exchange for replacement property formerly owned by a related person is not entitled to nonrecognition treatment if the related person receives cash or unlike property for the replacement property. (See *Like-Kind Exchanges Between Related Persons*, later.)

A qualified intermediary cannot be either of the following.

- Your agent at the time of the transaction. This includes a person who has been your employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period before the transfer of property you give up.

- A person who is related to you or your agent under the rules discussed in chapter 2 under *Non deductible Loss*, substituting “10%” for “50%.”

An intermediary is treated as acquiring and transferring property if all the following requirements are met.

- The intermediary acquires and transfers legal title to the property.
- The intermediary enters into an agreement with a person other than you for the transfer to that person of the property you give up and that property is transferred to that person.
- The intermediary enters into an agreement with the owner of the replacement property for the transfer of that property and the replacement property is transferred to you.

An intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment by the date of the relevant transfer of property.

Like-Kind Exchanges Using Qualified Exchange Accommodation Arrangements (QEAs)

The like-kind exchange rules generally do not apply to an exchange in which you acquire replacement property (new property) **before** you transfer relinquished property (property you give up). However, if you use a qualified exchange accommodation arrangement (QEAA), the transfer may qualify as a like-kind exchange.

Under a QEAA, either the replacement property or the relinquished property is transferred to an exchange accommodation titleholder (EAT), discussed later, who is treated as the beneficial owner of the property for federal income tax purposes. If the property is held in a QEAA, the IRS will accept the qualification of property as either replacement property or relinquished property and the treatment of an EAT as the beneficial owner of the property for federal income tax purposes.

Requirements for a QEAA. Property is held in a QEAA only if all the following requirements are met.

- You have a written agreement.
- The time limits for identifying and transferring the property are met.
- The qualified indications of ownership of property are transferred to an EAT.

Written agreement. Under a QEAA, you and the EAT must enter into a written agreement no later than 5 business days after the qualified indications of ownership (discussed later) are transferred to the EAT. The agreement must provide all the following.

- The EAT is holding the property for your benefit in order to facilitate an exchange under the like-kind exchange rules and Revenue Procedure 2000–37.

- You and the EAT agree to report the acquisition, holding, and disposition of the property on your federal income tax returns in a manner consistent with the agreement.
- The EAT will be treated as the beneficial owner of the property for all federal income tax purposes.

Property can be treated as being held in a QEAA even if the accounting, regulatory, or state, local, or foreign tax treatment of the arrangement between you and the EAT is different from the treatment required by the list above.

Bona fide intent. When the qualified indications of ownership of the property are transferred to the EAT, it must be your bona fide intent that the property held by the EAT represents either replacement property or relinquished property in an exchange intended to qualify for nonrecognition of gain (in whole or in part) or loss under the like-kind exchange rules.

Time limits for identifying and transferring property. Under a QEAA, the following time limits for identifying and transferring the property must be met.

- 1) No later than 45 days after the transfer of qualified indications of ownership of the replacement property to the EAT; you must identify the relinquished property in a manner consistent with the principles for deferred exchanges. See *Identification requirement* earlier under *Deferred Exchange*.
- 2) One of the following transfers must take place no later than 180 days after the transfer of qualified indications of ownership of the property to the EAT.
 - a) The replacement property is transferred to you (either directly or indirectly through a qualified intermediary, defined earlier under *Like-Kind Exchanges Using Qualified Intermediaries*).
 - b) The relinquished property is transferred to a person other than you or a disqualified person. A disqualified person is either of the following.
 - i) Your agent at the time of the transaction. This includes a person who has been your employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period before the transfer of the relinquished property.
 - ii) A person who is related to you or your agent under the rules discussed in chapter 2 under *Non deductible Loss*, substituting “10%” for “50%.”
- 3) The combined time period the relinquished property and replacement property are held in the QEAA cannot be longer than 180 days.

Exchange accommodation titleholder (EAT). The EAT must meet all the following requirements.

- Hold qualified indications of ownership (defined next) at all times from the date of acquisition of the property until the property is transferred (as described in (2), earlier).
- Be someone other than you or a disqualified person (as defined in 2(b), earlier).
- Be subject to federal income tax. If the EAT is treated as a partnership or S corporation, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax.

Qualified indications of ownership. Qualified indications of ownership are any of the following.

- Legal title to the property.
- Other indications of ownership of the property that are treated as beneficial ownership of the property under principles of commercial law (for example, a contract for deed).
- Interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (for example, a single member limited liability company) and that holds either legal title to the property or other indications of ownership.

Other permissible arrangements. Property will not fail to be treated as being held in a QEAA as a result of certain legal or contractual arrangements, regardless of whether the arrangements contain terms that typically would result from arm’s-length bargaining between unrelated parties for those arrangements. For a list of those arrangements, see Revenue Procedure 2000–37 in Internal Revenue Bulletin No. 2000–40.

Partially Nontaxable Exchanges

If, in addition to like-kind property, you receive money or unlike property in an exchange on which you realize a gain, you have a partially nontaxable exchange. You are taxed on the gain you realize, but only to the extent of the money and the fair market value of the unlike property you receive.



A loss is never deductible in a nontaxable exchange in which you receive unlike property or cash.

Figuring taxable gain. To figure the taxable gain, first determine the fair market value of any unlike property you receive and add it to any money you receive. Reduce that total by any exchange expenses (closing costs) you paid. The result is the maximum gain that can be taxed. Next, figure the gain on the whole exchange as discussed earlier under *Gain or Loss From Sales and Exchanges*. Your recognized (taxable) gain is the lesser of these two amounts.

Example. You exchange real estate held for investment with an adjusted basis of \$8,000 for other real estate you want to hold for investment. The fair market value of the real estate you receive is \$10,000. You also receive \$1,000 in

cash. You paid \$500 in exchange expenses. Although the total gain realized on the transaction is \$2,500, only \$500 (\$1,000 cash received minus the \$500 exchange expenses) is recognized (included in your income).

Assumption of liabilities. If the other party to a nontaxable exchange assumes any of your liabilities, you will be treated as if you received cash in the amount of the liability. For more information on the assumption of liabilities, see section 357(d) of the Internal Revenue Code.

Example. The facts are the same as in the previous example, except the property you give up is subject to a \$3,000 mortgage for which you were personally liable. The other party in the trade has agreed to pay off the mortgage. Figure the gain realized as follows.

FMV of like-kind property received . . .	\$10,000
Cash	1,000
Mortgage treated as assumed by other party	3,000
Total received	\$14,000
Minus: Exchange expenses	(500)
Amount realized	\$13,500
Minus: Adjusted basis of property you transferred	(8,000)
Realized gain	\$5,500

The realized gain is taxed only up to \$3,500, the sum of the cash received (\$1,000 – \$500 exchange expenses) and the mortgage (\$3,000).

Unlike property given up. If, in addition to like-kind property, you give up unlike property, you must recognize gain or loss on the unlike property you give up. The gain or loss is equal to the difference between the fair market value of the unlike property and the adjusted basis of the unlike property.

Example. You exchange stock and real estate you held for investment for real estate you also intend to hold for investment. The stock you transfer has a fair market value of \$1,000 and an adjusted basis of \$4,000. The real estate you exchange has a fair market value of \$19,000 and an adjusted basis of \$15,000. The real estate you receive has a fair market value of \$20,000. You do not recognize gain on the exchange of the real estate because it qualifies as a nontaxable exchange. However, you must recognize (report on your return) a \$3,000 loss on the stock because it is unlike property.

Basis of property received. The total basis for all properties (other than money) you receive in a partially nontaxable exchange is the total adjusted basis of the properties you give up, with the following adjustments.

- 1) Add both the following amounts.
 - a) Any additional costs you incur.
 - b) Any gain you recognize on the exchange.
- 2) Subtract both the following amounts.
 - a) Any money you receive.
 - b) Any loss you recognize on the exchange.

Allocate this basis first to the unlike property, other than money, up to its fair market value on

the date of the exchange. The rest is the basis of the like-kind property.

Multiple Property Exchanges

Under the like-kind exchange rules, you generally must make a property-by-property comparison to figure your recognized gain and the basis of the property you receive in the exchange. However, for exchanges of multiple properties, you do not make a property-by-property comparison if you do either of the following.

- Transfer and receive properties in two or more exchange groups.
- Transfer or receive more than one property within a single exchange group.

In these situations, you figure your recognized gain and the basis of the property you receive by comparing the properties within each exchange group.

Exchange groups. Each exchange group consists of properties transferred and received in the exchange that are of like kind or like class. (See *Like-Kind Property*, earlier.) If property could be included in more than one exchange group, you can include it in any one of those groups. However, the following may not be included in an exchange group.

- Money.
- Stock in trade or other property held primarily for sale.
- Stocks, bonds, notes, or other securities or evidences of debt or interest.
- Interests in a partnership.
- Certificates of trust or beneficial interests.
- Choses in action.

Example. Ben exchanges computer A (asset class 00.12), automobile A (asset class 00.22), and truck A (asset class 00.241) for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241), and \$400. All properties transferred were used in Ben's business. Similarly, all properties received will be used in his business.

The first exchange group consists of computers A and R, the second exchange group consists of automobiles A and R, and the third exchange group consists of trucks A and R.

Treatment of liabilities. Offset all liabilities you assume as part of the exchange against all liabilities of which you are relieved. Offset these liabilities whether they are recourse or nonrecourse and regardless of whether they are secured by or otherwise relate to specific property transferred or received as part of the exchange.

If **you assume more liabilities** than you are relieved of, allocate the difference among the exchange groups in proportion to the total fair market value of the properties you received in the exchange groups. The difference allocated to each exchange group may not be more than the total fair market value of the properties you received in the exchange group.

The amount of the liabilities allocated to an exchange group reduces the total fair market value of the properties received in that exchange group. This reduction is made in deter-

mining whether the exchange group has a surplus or a deficiency. (See *Exchange group surplus and deficiency*, later.) This reduction is also made in determining whether a residual group is created. (See *Residual group*, later.)

If **you are relieved of more liabilities** than you assume, treat the difference as cash, general deposit accounts (other than certificates of deposit), and similar items when making allocations to the residual group, discussed later.

The treatment of liabilities and any differences between amounts you assume and amounts you are relieved of will be the same even if the like-kind exchange treatment applies to only part of a larger transaction. If so, determine the difference in liabilities based on all liabilities you assume or are relieved of as part of the larger transaction.

Example. The facts are the same as in the preceding example. In addition, the fair market value of and liabilities secured by each property are as follows.

	Fair Market Value	Liability
Ben Transfers:		
Computer A	\$1,500	\$-0-
Automobile A	2,500	500
Truck A	2,000	-0-
Ben Receives:		
Computer R	\$1,600	\$-0-
Automobile R	3,100	750
Truck R	1,400	250
Cash	400	

All liabilities assumed by Ben (\$1,000) are offset by all liabilities of which he is relieved (\$500), resulting in a difference of \$500. The difference is allocated among Ben's exchange groups in proportion to the fair market value of the properties received in the exchange groups as follows.

- \$131 ($\$500 \times \$1,600 \div \$6,100$) is allocated to the first exchange group (computers A and R). The fair market value of computer R is reduced to \$1,469 ($\$1,600 - \131).
- \$254 ($\$500 \times \$3,100 \div \$6,100$) is allocated to the second exchange group (automobiles A and R). The fair market value of automobile R is reduced to \$2,846 ($\$3,100 - \254).
- \$115 ($\$500 \times \$1,400 \div \$6,100$) is allocated to the third exchange group (trucks A and R). The fair market value of truck R is reduced to \$1,285 ($\$1,400 - \115).

In each exchange group, Ben uses the reduced fair market value of the properties received to figure the exchange group's surplus or deficiency and to determine whether a residual group has been created.

Residual group. A residual group is created if the total fair market value of the properties transferred in all exchange groups differs from the total fair market value of the properties received in all exchange groups after taking into account the treatment of liabilities (discussed earlier). The residual group consists of money or other property that has a total fair market value equal

to that difference. It consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both.

Other property includes the following items.

- Stock in trade or other property held primarily for sale.
- Stocks, bonds, notes, or other securities or evidences of debt or interest.
- Interests in a partnership.
- Certificates of trust or beneficial interests.
- Choses in action.

Other property also includes property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred.

For asset acquisitions occurring **after March 15, 2001**, money and properties allocated to the residual group are considered to come from the following assets in the following order.

- 1) Cash and general deposit accounts (including checking and savings accounts but excluding certificates of deposit). Also, include here excess liabilities of which you are relieved over the amount of liabilities you assume.
- 2) Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
- 3) Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see section 1.338-6(b)(2)(iii) of the regulations for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
- 4) Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.
- 5) Assets other than those listed in (1), (2), (3), (4), (6) and (7).
- 6) All section 197 intangibles except goodwill and going concern value.
- 7) Goodwill and going concern value.

Within each category, you can choose which properties to allocate to the residual group. If an asset described in any of the categories above, except (1), is includible in more than one category, include it in the lower number category. For example, if an asset is described in both (3) and (4), include it in (3).

Example. Fran exchanges computer A (asset class 00.12) and automobile A (asset class 00.22) for printer B (asset class 00.12), automobile B (asset class 00.22), corporate stock, and \$500. Fran used computer A and automobile A in her business and will use printer B and automobile B in her business.

This transaction results in two exchange groups: (1) computer A and printer B, and (2) automobile A and automobile B.

The fair market values of the properties are as follows.

	Fair Market Value
Fran Transfers:	
Computer A	\$1,000
Automobile A	4,000
Fran Receives:	
Automobile B	\$2,950
Printer B	800
Corporate Stock	750
Cash	500

The total fair market value of the properties transferred in the exchange groups (\$5,000) is \$1,250 more than the total fair market value of the properties received in the exchange groups (\$3,750), so there is a residual group in that amount. It consists of the \$500 cash and the \$750 worth of corporate stock.

Exchange group surplus and deficiency. For each exchange group, you must determine whether there is an “exchange group surplus” or “exchange group deficiency.” An **exchange group surplus** is the total fair market value of the properties received in an exchange group (minus any excess liabilities you assume that are allocated to that exchange group) that is more than the total fair market value of the properties transferred in that exchange group. An **exchange group deficiency** is the total fair market value of the properties transferred in an exchange group that is more than the total fair market value of the properties received in that exchange group (minus any excess liabilities you assume that are allocated to that exchange group).

Example. Karen exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which she used in her business, for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which she will use in her business. Karen’s adjusted basis and the fair market value of the exchanged properties are as follows.

	Fair Adjusted Basis	Market Value
Karen Transfers:		
Automobile A	\$1,500	\$4,000
Computer A	375	1,000
Karen Receives:		
Printer B	\$2,050	
Automobile B	2,950	

The first exchange group consists of computer A and printer B. It has an exchange group surplus of \$1,050 because the fair market value of printer B (\$2,050) is more than the fair market value of computer A (\$1,000) by that amount.

The second exchange group consists of automobile A and automobile B. It has an exchange group deficiency of \$1,050 because the fair market value of automobile A (\$4,000) is

more than the fair market value of automobile B (\$2,950) by that amount.

Recognized gain. Gain or loss realized for each exchange group and the residual group is the difference between the total fair market value of the transferred properties in that exchange group or residual group and the total adjusted basis of the properties. For each exchange group, recognized gain is the lesser of the gain realized or the exchange group deficiency (if any). Losses are not recognized for an exchange group. The total gain recognized on the exchange of like-kind or like-class properties is the sum of all the gain recognized for each exchange group.

For a residual group, you must recognize the entire gain or loss realized.

For properties you transfer that are not within any exchange group or the residual group, figure realized and recognized gain or loss as explained under *Gain or Loss From Sales and Exchanges*, earlier.

Example. Based on the facts in the previous example, Karen recognizes gain on the exchange as follows.

For the first exchange group, the gain realized is the fair market value of computer A (\$1,000) minus its adjusted basis (\$375), or \$625. The gain recognized is the lesser of the gain realized (\$625) or the exchange group deficiency (\$0), or \$0.

For the second exchange group, the gain realized is the fair market value of automobile A (\$4,000) minus its adjusted basis (\$1,500), or \$2,500. The gain recognized is the lesser of the gain realized (\$2,500) or the exchange group deficiency (\$1,050), or \$1,050.

The total gain recognized by Karen in the exchange is the sum of the gains recognized with respect to both exchange groups (\$0 + \$1,050), or \$1,050.

Basis of properties received. The total basis of properties received in each exchange group is the sum of the following amounts.

- 1) The total adjusted basis of the transferred properties within that exchange group.
- 2) Your recognized gain on the exchange group.
- 3) The excess liabilities you assume that are allocated to the group.
- 4) The exchange group surplus (or minus the exchange group deficiency).

You allocate the total basis of each exchange group proportionately to each property received in the exchange group according to the property’s fair market value.

The basis of each property received within the residual group (other than money) is equal to its fair market value.

Example. Based on the facts in the two previous examples, the bases of the properties received by Karen in the exchange, printer B and automobile B, are determined in the following manner.

The basis of the property received in the first exchange group is \$1,425. This is the sum of the following amounts.

- 1) Adjusted basis of the property transferred within that exchange group (\$375).

- 2) Gain recognized for that exchange group (\$0).
- 3) Excess liabilities assumed allocated to that exchange group (\$0).
- 4) Exchange group surplus (\$1,050).

Printer B is the only property received within the first exchange group, so the entire basis of \$1,425 is allocated to printer B.

The basis of the property received in the second exchange group is \$1,500. This is figured as follows.

First, add the following amounts.

- 1) Adjusted basis of the property transferred within that exchange group (\$1,500).
- 2) Gain recognized for that exchange group (\$1,050).
- 3) Excess liabilities assumed allocated to that exchange group (\$0).

Then subtract the exchange group deficiency (\$1,050).

Automobile B is the only property received within the second exchange group, so the entire basis (\$1,500) is allocated to automobile B.

Like-Kind Exchanges Between Related Persons

Special rules apply to like-kind exchanges between related persons. These rules affect both direct and indirect exchanges. Under these rules, if either person disposes of the property within 2 years after the exchange, the exchange is disqualified from nonrecognition treatment. The gain or loss on the original exchange must be recognized as of the date of the later disposition.

Related persons. Under these rules, related persons include, for example, you and a member of your family (spouse, brother, sister, parent, child, etc.), you and a corporation in which you have more than 50% ownership, you and a partnership in which you directly or indirectly own more than a 50% interest of the capital or profits, and two partnerships in which you directly or indirectly own more than 50% of the capital interests or profits.



An exchange structured to avoid the related party rules is not a like-kind exchange. See Like-Kind Exchanges Using Qualified Intermediaries, earlier.

For more information on related persons, see *Nondeductible Loss* under *Sales and Exchanges Between Related Persons* in chapter 2.

Example. You used a panel truck in your house painting business. Your sister used a pickup truck in her landscaping business. In December 2002, you exchanged your panel truck plus \$200 for your sister's pickup truck. At that time, the fair market value (FMV) of your panel truck was \$7,000 and its adjusted basis was \$6,000. The fair market value of your sister's pickup truck was \$7,200 and its adjusted basis was \$1,000. You realized a gain of \$1,000 (the \$7,200 fair market value of the pickup truck minus the \$200 you paid minus the \$6,000 adjusted basis of the panel truck). Your sister realized a gain of \$6,200 (the \$7,000 fair market value of your panel truck plus the \$200 you paid

minus the \$1,000 adjusted basis of the pickup truck).

However, because this was a like-kind exchange, you recognized no gain. Your basis in the pickup truck was \$6,200 (the \$6,000 adjusted basis of the panel truck plus the \$200 you paid). Your sister recognized gain only to the extent of the money she received, \$200. Her basis in the panel truck was \$1,000 (the \$1,000 adjusted basis of the pickup truck minus the \$200 received, plus the \$200 gain recognized).

In 2003, you sold the pickup truck to a third party for \$7,000. You sold it within 2 years after the exchange, so the exchange is disqualified from nonrecognition treatment. On your 2003 tax return, you must report your \$1,000 gain on the 2002 exchange. You also report a loss on the sale of \$200 (the adjusted basis of the pickup truck, \$7,200 (its \$6,200 basis plus the \$1,000 gain recognized), minus the \$7,000 realized from the sale).

In addition, your sister must report on her 2003 tax return the \$6,000 balance of her gain on the 2002 exchange. Her adjusted basis in the panel truck is increased to \$7,000 (its \$1,000 basis plus the \$6,000 gain recognized).

Two-year holding period. The 2-year holding period begins on the date of the last transfer of property that was part of the like-kind exchange. If the holder's risk of loss on the property is substantially diminished during any period, however, that period is not counted toward the 2-year holding period. The holder's risk of loss on the property is substantially diminished by any of the following events.

- The holding of a put on the property.
- The holding by another person of a right to acquire the property.
- A short sale or other transaction.

A **put** is an option that entitles the holder to sell property at a specified price at any time before a specified future date.

A **short sale** involves property you generally do not own. You borrow the property to deliver to a buyer and, at a later date, buy substantially identical property and deliver it to the lender.

Exceptions to the rules for related persons. The following kinds of property dispositions are excluded from these rules.

- Dispositions due to the death of either related person.
- Involuntary conversions.
- Dispositions if it is established to the satisfaction of the IRS that neither the exchange nor the disposition had as a main purpose the avoidance of federal income tax.

Other Nontaxable Exchanges

The following discussions describe other exchanges that may not be taxable.

Partnership Interests

Exchanges of partnership interests do not qualify as nontaxable exchanges of like-kind property. This applies regardless of whether they are general or limited partnership interests or are

interests in the same partnership or different partnerships. However, under certain circumstances the exchange may be treated as a tax-free contribution of property to a partnership. See *Contribution of Property* in Publication 541, *Partnerships*.

An interest in a partnership that has a valid choice in effect under section 761(a) of the Internal Revenue Code to be excluded from all the rules of Subchapter K of the Code is treated as an interest in each of the partnership assets and not as a partnership interest. See *Exclusion From Partnership Rules* in Publication 541.

U.S. Treasury Notes or Bonds

Certain issues of U.S. Treasury obligations may be exchanged for certain other issues designated by the Secretary of the Treasury with no gain or loss recognized on the exchange. See *U.S. Treasury Bills, Notes, and Bonds* under *Interest Income* in Publication 550 for more information on the tax treatment of income from these investments.



For other information on these notes and bonds, call the Bureau of the Public Debt at 1-304-480-6158, or write to the following address.

Bureau of the Public Debt
Attn: Marketable Assistance Branch
P.O. Box 426
Parkersburg, WV 26101



Or, on the Internet, visit:
www.publicdebt.treas.gov

Insurance Policies and Annuities

No gain or loss is recognized if you make any of the following exchanges.

- A life insurance contract for another or for an endowment or annuity contract.
- An endowment contract for an annuity contract or for another endowment contract providing for regular payments beginning at a date not later than the beginning date under the old contract.
- One annuity contract for another if the insured or annuitant remains the same.
- A portion of an annuity contract for a new annuity contract if the insured or annuitant remains the same.

If you realize a gain on the exchange of an endowment contract or annuity contract for a life insurance contract or an exchange of an annuity contract for an endowment contract, you must recognize the gain.

For information on transfers and rollovers of employer-provided annuities, see Publication 575, *Pension and Annuity Income*, or Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans)*.

Cash received. The nonrecognition and nontaxable transfer rules do not apply to a rollover in which you receive cash proceeds from the surrender of one policy and invest the cash in another policy. However, you can treat a cash distribution and reinvestment as meeting the

nonrecognition or nontaxable transfer rules if all the following requirements are met.

- 1) When you receive the distribution, the insurance company that issued the policy or contract is subject to a rehabilitation, conservatorship, insolvency, or similar state proceeding.
- 2) You withdraw all amounts to which you are entitled or, if less, the maximum permitted under the state proceeding.
- 3) You reinvest the distribution within 60 days after receipt in a single policy or contract issued by another insurance company or in a single custodial account.
- 4) You assign all rights to future distributions to the new issuer for investment in the new policy or contract if the distribution was restricted by the state proceeding.
- 5) You would have qualified under the nonrecognition or nontaxable transfer rules if you had exchanged the affected policy or contract for the new one.

If you do not reinvest all of the cash distribution, the rules for partially nontaxable exchanges, discussed earlier, apply.

In addition to meeting these five requirements, you must do both the following.

- 1) Give to the issuer of the new policy or contract a statement that includes all the following information.
 - a) The gross amount of cash distributed.
 - b) The amount reinvested.
 - c) Your investment in the affected policy or contract on the date of the initial cash distribution.
- 2) Attach the following items to your timely filed tax return for the year of the initial distribution.
 - a) A statement titled "Election under Rev. Proc. 92-44" that includes the name of the issuer and the policy number (or similar identifying number) of the new policy or contract.
 - b) A copy of the statement given to the issuer of the new policy or contract.

Property Exchanged for Stock

If you transfer property to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock, described later), and immediately afterward you are in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply in the following situations.

- The corporation is an investment company.
- You transfer the property in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.
- The stock is received in exchange for the corporation's debt (other than a security) or for interest on the corporation's debt

(including a security) that accrued while you held the debt.

Control of a corporation. To be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.



The control requirement can be met even though there are successive transfers of property and stock. For more information, see Revenue Ruling 2003-51 in Internal Revenue Bulletin No. 2003-21.

Example 1. You and Bill Jones buy property for \$100,000. You both organize a corporation when the property has a fair market value of \$300,000. You transfer the property to the corporation for all its authorized capital stock, which has a par value of \$300,000. No gain is recognized by you, Bill, or the corporation.

Example 2. You and Bill transfer the property with a basis of \$100,000 to a corporation in exchange for stock with a fair market value of \$300,000. This represents only 75% of each class of stock of the corporation. The other 25% was already issued to someone else. You and Bill recognize a taxable gain of \$200,000 on the transaction.

Services rendered. The term *property* does not include services rendered or to be rendered to the issuing corporation. The value of stock received for services is income to the recipient.

Example. You transfer property worth \$35,000 and render services valued at \$3,000 to a corporation in exchange for stock valued at \$38,000. Right after the exchange, you own 85% of the outstanding stock. No gain is recognized on the exchange of property. However, you recognize ordinary income of \$3,000 as payment for services you rendered to the corporation.

Property of relatively small value. The term *property* does not include property of a relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor if the main purpose of the transfer is to qualify for the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if its fair market value is at least 10% of the fair market value of the stock and securities already owned or to be received for services by the transferor.

Stock received in disproportion to property transferred. If a group of transferors exchange property for corporate stock, each transferor does not have to receive stock in proportion to his or her interest in the property transferred. If a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock were first received in proportion and then some of it used to make gifts, pay compensation for services, or satisfy the transferor's obligations.

Money or other property received. If, in an otherwise nontaxable exchange of property for corporate stock, you also receive money or property other than stock, you may have to recognize gain. You must recognize gain only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring the recognized gain in this situation generally follow those for a partially nontaxable exchange discussed earlier under *Like-Kind Exchanges*. If the property you give up includes depreciable property, the recognized gain may have to be reported as ordinary income from depreciation. See chapter 3. No loss is recognized.

Nonqualified preferred stock. Nonqualified preferred stock is treated as property other than stock. Generally, it is preferred stock with any of the following features.

- The holder has the right to require the issuer or a related person to redeem or buy the stock.
- The issuer or a related person is required to redeem or buy the stock.
- The issuer or a related person has the right to redeem or buy the stock and, on the issue date, it is more likely than not that the right will be exercised.
- The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.

For a detailed definition of nonqualified preferred stock, see section 351(g)(2) of the Internal Revenue Code.

Liabilities. If the corporation assumes your liabilities, the exchange generally is not treated as if you received money or other property. There are two exceptions to this treatment.

- If the liabilities the corporation assumes are more than your adjusted basis in the property you transfer, gain is recognized up to the difference. However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
- If there is no good business reason for the corporation to assume your liabilities, or if your main purpose in the exchange is to avoid federal income tax, the assumption is treated as if you received money in the amount of the liabilities.

For more information on the assumption of liabilities, see section 357(d) of the Internal Revenue Code.

Example. You transfer property to a corporation for stock. Immediately after the transfer, you control the corporation. You also receive \$10,000 in the exchange. Your adjusted basis in the transferred property is \$20,000. The stock you receive has a fair market value (FMV) of \$16,000. The corporation also assumes a \$5,000 mortgage on the property for which you are personally liable. Gain is realized as follows.

FMV of stock received	\$16,000
Cash received	10,000
Liability assumed by corporation	5,000
Total received	\$31,000

Minus: Adjusted basis of property transferred	20,000
Realized gain	\$11,000

The liability assumed is not treated as money or other property. The recognized gain is limited to \$10,000, the cash received.

Transfers to Spouse

No gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse if incident to divorce. This rule does not apply to the following.

- The recipient of the transfer is a nonresident alien.
- A transfer in trust to the extent the liabilities assumed and the liabilities on the property are more than the property's adjusted basis.
- A transfer of certain stock redemptions, as discussed in section 1.1041-2 of the regulations.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the property to the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

For more information on transfers to a spouse, see *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

Rollover of Gain From Publicly Traded Securities

You can choose to roll over a capital gain from the sale of publicly traded securities (securities traded on an established securities market) into a specialized small business investment company (SSBIC). If you make this choice, the gain from the sale is recognized only to the extent the amount realized is more than the cost of the SSBIC common stock or partnership interest bought during the 60-day period beginning on the date of the sale. You must reduce your basis in the SSBIC stock or partnership interest by the gain not recognized.

The gain that can be rolled over during any tax year is limited. For individuals, the limit is the lesser of the following amounts.

- \$50,000 (\$25,000 for married individuals filing separately).
- \$500,000 (\$250,000 for married individuals filing separately) minus the gain rolled over in all earlier tax years.

For more information, see chapter 4 of Publication 550.

For C corporations, the limit is the lesser of the following amounts.

- \$250,000.
- \$1 million minus the gain rolled over in all earlier tax years.

Sales of Small Business Stock

If you sell qualified small business stock, you may be able to roll over your gain tax free or exclude part of the gain from your income. Qualified small business stock is stock originally issued by a qualified small business after August 10, 1993, that meets all 7 tests listed in chapter 4 of Publication 550.

Rollover of gain. You can choose to roll over a capital gain from the sale of qualified small business stock held longer than 6 months into other qualified small business stock. This choice is not allowed to C corporations. If you make this choice, the gain from the sale generally is recognized only to the extent the amount realized is more than the cost of the replacement qualified small business stock bought within 60 days of the date of sale. You must reduce your basis in the replacement qualified small business stock by the gain not recognized.

Exclusion of gain. You may be able to exclude from your gross income one-half your gain from the sale or exchange of qualified small business stock held by you longer than 5 years. This exclusion is not allowed to C corporations. Different rules apply when the stock is held by a partnership, S corporation, regulated investment company, or common trust fund.

Your gain that is eligible for the exclusion from the stock of any one issuer is limited to the greater of the following amounts.

- Ten times your basis in all qualified stock of the issuer you sold or exchanged during the year.
- \$10 million (\$5 million for married individuals filing separately) minus the gain from the stock of the same issuer you used to figure your exclusion in earlier years.

More information. For more information on sales of small business stock, see chapter 4 of Publication 550.

Rollover of Gain From Sale of Empowerment Zone Assets

You may qualify for a tax-free rollover of certain gains from the sale of qualified empowerment zone assets. This means that if you buy certain replacement property and make the choice de-

scribed in this section, you postpone part or all of the recognition of your gain.

You can make this choice if you meet all the following tests.

- 1) You hold a qualified empowerment zone asset for more than 1 year and sell it at a gain.
- 2) Your gain from the sale is a capital gain.
- 3) During the 60-day period beginning on the date of the sale, you buy a replacement qualified empowerment zone asset in the same zone as the asset sold.



Any part of the gain that is ordinary income cannot be postponed and must be recognized.

Qualified empowerment zone asset. This means certain stock or partnership interests in an enterprise zone business. It also includes certain tangible property used in an enterprise zone business. You must have acquired the asset after December 21, 2000.

Amount of gain recognized. If you make the choice described in this section, you must recognize gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of the qualified empowerment zone asset that you bought during the 60-day period beginning on the date of sale (and did not previously take into account in rolling over gain on an earlier sale of qualified empowerment zone assets).

If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain. If this amount is less than the amount of your gain, you can postpone the rest of your gain by adjusting the basis of your replacement property as described next.

Basis of replacement property. You must subtract the amount of postponed gain from the basis of the qualified empowerment zone assets you bought as replacement property.

More information. For more information about empowerment zones, see Publication 954, *Tax Incentives for Distressed Communities*. For more information about this rollover of gain, see section 1397B of the Internal Revenue Code.

2.

Ordinary or Capital Gain or Loss

Introduction

You must classify your gains and losses as either ordinary or capital (and your capital gains

or losses as either short-term or long-term). You must do this to figure your net capital gain or loss.

For individuals, a net capital gain may be taxed at a lower tax rate than ordinary income. See *Capital Gains Tax Rates* in chapter 4. Your deduction for a net capital loss may be limited. See *Treatment of Capital Losses* in chapter 4.

Capital gain or loss. Generally, you will have a capital gain or loss if you sell or exchange a capital asset. You also may have a capital gain if your section 1231 transactions result in a net gain.

Section 1231 transactions. Section 1231 transactions are sales and exchanges of property held longer than 1 year and either used in a trade or business or held for the production of rents or royalties. They also include certain involuntary conversions of business or investment property, including capital assets. See *Section 1231 Gains and Losses* in chapter 3 for more information.

Topics

This chapter discusses:

- Capital assets
- Noncapital assets
- Sales and exchanges between related persons
- Other dispositions

Useful Items

You may want to see:

Publication

- 550** Investment Income and Expenses
- 954** Tax Incentives for Distressed Communities

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 4797** Sales of Business Property
- 8594** Asset Acquisition Statement Under Section 1060

See chapter 5 for information about getting publications and forms.

Capital Assets

Almost everything you own and use for personal purposes or investment is a capital asset. For exceptions, see *Noncapital Assets*, later.

The following items are examples of capital assets.

- Stocks and bonds.
- A home owned and occupied by you and your family.
- Timber grown on your home property or investment property, even if you make casual sales of the timber.
- Household furnishings.
- A car used for pleasure or commuting.

- Coin or stamp collections.
- Gems and jewelry.
- Gold, silver, and other metals.

Personal-use property. Property held for personal use is a capital asset. **Gain** from a sale or exchange of that property is a capital gain. **Loss** from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal-use property only if it results from a casualty or theft.

Investment property. Investment property (such as stocks and bonds) is a capital asset, and a gain or loss from its sale or exchange is a capital gain or loss. This treatment does not apply to property used to produce rental income. See *Business assets*, later, under *Noncapital Assets*.

Release of restriction on land. Amounts you receive for the release of a restrictive covenant in a deed to land are treated as proceeds from the sale of a capital asset.

Noncapital Assets

A noncapital asset is property that is not a capital asset. The following kinds of property are not capital assets.

- 1) Property held mainly for sale to customers or property that will physically become part of merchandise for sale to customers. This includes stock in trade, inventory, and other property you hold mainly for sale to customers in your trade or business. Inventories are discussed in Publication 538, *Accounting Periods and Methods*.
- 2) Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of any properties described in (1).
- 3) Depreciable property used in your trade or business or as rental property (including section 197 intangibles defined later), even if the property is fully depreciated (or amortized). Sales of this type of property are discussed in chapter 3.
- 4) Real property used in your trade or business or as rental property, even if the property is fully depreciated.
- 5) A copyright; a literary, musical, or artistic composition; a letter; a memorandum; or similar property (such as drafts of speeches, recordings, transcripts, manuscripts, drawings, or photographs)—
 - a) Created by your personal efforts,
 - b) Prepared or produced for you (in the case of a letter, memorandum, or similar property), or
 - c) Acquired from a person who created the property or for whom the property was prepared under circumstances (for example, by gift) entitling you to the basis of the person who created the property, or for whom it was prepared or produced.

- 6) U.S. Government publications you got from the government for free or for less than the normal sales price or that you acquired under circumstances entitling you to the basis of someone who got the publications for free or for less than the normal sales price.
- 7) Any commodities derivative financial instrument (discussed later) held by a commodities derivatives dealer unless it meets both the following requirements.
 - a) It is established to the satisfaction of the IRS that the instrument has no connection to the activities of the dealer as a dealer.
 - b) The instrument is clearly identified in the dealer's records as meeting (a) by the end of the day on which it was acquired, originated, or entered into.
- 8) Any hedging transaction (defined later) that is clearly identified as a hedging transaction by the end of the day on which it was acquired, originated, or entered into.
- 9) Supplies of a type you regularly use or consume in the ordinary course of your trade or business.

Property held mainly for sale to customers.

Stock in trade, inventory, and other property you hold mainly for sale to customers in your trade or business are not capital assets. Inventories are discussed in Publication 538.

Business assets. Real property and depreciable property used in your trade or business or as rental property (including section 197 intangibles defined later under *Dispositions of Intangible Property*) are not capital assets. The sale or disposition of business property is discussed in chapter 3.

Letters and memorandums. Letters, memorandums, and similar property (such as drafts of speeches, recordings, transcripts, manuscripts, drawings, or photographs) are not treated as capital assets (as discussed earlier) if your personal efforts created them or if they were prepared or produced for you. Nor is this property a capital asset if your basis in it is determined by reference to the person who created it or the person for whom it was prepared. For this purpose, letters and memorandums addressed to you are considered prepared for you. If letters or memorandums are prepared by persons under your administrative control, they are considered prepared for you whether or not you review them.

Commodities derivative financial instrument. A commodities derivative financial instrument is a commodities contract or other financial instrument for commodities (other than a share of corporate stock, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract) the value or settlement price of which is calculated or determined by reference to a specified index (as defined in section 1221(b) of the Internal Revenue Code).

Commodities derivative dealer. A commodities derivative dealer is a person who regularly offers to enter into, assume, offset, assign,

or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.

Hedging transaction. A hedging transaction is any transaction you enter into in the normal course of your trade or business primarily to manage any of the following.

- 1) Risk of price changes or currency fluctuations involving ordinary property you hold or will hold.
- 2) Risk of interest rate or price changes or currency fluctuations for borrowings you make or will make, or ordinary obligations you incur or will incur.

Sales and Exchanges Between Related Persons

This section discusses the rules that may apply to the sale or exchange of property between related persons. If these rules apply, gains may be treated as ordinary income and losses may not be deductible. See *Transfers to Spouse* in chapter 1 for rules that apply to spouses.

Gain Is Ordinary Income

If a gain is recognized on the sale or exchange of property to a related person, the gain may be ordinary income even if the property is a capital asset. It is ordinary income if the sale or exchange is a depreciable property transaction or a controlled partnership transaction.

Depreciable property transaction. Gain on the sale or exchange of property, including a leasehold or a patent application, that is depreciable property in the hands of the person who receives it is ordinary income if the transaction is either directly or indirectly between any of the following pairs of entities.

- 1) A person and the person's controlled entity or entities.
- 2) A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary unless the beneficiary's interest in the trust is a remote contingent interest; that is, the value of the interest computed actuarially is 5% or less of the value of the trust property.
- 3) An executor and a beneficiary of an estate unless the sale or exchange is in satisfaction of a pecuniary bequest.
- 4) An employer (or any person related to the employer under rules (1), (2), or (3)) and a welfare benefit fund (within the meaning of section 419(e) of the Internal Revenue Code) that is controlled directly or indirectly by the employer (or any person related to the employer).

A person's controlled entity is either of the following.

- 1) A corporation in which more than 50% of the value of all outstanding stock, or a partnership in which more than 50% of the

capital interest or profits interest, is directly or indirectly owned by or for that person.

- 2) An entity whose relationship with that person is one of the following.
 - a) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest in the partnership.
 - b) Two corporations that are members of the same controlled group as defined in section 1563(a) of the Internal Revenue Code, except that "more than 50%" is substituted for "at least 80%" in that definition.
 - c) Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
 - d) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

Controlled partnership transaction. A gain recognized in a controlled partnership transaction may be ordinary income. The gain is ordinary income if it results from the sale or exchange of property that, in the hands of the party who receives it, is a noncapital asset such as trade accounts receivable, inventory, stock in trade, or depreciable or real property used in a trade or business.

A controlled partnership transaction is a transaction directly or indirectly between either of the following pairs of entities.

- A partnership and a partner who directly or indirectly owns more than 50% of the capital interest or profits interest in the partnership.
- Two partnerships, if the same persons directly or indirectly own more than 50% of the capital interests or profits interests in both partnerships.

Determining ownership. In the transactions under *Depreciable property transaction* and *Controlled partnership transaction*, earlier, use the following rules to determine the ownership of stock or a partnership interest.

- 1) Stock or a partnership interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. (However, for a partnership interest owned by or for a C corporation, this applies only to shareholders who directly or indirectly own 5% or more in value of the stock of the corporation.)
- 2) An individual is considered as owning the stock or partnership interest directly or indirectly owned by or for his or her family. Family includes only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
- 3) For purposes of applying (1) or (2), stock or a partnership interest **constructively**

owned by a person under (1) is treated as actually owned by that person. But stock or a partnership interest constructively owned by an individual under (2) is not treated as owned by the individual for reapplying (2) to make another person the constructive owner of that stock or partnership interest.

Non deductible Loss

A loss on the sale or exchange of property between related persons is not deductible. This applies to both direct and indirect transactions, but not to distributions of property from a corporation in a complete liquidation. The following are **related persons**.

- 1) Members of a family, including only brothers, sisters, half-brothers, half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) An individual and a corporation if the individual directly or indirectly owns more than 50% in value of the outstanding stock of the corporation.
- 3) Two corporations that are members of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
- 4) A trust fiduciary and a corporation if the trust or the grantor of the trust directly or indirectly owns more than 50% in value of the outstanding stock of the corporation.
- 5) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- 6) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 7) A tax-exempt educational or charitable organization and a person who directly or indirectly controls the organization, or a member of that person's family.
- 8) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest in the partnership.
- 9) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 10) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 11) An executor and a beneficiary of an estate unless the sale or exchange is in satisfaction of a pecuniary bequest.
- 12) Two partnerships if the same persons directly or indirectly own more than 50% of the capital interests or profits interests in both partnerships.
- 13) A person and a partnership if the person directly or indirectly owns more than 50% of the capital interest or profits interest in the partnership.

If a sale or exchange is between any of these related persons and involves the lump-sum sale of a number of blocks of stock or pieces of property, the gain or loss must be figured separately for each block of stock or piece of property. The gain on each item is taxable. The loss on any item is nondeductible. Gains from the sales of any of these items may not be offset by losses on the sales of any of the other items.

Partnership interests. The nondeductible loss rule does not apply to a sale or exchange of an interest in the partnership between the related persons described in (12) or (13) above.

Controlled groups. Losses on transactions between members of the same controlled group described in (3) earlier are deferred rather than denied.

For more information, see section 267(f) of the Internal Revenue Code.

Ownership of stock or partnership interests. In determining whether an individual directly or indirectly owns any of the outstanding stock of a corporation or an interest in a partnership for a loss on a sale or exchange, the following rules apply.

- 1) Stock or a partnership interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries. (However, for a partnership interest owned by or for a C corporation, this applies only to shareholders who directly or indirectly own 5% or more in value of the stock of the corporation.)
- 2) An individual is considered as owning the stock or partnership interest directly or indirectly owned by or for his or her family. Family includes only brothers, sisters, half-brothers, half-sisters, spouse, ancestors, and lineal descendants.
- 3) An individual owning (other than by applying (2)) any stock in a corporation is considered to own the stock directly or indirectly owned by or for his or her partner.
- 4) For purposes of applying (1), (2), or (3), stock or a partnership interest constructively owned by a person under (1) is treated as actually owned by that person. But stock or a partnership interest constructively owned by an individual under (2) or (3) is not treated as owned by the individual for reapplying either (2) or (3) to make another person the constructive owner of that stock or partnership interest.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if under a prearranged plan a related person or entity buys the same stock you had owned. This does not apply to a cross-trade between related parties through an exchange that is purely coincidental and is not prearranged.

Property received from a related person. If, in a purchase or exchange, you received property from a related person who had a loss that was not allowable and you later sell or exchange the property at a gain, you recognize the gain only to the extent it is more than the loss previ-

ously disallowed to the related person. This rule applies only to the original transferee.

Example 1. Your brother sold stock to you for \$7,600. His cost basis was \$10,000. His loss of \$2,400 was not deductible. You later sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900 (\$10,500 – \$7,600). Your recognized gain is only \$500, the gain that is more than the \$2,400 loss not allowed to your brother.

Example 2. Assume the same facts as in Example 1, except that you sell the stock for \$6,900 instead of \$10,500. Your recognized loss is only \$700 (\$7,600 – \$6,900). You cannot deduct the loss not allowed to your brother.

Other Dispositions

This section discusses rules for determining the treatment of gain or loss from various dispositions of property.

Sale of a Business

The sale of a business usually is not a sale of one asset. Instead, all the assets of the business are sold. Generally, when this occurs, each asset is treated as being sold separately for determining the treatment of gain or loss.

A business usually has many assets. When sold, these assets must be classified as capital assets, depreciable property used in the business, real property used in the business, or property held for sale to customers, such as inventory or stock in trade. The gain or loss on each asset is figured separately. The sale of capital assets results in capital gain or loss. The sale of real property or depreciable property used in the business and held longer than 1 year results in gain or loss from a section 1231 transaction (discussed in chapter 3). The sale of inventory results in ordinary income or loss.

Partnership interests. An interest in a partnership or joint venture is treated as a capital asset when sold. The part of any gain or loss from unrealized receivables or inventory items will be treated as ordinary gain or loss. For more information, see *Disposition of Partner's Interest* in Publication 541, *Partnerships*.

Corporation interests. Your interest in a corporation is represented by stock certificates. When you sell these certificates, you usually realize capital gain or loss. For information on the sale of stock, see chapter 4 in Publication 550.

Corporate liquidations. Corporate liquidations of property generally are treated as a sale or exchange. Gain or loss generally is recognized by the corporation on a liquidating sale of its assets. Gain or loss generally is recognized also on a liquidating distribution of assets as if the corporation sold the assets to the distributee at fair market value.

In certain cases in which the distributee is a corporation in control of the distributing corporation, the distribution may not be taxable. For more information, see Internal Revenue Code section 332 and its regulations.

Allocation of consideration paid for a business. The sale of a trade or business for a lump sum is considered a sale of each individual asset rather than of a single asset. Except for assets exchanged under any nontaxable exchange rules, both the buyer and seller of a business must use the residual method (explained later) to allocate the consideration to each business asset transferred. This method determines gain or loss from the transfer of each asset and how much of the consideration is for goodwill and certain other intangible property. It also determines the buyer's basis in the business assets.

Consideration. The buyer's consideration is the cost of the assets acquired. The seller's consideration is the amount realized (money plus the fair market value of property received) from the sale of assets.

Residual method. The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under section 743(b) of the Internal Revenue Code. Section 743(b) applies if a partnership has an election in effect under section 754 of the Internal Revenue Code.

A group of assets constitutes a trade or business if either of the following applies.

- Goodwill or going concern value could, under any circumstances, attach to them.
- The use of the assets would constitute an active trade or business under section 355 of the Internal Revenue Code.

The residual method provides for the consideration to be reduced first by the cash and general deposit accounts (including checking and savings accounts but excluding certificates of deposit). The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

For asset acquisitions occurring **after March 15, 2001**, make the allocation among the following assets in proportion to (but not more than) their fair market value on the purchase date in the following order.

- 1) Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
- 2) Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see section 1.338-6(b)(2)(iii) of the regulations for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
- 3) Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.

- 4) All other assets except section 197 intangibles.
- 5) Section 197 intangibles (other than goodwill and going concern value).
- 6) Goodwill and going concern value (whether the goodwill or going concern value qualifies as a section 197 intangible).

If an asset described in (1) through (6) is includable in more than one category, include it in the lower number category. For example, if an asset is described in both (4) and (6), include it in (4).

Example. The total paid in the January 10, 2003, sale of the assets of Company SKB is \$21,000. No cash or deposit accounts or similar accounts were sold. The company's U.S. Government securities sold had a fair market value of \$3,200. The only other asset transferred (other than goodwill and going concern value) was inventory with a fair market value of \$15,000. Of the \$21,000 paid for the assets of Company SKB, \$3,200 is allocated to U.S. Government securities, \$15,000 to inventory assets, and the remaining \$2,800 to goodwill and going concern value.

Agreement. The buyer and seller may enter into a written agreement as to the allocation of any consideration or the fair market value of any of the assets. This agreement is binding on both parties unless the IRS determines the amounts are not appropriate.

Reporting requirement. Both the buyer and seller involved in the sale of business assets must report to the IRS the allocation of the sales price among section 197 intangibles and the other business assets. Use **Form 8594** to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.

Dispositions of Intangible Property

Intangible property is any personal property that has value but cannot be seen or touched. It includes such items as patents, copyrights, and the goodwill value of a business.

Gain or loss on the sale or exchange of amortizable or depreciable intangible property held longer than 1 year (other than an amount recaptured as ordinary income) is a section 1231 gain or loss. The treatment of section 1231 gain or loss and the recapture of amortization and depreciation as ordinary income are explained in chapter 3. See chapter 9 of Publication 535, *Business Expenses*, for information on amortizable intangible property and chapter 1 of Publication 946, *How To Depreciate Property*, for information on intangible property that can and cannot be depreciated. Gain or loss on dispositions of other intangible property is ordinary or capital depending on whether the property is a capital asset or a noncapital asset.

The following discussions explain special rules that apply to certain dispositions of intangible property.

Section 197 Intangibles

Section 197 intangibles are certain intangible assets acquired after August 10, 1993 (after July 25, 1991, if chosen), and held in connection with the conduct of a trade or business or an activity entered into for profit whose costs are amortized over 15 years. They include the following assets.

- Goodwill.
- Going concern value.
- Workforce in place.
- Business books and records, operating systems, and other information bases.
- Patents, copyrights, formulas, processes, designs, patterns, know how, formats, and similar items.
- Customer-based intangibles.
- Supplier-based intangibles.
- Licenses, permits, and other rights granted by a governmental unit.
- Covenants not to compete entered into in connection with the acquisition of a business.
- Franchises, trademarks, and trade names.

For more information, see chapter 9 of Publication 535.

Dispositions. The following rules apply to dispositions of section 197 intangibles.

Covenant not to compete. A covenant not to compete (or similar arrangement) that is a section 197 intangible cannot be treated as disposed of or worthless before you have disposed of your entire interest in the trade or business for which the covenant was entered into. Members of the same controlled group of corporations and commonly controlled businesses are treated as a single entity in determining whether a member has disposed of its entire interest in a trade or business.

Nondeductible loss. You cannot deduct a loss from the disposition or worthlessness of a section 197 intangible you acquired in the same transaction (or series of related transactions) as another section 197 intangible you still hold. Instead, you must increase the adjusted basis of your retained section 197 intangible by the non-deductible loss. If you retain more than one section 197 intangible, increase each intangible's adjusted basis. Figure the increase by multiplying the nondeductible loss by a fraction, the numerator (top number) of which is the retained intangible's adjusted basis on the date of the loss and the denominator (bottom number) of which is the total adjusted basis of all retained intangibles on the date of the loss.

In applying this rule, members of the same controlled group of corporations and commonly controlled businesses are treated as a single entity. For example, a corporation cannot deduct a loss on the sale of a section 197 intangible if, after the sale, a member of the same controlled group retains other section 197 intangibles acquired in the same transaction as the intangible sold.

Anti-churning rules. Anti-churning rules prevent a taxpayer from converting section 197 intangibles that do not qualify for amortization

into property that would qualify for amortization. However, these rules do not apply to part of the basis of property acquired by certain related persons if the transferor chooses to do both the following.

- Recognize gain on the transfer of the property.
- Pay income tax on the gain at the highest tax rate.

If the transferor is a partnership or S corporation, the partnership or S corporation (not the partners or shareholders) can make the choice. But each partner or shareholder must pay the tax on his or her share of gain.

To make the choice, you, as the transferor, must attach a statement containing certain information to your income tax return for the year of the transfer. You must file the tax return by the due date (including extensions). You must also notify the transferee of the choice in writing by the due date of the return.

If you timely filed your return without making the choice, you can make the choice by filing an amended return within 6 months after the due date of the return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the statement. File the amended return at the same address the original return was filed.

For more information about making the choice, see section 1.197-2(h)(9) of the regulations. For information about reporting the tax on your income tax return, see the instructions for Form 4797.

Patents

The transfer of a patent by an individual is treated as a sale or exchange of a capital asset held longer than 1 year. This applies even if the payments for the patent are made periodically during the transferee's use or are contingent on the productivity, use, or disposition of the patent. For information on the treatment of gain or loss on the transfer of capital assets, see chapter 4.

This treatment applies to your transfer of a patent if you meet all the following conditions.

- You are the holder of the patent.
- You transfer the patent other than by gift, inheritance, or devise.
- You transfer all substantial rights to the patent or an undivided interest in all such rights.
- You do not transfer the patent to a related person.

Holder. You are the holder of a patent if you are either of the following.

- The individual whose effort created the patent property and who qualifies as the original and first inventor.
- The individual who bought an interest in the patent from the inventor before the invention was tested and operated successfully under operating conditions and who is neither related to, nor the employer of, the inventor.

All substantial rights. All substantial rights to patent property are all rights that have value when they are transferred. A security interest (such as a lien), or a reservation calling for forfeiture for nonperformance, is not treated as a substantial right for these rules and may be kept by you as the holder of the patent.

All substantial rights to a patent are not transferred if any of the following apply to the transfer.

- The rights are limited geographically within a country.
- The rights are limited to a period less than the remaining life of the patent.
- The rights are limited to fields of use within trades or industries and are less than all the rights that exist and have value at the time of the transfer.
- The rights are less than all the claims or inventions covered by the patent that exist and have value at the time of the transfer.

Related persons. This tax treatment does not apply if the transfer is directly or indirectly between you and a related person as defined earlier under *Nondeductible Loss*, with the following changes.

- 1) Members of your family include your spouse, ancestors, and lineal descendants, but not your brothers, sisters, half-brothers, or half-sisters.
- 2) Substitute "25% or more" ownership for "more than 50%" in that listing.

If you fit within the definition of a related person independent of family status, the brother-sister exception in (1), earlier, does not apply. For example, a transfer between a brother and a sister as beneficiary and fiduciary of the same trust is a transfer between related persons. The brother-sister exception does not apply because the trust relationship is independent of family status.

Franchise, Trademark, or Trade Name

If you transfer or renew a franchise, trademark, or trade name for a price contingent on its productivity, use, or disposition, the amount you receive generally is treated as an amount realized from the sale of a noncapital asset. A franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities within a specified area.

Significant power, right, or continuing interest. If you keep any significant power, right, or continuing interest in the subject matter of a franchise, trademark, or trade name that you transfer or renew, the amount you receive is ordinary royalty income rather than an amount realized from a sale or exchange.

A significant power, right, or continuing interest in a franchise, trademark, or trade name includes, but is not limited to, the following rights in the transferred interest.

- A right to disapprove any assignment of the interest, or any part of it.
- A right to end the agreement at will.

- A right to set standards of quality for products used or sold, or for services provided, and for the equipment and facilities used to promote such products or services.
- A right to make the recipient sell or advertise only your products or services.
- A right to make the recipient buy most supplies and equipment from you.
- A right to receive payments based on the productivity, use, or disposition of the transferred item of interest if those payments are a substantial part of the transfer agreement.

Subdivision of Land

If you own a tract of land and, to sell or exchange it, you subdivide it into individual lots or parcels, the gain normally is ordinary income. However, you may receive capital gain treatment on at least part of the proceeds provided you meet certain requirements. See section 1237 of the Internal Revenue Code.

Timber

Standing timber held as investment property is a capital asset. Gain or loss from its sale is reported as a capital gain or loss on Schedule D (Form 1040). If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is ordinary business income or loss. It is reported in the gross receipts or sales and cost of goods sold items of your return.

Farmers who cut timber on their land and sell it as logs, firewood, or pulpwood usually have no cost or other basis for that timber. These sales constitute a very minor part of their farm businesses. In these cases, amounts realized from such sales, and the expenses of cutting, hauling, etc., are ordinary farm income and expenses reported on Schedule F (Form 1040), *Profit or Loss From Farming*.

Different rules apply if you owned the timber longer than 1 year and choose to either:

- Treat timber cutting as a sale or exchange, or
- Enter into a cutting contract.

Under the rules discussed below, disposition of the timber is treated as a section 1231 transaction. See chapter 3. Gain or loss is reported on Form 4797.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old when severed from their roots and sold for ornamental purposes are included in the term timber. They qualify for both rules discussed below.

Choice to treat cutting as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until a sale or exchange occurs that gain or loss is realized. But if you owned or had a contractual right to cut timber, you can choose to treat the cutting of timber as a section 1231 transaction in the year the timber is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary business income or loss. See *Example*, later.

To choose this treatment, you must:

- Own, or hold a contractual right to cut, the timber for a period of more than 1 year before it is cut, and
- Cut the timber for sale or for use in your trade or business.

Making the choice. You make the choice on your return for the year the cutting takes place by including in income the gain or loss on the cutting and including a computation of the gain or loss. You do not have to make the choice in the first year you cut timber. You can make it in any year to which the choice would apply. If the timber is partnership property, the choice is made on the partnership return. This choice cannot be made on an amended return.

Once you have made the choice, it remains in effect for all later years unless you cancel it.

Canceling a post-1986 choice. You can cancel a choice you made for a tax year beginning after 1986 only if you can show undue hardship and get the approval of the IRS. Thereafter, you may not make any new choice unless you have the approval of the IRS.

Canceling a pre-1987 choice. You can cancel a choice you made for a tax year beginning before 1987 without the approval of the IRS. You can cancel the choice by attaching a statement to your tax return for the year the cancellation is to be effective. If you make this cancellation, which can be made only once, you can make a new choice without the approval of the IRS. Any further cancellation will require the approval of the IRS.

The statement must include all the following information.

- Your name, address, and taxpayer identification number.
- The year the cancellation is effective and the timber to which it applies.
- That the cancellation being made is of the choice to treat the cutting of timber as a sale or exchange under section 631(a) of the Internal Revenue Code.
- That the cancellation is being made under section 311(d) of Public Law 99-514.
- That you are entitled to make the cancellation under section 311(d) of Public Law 99-514 and temporary regulations section 301.9100-7T.

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut.

Your adjusted basis for depletion of cut timber is based on the number of units (feet board measure, log scale, or other units) of timber cut during the tax year and considered to be sold or exchanged. Your adjusted basis for depletion is also based on the depletion unit of timber in the account used for the cut timber, and should be figured in the same manner as shown in section 611 of the Internal Revenue Code and regulation section 1.611-3.

Timber depletion is discussed in chapter 10 in Publication 535.

Example. In April 2003, you had owned 4,000 MBF (1,000 board feet) of standing timber

longer than 1 year. It had an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 2003, the timber had a fair market value (FMV) of \$350 per MBF. It was cut in April for sale. On your 2003 tax return, you choose to treat the cutting of the timber as a sale or exchange. You report the difference between the fair market value and your adjusted basis for depletion as a gain. This amount is reported on Form 4797 along with your other section 1231 gains and losses to figure whether it is treated as capital gain or as ordinary gain. You figure your gain as follows.

FMV of timber January 1, 2003	\$1,400,000
Minus: Adjusted basis for depletion	160,000
	<u>1,240,000</u>

Section 1231 gain **\$1,240,000**

The fair market value becomes your basis in the cut timber and a later sale of the cut timber including any by-product or tree tops will result in ordinary business income or loss.

Cutting contract. You must treat the disposal of standing timber under a cutting contract as a section 1231 transaction if all the following apply to you.

- You are the owner of the timber.
- You held the timber longer than 1 year before its disposal.
- You kept an economic interest in the timber.

The difference between the amount realized from the disposal of the timber and its adjusted basis for depletion is treated as gain or loss on its sale. Include this amount on Form 4797 along with your other section 1231 gains or losses to figure whether it is treated as capital or ordinary gain or loss.

Date of disposal. The date of disposal is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you can choose to treat the date of payment as the date of disposal.

This choice applies only to figure the holding period of the timber. It has no effect on the time for reporting gain or loss (generally when the timber is sold or exchanged).

To make this choice, attach a statement to the tax return filed by the due date (including extensions) for the year payment is received. The statement must identify the advance payments subject to the choice and the contract under which they were made.

If you timely filed your return for the year you received payment without making the choice, you still can make the choice by filing an amended return within 6 months after the due date for that year's return (excluding extensions). Attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" at the top of the statement. File the amended return at the same address the original return was filed.

Owner. The owner of timber is any person who owns an interest in it, including a sublessor and the holder of a contract to cut the timber. You own an interest in timber if you have the right to cut it for sale on your own account or for use in your business.

Economic interest. You have kept an economic interest in standing timber if, under the cutting contract, the expected return on your investment is conditioned on the cutting of the timber.

Tree stumps. Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators after the saleable standing timber was cut and removed from the land are considered by-products. Gain from the sale of stumps in lots or tonnage by such operators is taxed as ordinary income.

Precious Metals and Stones, Stamps, and Coins

Gold, silver, gems, stamps, coins, etc., are capital assets except when they are held for sale by a dealer. Any gain or loss from their sale or exchange generally is a capital gain or loss. If you are a dealer, the amount received from the sale is ordinary business income.

Coal and Iron Ore

You must treat the disposal of coal (including lignite) or iron ore mined in the United States as a section 1231 transaction if both the following apply to you.

- You owned the coal or iron ore longer than 1 year before its disposal.
- You kept an economic interest in the coal or iron ore.

For this rule, the date the coal or iron ore is mined is considered the date of its disposal.

Your gain or loss is the difference between the amount realized from disposal of the coal or iron ore and the adjusted basis you use to figure cost depletion (increased by certain expenses not allowed as deductions for the tax year). This amount is included on Form 4797 along with your other section 1231 gains and losses.

You are considered an **owner** if you own or sublet an economic interest in the coal or iron ore in place. If you own only an option to buy the coal in place, you do not qualify as an owner. In addition, this gain or loss treatment does not apply to income realized by an owner who is a co-adventurer, partner, or principal in the mining of coal or iron ore.

The expenses of making and administering the contract under which the coal or iron ore was disposed of and the expenses of preserving the economic interest kept under the contract are not allowed as deductions in figuring taxable income. Rather, their total, along with the adjusted depletion basis, is deducted from the amount received to determine gain. If the total of these expenses plus the adjusted depletion basis is more than the amount received, the result is a loss.

Special rule. The above treatment does not apply if you directly or indirectly dispose of the iron ore or coal to any of the following persons.

- A related person whose relationship to you would result in the disallowance of a loss (see *Non deductible Loss under Sales and*

Exchanges Between Related Persons, earlier).

- An individual, trust, estate, partnership, association, company, or corporation owned or controlled directly or indirectly by the same interests that own or control your business.

Conversion Transactions

Recognized gain on the disposition or termination of any position held as part of certain conversion transactions is treated as ordinary income. This applies if substantially all your expected return is attributable to the time value of your net investment (like interest on a loan) and the transaction is any of the following.

- An applicable straddle (generally, any set of offsetting positions with respect to personal property, including stock).
- A transaction in which you acquire property and, at or about the same time, you contract to sell the same or substantially identical property at a specified price.
- Any other transaction that is marketed and sold as producing capital gain from a transaction in which substantially all of your expected return is due to the time value of your net investment.

For more information, see chapter 4 of Publication 550.

3.

Ordinary or Capital Gain or Loss for Business Property

Introduction

When you dispose of business property, your taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary or capital is determined under rules for section 1231 transactions.

When you dispose of depreciable property (section 1245 property or section 1250 property) at a gain, you may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any remaining gain is a section 1231 gain.

Topics

This chapter discusses:

- Section 1231 gains and losses

- Depreciation recapture

Useful Items

You may want to see:

Publication

- 534** Depreciating Property Placed in Service Before 1987
- 537** Installment Sales
- 551** Basis of Assets
- 946** How To Depreciate Property
- 954** Tax Incentives for Distressed Communities

Form (and Instructions)

- 4797** Sales of Business Property

See chapter 5 for information about getting publications and forms.

Section 1231 Gains and Losses

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions. Their treatment as ordinary or capital depends on whether you have a net gain or a net loss from all your section 1231 transactions.



If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account as section 1231 gain.

Section 1231 transactions. The following transactions result in gain or loss subject to section 1231 treatment.

- **Sales or exchanges of real property or depreciable personal property.** This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. Depreciable personal property includes amortizable section 197 intangibles (described in chapter 2 under *Other Dispositions*).
- **Sales or exchanges of leaseholds.** The leasehold must be used in a trade or business and held longer than 1 year.
- **Sales or exchanges of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 2 years or longer.
- **Sales or exchanges of other livestock.** This livestock does not include poultry. It must be held for draft, breeding, dairy, or sporting purposes and held for 1 year or longer.
- **Sales or exchanges of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person and the land must be held longer than 1 year. The taxpayer cannot keep any right

or option to directly or indirectly reacquire the land (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a lease on the land, though sold to the same person in the same transaction, are not included.

- **Cutting of timber or disposal of timber, coal, or iron ore.** The cutting or disposal must be treated as a sale, as described in chapter 2 under *Timber and Coal and Iron Ore*.
- **Condemnations.** The condemned property must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
- **Casualties and thefts.** The casualty or theft must have affected business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). You must have held the property longer than 1 year. However, if your casualty or theft losses are more than your casualty or theft gains, neither the gains nor the losses are taken into account in the section 1231 computation. For more information on casualties and thefts, see Publication 547, *Casualties, Disasters, and Thefts*.

Property for sale to customers. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is not a section 1231 transaction. If you will get back all, or nearly all, of your investment in the property by selling it rather than by using it up in your business, it is property held mainly for sale to customers.

Example. You manufacture and sell steel cable, which you deliver on returnable reels that are depreciable property. Customers make deposits on the reels, which you refund if the reels are returned within a year. If they are not returned, you keep each deposit as the agreed-upon sales price. Most reels are returned within the 1-year period. You keep adequate records showing depreciation and other charges to the capitalized cost of the reels. Under these conditions, the reels are not property held for sale to customers in the ordinary course of your business. Any gain or loss resulting from their not being returned may be capital or ordinary, depending on your section 1231 transactions.

Copyrights. The sale of a copyright, a literary, musical, or artistic composition, or similar property is not a section 1231 transaction if your personal efforts created the property, or if you acquired the property in a way that entitled you to the basis of the previous owner whose personal efforts created it (for example, if you receive the property as a gift). The sale of such property results in ordinary income and generally is reported in Part II of Form 4797.

Treatment as ordinary or capital. To determine the treatment of section 1231 gains and losses, combine all your section 1231 gains and losses for the year.

- If you have a **net section 1231 loss**, it is ordinary loss.
- If you have a **net section 1231 gain**, it is ordinary income up to the amount of your nonrecaptured section 1231 losses from previous years. The rest, if any, is long-term capital gain.

Nonrecaptured section 1231 losses. Your nonrecaptured section 1231 losses are your net section 1231 losses for the previous 5 years that have not been applied against a net section 1231 gain by treating the gain as ordinary income. These losses are applied against your net section 1231 gain beginning with the earliest loss in the 5-year period.

Example. Ashley, Inc., a graphic arts company, is a calendar year corporation. In 2000, it had a net section 1231 loss of \$8,000. For tax years 2002 and 2003, the company has net section 1231 gains of \$5,250 and \$4,600, respectively. In figuring taxable income for 2002, Ashley treated its net section 1231 gain of \$5,250 as ordinary income by recapturing \$5,250 of its \$8,000 net section 1231 loss from 2000. In 2003 it applies its remaining net section 1231 loss, \$2,750 (\$8,000 – \$5,250) against its net section 1231 gain, \$4,600. For 2003, the company reports \$2,750 as ordinary income and \$1,850 (\$4,600 – \$2,750) as long-term capital gain.

Tax rate on capital gain. The tax rate on the net capital gain of an individual, estate, or trust is determined by treating any ordinary income from a net section 1231 gain as consisting of, first, any net section 1231 gain in the 28% group, then any net section 1231 gain in the 25% group, and finally any net section 1231 gain in the 20% (15% after May 5, 2003) group. Any long-term capital gain is treated as consisting of any remaining net section 1231 gain in each group. See *Capital Gains Tax Rates* in chapter 4.



*After May 5, 2003, the capital gains tax rate for noncorporate taxpayers with a net section 1231 gain in the 20% group is reduced from 20% to 15%. See *Capital Gains Tax Rates* in chapter 4.*

Example. The facts are the same as in the previous example, except that the company is operated by an individual as a sole proprietorship. The \$4,600 net section 1231 gain for 2003 is the total of a \$1,000 net section 1231 gain in the 28% group and a \$3,600 net section 1231 gain in the 20% group. The \$2,750 treated as ordinary income consists of the \$1,000 gain in the 28% group and \$1,750 of the gain in the 20% group. The tax rate on the individual's net capital gain for 2003 is determined by including the \$1,850 long-term capital gain in the 20% group.

Depreciation Recapture

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income.



To figure any gain that must be reported as ordinary income, you must keep permanent records of the facts necessary to figure the depreciation or amortization allowed or allowable on your property. This includes the date and manner of acquisition, cost or other basis, depreciation or amortization, and all other adjustments that affect basis.

On property you acquired in a nontaxable exchange or as a gift, your records also must indicate the following information.

- Whether the adjusted basis was figured using depreciation or amortization you claimed on other property.
- Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Corporate distributions. For information on property distributed by corporations, see *Distributions to Shareholders* in Publication 542, *Corporations*.

General asset accounts. Different rules apply to dispositions of property you depreciated using a general asset account. For information on these rules, see section 1.168(i)–1(e) of the regulations.

Section 1245 Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property. See *Gain Treated as Ordinary Income*, later.

Any gain recognized that is more than the part that is ordinary income from depreciation is a section 1231 gain. See *Treatment as ordinary or capital* under *Section 1231 Gains and Losses*, earlier.

Section 1245 property. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property.

- 1) Personal property (either tangible or intangible).
- 2) Other tangible property (except buildings and their structural components) used as any of the following.
 - a) An integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
 - b) A research facility in any of the activities in (a).
 - c) A facility in any of the activities in (a) for the bulk storage of fungible commodities.
- 3) That part of real property (not included in (2)) with an adjusted basis that was reduced by certain amortization deductions (including those for certified pollution control facilities, childcare facilities, removal of architectural barriers to persons with disabilities and the elderly, or reforestation expenses) or a section 179 deduction.

- 4) Single purpose agricultural (livestock) or horticultural structures.
- 5) Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

Buildings and structural components.

Section 1245 property does not include buildings and structural components. Do **not** treat structures that are essentially items of machinery or equipment as buildings and structural components. Also, do not treat as buildings structures that house property used as an integral part of an activity if the structures' use is so closely related to the property's use that the structures can be expected to be replaced when the property they initially house is replaced. The fact that the structures are specially designed to withstand the stress and other demands of the property and the fact that the structures cannot be used economically for other purposes indicate that they are closely related to the use of the property they house. Structures such as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples are not treated as buildings.

Facility for bulk storage of fungible commodities. This term includes oil or gas storage tanks and grain storage bins. Bulk storage means the storage of a commodity in a large mass before it is used. For example, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage. To be fungible, a commodity must be such that one part may be used in place of another.

Stored materials that vary in composition, size, and weight are not fungible. Materials are not fungible if one part cannot be used in place of another part and the materials cannot be estimated and replaced by simple reference to weight, measure, and number. For example, the storage of different grades and forms of aluminum scrap is not storage of fungible commodities.

Gain Treated as Ordinary Income

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is the **lesser** of the following amounts.

- 1) The depreciation and amortization allowed or allowable on the property.
- 2) The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

A limit on this amount for gain on like-kind exchanges and involuntary conversions is explained later.

For any other disposition of section 1245 property, ordinary income is the lesser of (1) earlier or the amount by which its fair market value is more than its adjusted basis. See *Gifts and Transfers at Death*, later.

Use Part III of Form 4797 to figure the ordinary income part of the gain.

Depreciation taken on other property or taken by other taxpayers. Depreciation and amortization include the amounts you claimed

on the section 1245 property as well as the following depreciation and amortization amounts.

- Amounts you claimed on property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion.
- Amounts a previous owner of the section 1245 property claimed if your basis is determined with reference to that person's adjusted basis (for example, the donor's depreciation deductions on property you received as a gift).

Depreciation and amortization. Depreciation and amortization that must be recaptured as ordinary income include (but are not limited to) the following items.

- 1) Ordinary depreciation deductions.
- 2) The 30% special depreciation allowance for property acquired after September 10, 2001.
- 3) The 50% special depreciation allowance for property acquired after May 5, 2003.
- 4) Amortization deductions for all the following costs.
 - a) Acquiring a lease.
 - b) Lessee improvements.
 - c) Pollution control facilities.
 - d) Reforestation expenses.
 - e) Section 197 intangibles.
 - f) Childcare facility expenses made before 1982.
 - g) Franchises, trademarks, and trade names acquired before August 11, 1993.
- 5) The section 179 deduction.
- 6) Deductions for all the following costs.
 - a) Removing barriers to the disabled and the elderly.
 - b) Tertiary injectant expenses.
 - c) Depreciable clean-fuel vehicles and refueling property (minus the amount of any recaptured deduction).
 - d) Environmental cleanup costs.
- 7) Any basis reduction for the investment credit (minus any basis increase for credit recapture).
- 8) Any basis reduction for the qualified electric vehicle credit (minus any basis increase for credit recapture).

Example. You file your returns on a calendar year basis. In February 2001, you bought and placed in service for 100% use in your business a light-duty truck (5-year property) that cost \$10,000. You used the half-year convention and your MACRS deductions for the truck were \$2,000 in 2001 and \$3,200 in 2002. You did not take the section 179 deduction on it. You sold the truck in May 2003 for \$7,000. The MACRS deduction in 2003, the year of sale, is \$960 (1/2

of \$1,920). Figure the gain treated as ordinary income as follows.

1) Amount realized	\$7,000
2) Cost (February 2001)	\$10,000
3) Depreciation allowed or allowable (MACRS deductions: \$2,000 + \$3,200 + \$960)	6,160
4) Adjusted basis (subtract line 3 from line 2)	\$3,840
5) Gain realized (subtract line 4 from line 1)	\$3,160
6) Gain treated as ordinary income (lesser of line 3 or line 5)	\$3,160

Depreciation on other tangible property. You must take into account depreciation during periods when the property was not used as an integral part of an activity or did not constitute a research or storage facility, as described earlier under *Section 1245 property*.

For example, if depreciation deductions taken on certain storage facilities amounted to \$10,000, of which \$6,000 is from the periods before their use in a prescribed business activity, you must use the entire \$10,000 in determining ordinary income from depreciation.

Depreciation allowed or allowable. The greater of the depreciation allowed or allowable is generally the amount to use in figuring the part of gain to report as ordinary income. If, in prior years, you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method.

This treatment applies only when figuring what part of gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

Multiple asset accounts. In figuring ordinary income from depreciation, you can treat any number of units of section 1245 property in a single depreciation account as one item if the total ordinary income from depreciation figured by using this method is not less than it would be if depreciation on each unit were figured separately.

Example. In one transaction you sold 50 machines, 25 trucks, and certain other property that is not section 1245 property. All of the depreciation was recorded in a single depreciation account. After dividing the total received among the various assets sold, you figured that each unit of section 1245 property was sold at a gain. You can figure the ordinary income from depreciation as if the 50 machines and 25 trucks were one item.

However, if 5 of the trucks had been sold at a loss, only the 50 machines and 20 of the trucks could be treated as one item in determining the ordinary income from depreciation.

Normal retirement. The normal retirement of section 1245 property in multiple asset accounts does not require recognition of gain as ordinary income from depreciation if your method of accounting for asset retirements does not require recognition of that gain.

Section 1250 Property

Gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. To determine the additional depreciation on section 1250 property, see *Additional Depreciation*, later.

Section 1250 property defined. This includes all real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable.

If your section 1250 property becomes section 1245 property because you change its use, you can never again treat it as section 1250 property.

Additional Depreciation

If you hold section 1250 property longer than 1 year, the additional depreciation is the actual depreciation adjustments that are more than the depreciation figured using the straight line method. For a list of items treated as depreciation adjustments, see *Depreciation and amortization under Gain Treated as Ordinary Income*, earlier.

If you hold section 1250 property for 1 year or less, all the depreciation is additional depreciation.

You will not have additional depreciation if any of the following conditions apply to the property disposed of.

- You figured depreciation for the property using the straight line method or any other method that does not result in depreciation that is more than the amount figured by the straight line method; you held the property longer than 1 year; and, if the property was qualified New York Liberty Zone property, you made a timely election not to claim the 30% or 50% special depreciation allowance. (In addition, if the property was in a renewal community, you must not have elected to claim a commercial revitalization deduction as figured under section 1400I of the Internal Revenue Code.)
- The property was residential low-income rental property you held for 16 $\frac{2}{3}$ years or longer. (For low-income rental housing on which the special 60-month depreciation for rehabilitation expenses was allowed, the 16 $\frac{2}{3}$ years start when the rehabilitated property is placed in service.)
- You chose the alternate ACRS method for the property, which was a type of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- The property was residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made); you held it longer than 1 year; and, if the property was qualified New York Liberty Zone property, you made a timely election not to claim the 30% or the 50% special depreciation allowance. These

properties are depreciated using the straight line method. (In addition, if the property was in a renewal community, you must not have elected to claim a commercial revitalization deduction as figured under section 1400I of the Internal Revenue Code.)

Depreciation taken by other taxpayers or on other property. Additional depreciation includes all depreciation adjustments to the basis of section 1250 property whether allowed to you or another person (as carryover basis property).

Example. Larry Johnson gives his son section 1250 property on which he took \$2,000 in depreciation deductions, of which \$500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the \$500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of \$1,000 on the property, of which \$200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is \$700 (\$500 allowed the father plus \$200 allowed the son).

Depreciation allowed or allowable. The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) generally is the amount to use in figuring the part of the gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the lesser figure will be the depreciation adjustment for figuring additional depreciation.

Retired or demolished property. The adjustments reflected in adjusted basis generally do not include deductions for depreciation on retired or demolished parts of section 1250 property unless these deductions are reflected in the basis of replacement property that is section 1250 property.

Example. A wing of your building is totally destroyed by fire. The depreciation adjustments figured in the adjusted basis of the building after the wing is destroyed do not include any deductions for depreciation on the destroyed wing unless it is replaced and the adjustments for depreciation on it are reflected in the basis of the replacement property.

Figuring straight line depreciation. The useful life and salvage value you would have used to figure straight line depreciation are the same as those used under the depreciation method you actually used. If you did not use a useful life under the depreciation method actually used (such as with the units-of-production method) or if you did not take salvage value into account (such as with the declining balance method), the useful life or salvage value for figuring what would have been the straight line depreciation is the useful life and salvage value you would have used under the straight line method.

Salvage value and useful life are not used for the ACRS method of depreciation. Figure straight line depreciation for ACRS real property by using its 15-, 18-, or 19-year recovery period as the property's useful life.

The straight line method is applied without any basis reduction for the investment credit.

Property held by lessee. If a lessee makes a leasehold improvement, the lease period for figuring what would have been the straight line depreciation adjustments includes all renewal periods. This inclusion of the renewal periods cannot extend the lease period taken into account to a period that is longer than the remaining useful life of the improvement. The same rule applies to the cost of acquiring a lease.

The term **renewal period** means any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee. However, the inclusion of renewal periods cannot extend the lease by more than two-thirds of the period that was the basis on which the actual depreciation adjustments were allowed.

Rehabilitation expenses. A part of the special 60-month depreciation adjustment allowed for rehabilitation expenses incurred before 1987 in connection with low-income rental housing is additional depreciation. The additional depreciation is the special depreciation adjustments that are more than the adjustments that would have resulted if the straight line method, normal useful life, and salvage value had been used.

Example. On January 7, 2003, Fred Plums, a calendar year taxpayer, sold real property in which the entire basis was from rehabilitation expenses of \$40,000 incurred in 1985. The property was placed in service on January 3, 1986. Under the special depreciation provisions for rehabilitation expenses, the property was depreciated under the straight line method using a useful life of 60 months (5 years) and no salvage value. If Fred had used the regular straight line method, he would have used a salvage value of \$4,000 and a useful life of 15 years, and would have had a depreciable basis of \$36,000. Depreciation under the straight line method would have been \$2,400 each year ($\frac{1}{15} \times \$36,000$). On January 1, 2003, the additional depreciation for the property was \$4,000, figured as follows.

	Depreciation Claimed	Straight Line Depreciation	Additional Depreciation
1986	8,000	2,400	5,600
1987	8,000	2,400	5,600
1988	8,000	2,400	5,600
1989	8,000	2,400	5,600
1990	8,000	2,400	5,600
1991		2,400	(2,400)
1992		2,400	(2,400)
1993		2,400	(2,400)
1994		2,400	(2,400)
1995		2,400	(2,400)
1996		2,400	(2,400)
1997		2,400	(2,400)
1998		2,400	(2,400)
1999		2,400	(2,400)
2000		2,400	(2,400)
Total	\$40,000	\$36,000	\$4,000

Applicable Percentage

The applicable percentage used to figure the ordinary income because of additional depreciation depends on whether the real property you

disposed of is nonresidential real property, residential rental property, or low-income housing. The percentages for these types of real property are as follows.

Nonresidential real property. For real property that is not residential rental property, the applicable percentage for periods after 1969 is 100%. For periods before 1970, the percentage is zero and no ordinary income because of additional depreciation before 1970 will result from its disposition.

Residential rental property. For residential rental property (80% or more of the gross income is from dwelling units) other than low-income housing, the applicable percentage for periods after 1975 is 100%. The percentage for periods before 1976 is zero. Therefore, no ordinary income because of additional depreciation before 1976 will result from a disposition of residential rental property.

Low-income housing. Low-income housing includes all the following types of residential rental property.

- Federally assisted housing projects if the mortgage is insured under section 221(d)(3) or 236 of the National Housing Act or housing financed or assisted by direct loan or tax abatement under similar provisions of state or local laws.
- Low-income rental housing for which a depreciation deduction for rehabilitation expenses was allowed.
- Low-income rental housing held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under provisions of state or local laws that authorize similar subsidies for low-income families.
- Housing financed or assisted by direct loan or insured under Title V of the Housing Act of 1949.

The applicable percentage for low-income housing is 100% minus 1% for each full month the property was held over 100 full months. If you have held low-income housing at least 16 years and 8 months, the percentage is zero and no ordinary income will result from its disposition.

Foreclosure. If low-income housing is disposed of because of foreclosure or similar proceedings, the monthly applicable percentage reduction is figured as if you disposed of the property on the starting date of the proceedings.

Example. On June 1, 1991, you acquired low-income housing property. On April 3, 2002 (130 months after the property was acquired), foreclosure proceedings were started on the property and on December 3, 2003 (150 months after the property was acquired), the property was disposed of as a result of the foreclosure proceedings. The property qualifies for a reduced applicable percentage because it was held more than 100 full months. The applicable percentage reduction is 30% (130 months minus 100 months) rather than 50% (150 months minus 100 months) because it does not apply after April 3, 2002, the starting date of the foreclosure proceedings. Therefore, 70% of the additional depreciation is treated as ordinary income.

Holding period. The holding period used to figure the applicable percentage for low-income housing generally starts on the day after you acquired it. For example, if you bought low-income housing on January 1, 1987, the holding period starts on January 2, 1987. If you sold it on January 2, 2003, the holding period is exactly 192 full months. The applicable percentage for additional depreciation is 8%, or 100% minus 1% for each full month the property was held over 100 full months.

Holding period for constructed, reconstructed, or erected property. The holding period used to figure the applicable percentage for low-income housing you constructed, reconstructed, or erected starts on the first day of the month it is placed in service in a trade or business, in an activity for the production of income, or in a personal activity.

Property acquired by gift or received in a tax-free transfer. For low-income housing you acquired by gift or in a tax-free transfer the basis in the hands of the transferor, the holding period for the applicable percentage includes the holding period of the transferor.

If the adjusted basis of the property in your hands just after acquiring it is more than its adjusted basis to the transferor just before transferring it, the holding period of the difference is figured as if it were a separate improvement. See *Low-Income Housing With Two or More Elements*, next.

Low-Income Housing With Two or More Elements

If you dispose of low-income housing property that has two or more separate elements, the applicable percentage used to figure ordinary income because of additional depreciation may be different for each element. The gain to be reported as ordinary income is the sum of the ordinary income figured for each element.

The following are the types of separate elements.

- A separate improvement (defined later).
- The basic section 1250 property plus improvements not qualifying as separate improvements.
- The units placed in service at different times before all the section 1250 property is finished. For example, this happens when a taxpayer builds an apartment building of 100 units and places 30 units in service (available for renting) on January 4, 2002, 50 on July 18, 2002, and the remaining 20 on January 18, 2003. As a result, the apartment house consists of three separate elements.

The 36-month test for separate improvements. A **separate improvement** is any improvement (qualifying under *The 1-year test*, below) added to the capital account of the property, but only if the total of the improvements during the 36-month period ending on the last day of any tax year is more than the greatest of the following amounts.

- 1) One-fourth of the adjusted basis of the property at the start of the first day of the

36-month period, or the first day of the holding period of the property, whichever is later.

- 2) One-tenth of the unadjusted basis (adjusted basis plus depreciation and amortization adjustments) of the property at the start of the period determined in (1).
- 3) \$5,000.

The 1-year test. An addition to the capital account for any tax year (including a short tax year) is treated as an improvement only if the sum of all additions for the year is more than the greater of \$2,000 or 1% of the unadjusted basis of the property. The unadjusted basis is figured as of the start of that tax year or the holding period of the property, whichever is later. In applying the 36-month test, improvements in any one of the 3 years are omitted entirely if the total improvements in that year do not qualify under the 1-year test.

Example. The unadjusted basis of a calendar year taxpayer's property was \$300,000 on January 1, 1990. During that year, the taxpayer made improvements A, B, and C, which cost \$1,000, \$600, and \$700, respectively. The sum of the improvements, \$2,300, is less than 1% of the unadjusted basis (\$3,000), so the improvements in 1990 do not satisfy the 1-year test and are not treated as improvements for the 36-month test. However, if improvement C had cost \$1,500, the sum of the 1990 improvements would have been \$3,100. It then would be necessary to apply the 36-month test to figure if the improvements must be treated as separate improvements.

Addition to the capital account. Any addition to the capital account made after the initial acquisition or completion of the property by you or any person who held the property during a period included in your holding period is to be considered when figuring the total amount of separate improvements.

The addition to the capital account of depreciable real property is the **gross addition** not reduced by amounts attributable to replaced property. For example, if a roof with an adjusted basis of \$20,000 is replaced by a new roof costing \$50,000, the improvement is the gross addition to the account, \$50,000, and not the net addition of \$30,000. The \$20,000 adjusted basis of the old roof is no longer reflected in the basis of the property. The status of an addition to the capital account is not affected by whether it is treated as a separate property for determining depreciation deductions.

Whether an expense is treated as an addition to the capital account may depend on the final disposition of the entire property. If the expense item property and the basic property are sold in two separate transactions, the entire section 1250 property is treated as consisting of two distinct properties.

Unadjusted basis. In figuring the unadjusted basis as of a certain date, include the actual cost of all previous additions to the capital account plus those that did not qualify as separate improvements. However, the cost of components retired before that date is not included in the unadjusted basis.

Holding period. Use the following guidelines for figuring the applicable percentage for property with two or more elements.

- The holding period of a separate element placed in service before the entire section 1250 property is finished starts on the first day of the month that the separate element is placed in service.
- The holding period for each separate improvement qualifying as a separate element starts on the day after the improvement is acquired or, for improvements constructed, reconstructed, or erected, the first day of the month that the improvement is placed in service.
- The holding period for each improvement **not** qualifying as a separate element takes the holding period of the basic property.

If an improvement by itself does not meet the 1-year test (greater of \$2,000 or 1% of the unadjusted basis), but it does qualify as a separate improvement that is a separate element (when grouped with other improvements made during the tax year), determine the start of its holding period as follows. Use the first day of a calendar month that is closest to the middle of the tax year. If there are two first days of a month that are equally close to the middle of the year, use the earlier date.

Figuring ordinary income attributable to each separate element. Figure ordinary income attributable to each separate element as follows.

Step 1. Divide the element's additional depreciation after 1975 by the sum of all the elements' additional depreciation after 1975 to determine the percentage used in Step 2.

Step 2. Multiply the percentage figured in Step 1 by the lesser of the additional depreciation after 1975 for the entire property or the gain from disposition of the entire property (the difference between the fair market value or amount realized and the adjusted basis).

Step 3. Multiply the result in Step 2 by the applicable percentage for the element.

Example. You sold at a gain of \$25,000 low-income housing property subject to the ordinary income rules of section 1250. The property consisted of four elements (W, X, Y, and Z).

Step 1. The additional depreciation for each element is: W—\$12,000; X—None; Y—\$6,000; and Z—\$6,000. The sum of the additional depreciation for all the elements is \$24,000.

Step 2. The depreciation deducted on element X was \$4,000 less than it would have been under the straight line method. Additional depreciation on the property as a whole is \$20,000 (\$24,000 – \$4,000). \$20,000 is lower than the \$25,000 gain on the sale, so \$20,000 is used in Step 2.

Step 3. The applicable percentages to be used in Step 3 for the elements are: W—68%; X—85%; Y—92%; and Z—100%.

From these facts, the sum of the ordinary income for each element is figured as follows.

	Step 1	Step 2	Step 3	Ordinary Income
W	.50	\$10,000	68%	\$ 6,800
X	-0-	-0-	85%	-0-

Y	.25	5,000	92%	4,600
Z	.25	5,000	100%	5,000

Sum of ordinary income of separate elements **\$16,400**

Gain Treated as Ordinary Income

To find what part of the gain from the disposition of section 1250 property is treated as ordinary income, follow these steps.

- 1) In a sale, exchange, or involuntary conversion of the property, figure the amount realized that is more than the adjusted basis of the property. In any other disposition of the property, figure the fair market value that is more than the adjusted basis.
- 2) Figure the additional depreciation for the periods after 1975.
- 3) Multiply the lesser of (1) or (2) by the applicable percentage, discussed earlier. Stop here if this is residential rental property or if (2) is equal to or more than (1). This is the gain treated as ordinary income because of additional depreciation.
- 4) Subtract (2) from (1).
- 5) Figure the additional depreciation for periods after 1969 but before 1976.
- 6) Add the lesser of (4) or (5) to the result in (3). This is the gain treated as ordinary income because of additional depreciation.

A limit on the amount treated as ordinary income for gain on like-kind exchanges and involuntary conversions is explained later.

Use Part III, Form 4797, to figure the ordinary income part of the gain.

Corporations. Corporations, other than S corporations, have an additional amount to recognize as ordinary income on the sale or other disposition of section 1250 property. The additional amount treated as ordinary income is 20% of the excess of the amount that would have been ordinary income if the property were section 1245 property over the amount treated as ordinary income under section 1250. Report this additional ordinary income on line 26(f) of Form 4797, Part III.

Installment Sales

If you report the sale of property under the installment method, any depreciation recapture under section 1245 or 1250 is taxable as ordinary income in the year of sale. This applies even if no payments are received in that year. If the gain is more than the depreciation recapture income, report the rest of the gain using the rules of the installment method. For this purpose, include the recapture income in your installment sale basis to determine your gross profit on the installment sale.

If you dispose of **more than one asset** in a single transaction, you must figure the gain on each asset separately so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to each asset. Report any depreciation recapture income in the year of sale before using the installment method for any remaining gain.

For a detailed discussion of installment sales, see Publication 537.

Gifts

If you make a gift of depreciable personal property or real property, you do not have to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property in a disposition subject to recapture, the donee must take into account the depreciation you deducted in figuring the gain to be reported as ordinary income.

For low-income housing, the donee must take into account the donor's holding period to figure the applicable percentage. See *Applicable Percentage* and its discussion *Holding period* under *Section 1250 Property*, earlier.

Part gift and part sale or exchange. If you transfer depreciable personal property or real property for less than its fair market value in a transaction considered to be partly a gift and partly a sale or exchange and you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain) to recapture depreciation. If the depreciation (additional depreciation, if section 1250 property) is more than the gain, the balance is carried over to the transferee to be taken into account on any later disposition of the property. However, see *Bargain sale to charity*, later.

Example. You transferred depreciable personal property to your son for \$20,000. When transferred, the property had an adjusted basis to you of \$10,000 and a fair market value of \$40,000. You took depreciation of \$30,000. You are considered to have made a gift of \$20,000, the difference between the \$40,000 fair market value and the \$20,000 sale price to your son. You have a taxable gain on the transfer of \$10,000 (\$20,000 sale price minus \$10,000 adjusted basis) that must be reported as ordinary income from depreciation. You report \$10,000 of your \$30,000 depreciation as ordinary income on the transfer of the property, so the remaining \$20,000 depreciation is carried over to your son for him to take into account on any later disposition of the property.

Gift to charitable organization. If you give property to a charitable organization, you figure your deduction for your charitable contribution by reducing the fair market value of the property by the ordinary income and short-term capital gain that would have resulted had you sold the property at its fair market value at the time of the contribution. Thus, your deduction for depreciable real or personal property given to a charitable organization does not include the potential ordinary gain from depreciation.

You also may have to reduce the fair market value of the contributed property by the long-term capital gain (including any section 1231 gain) that would have resulted had the property been sold. For more information, see *Giving Property That Has Increased in Value* in Publication 526, *Charitable Contributions*.

Bargain sale to charity. If you transfer section 1245 or section 1250 property to a charitable organization for less than its fair market value and a deduction for the contribution part of the transfer is allowable, your ordinary income from depreciation is figured under different rules. First, figure the ordinary income as if you had sold the property at its fair market value. Then, allocate that amount between the sale

and the contribution parts of the transfer in the same proportion that you allocated your adjusted basis in the property to figure your gain. (See *Bargain Sale* under *Gain or Loss From Sales and Exchanges* in chapter 1.) Report as ordinary income the lesser of the ordinary income allocated to the sale or your gain from the sale.

Example. You sold section 1245 property in a bargain sale to a charitable organization and are allowed a deduction for your contribution. Your gain on the sale was \$1,200, figured by allocating 20% of your adjusted basis in the property to the part sold. If you had sold the property at its fair market value, your ordinary income would have been \$5,000. Your ordinary income is \$1,000 ($\$5,000 \times 20\%$) and your section 1231 gain is \$200 ($\$1,200 - \$1,000$).

Transfers at Death

When a taxpayer dies, no gain is reported on depreciable personal property or real property transferred to his or her estate or beneficiary. For information on the tax liability of a decedent, see Publication 559, *Survivors, Executors, and Administrators*.

However, if the decedent disposed of the property while alive and, because of his or her method of accounting or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported in the same way the decedent would have had to report it if he or she were still alive.

Ordinary income due to depreciation must be reported on a transfer from an executor, administrator, or trustee to an heir, beneficiary, or other individual if the transfer is a sale or exchange on which gain is realized.

Example 1. Janet Smith owned depreciable property that, upon her death, was inherited by her son. No ordinary income from depreciation is reportable on the transfer, even though the value used for estate tax purposes is more than the adjusted basis of the property to Janet when she died. However, if she sold the property before her death and realized a gain and if, because of her method of accounting, the proceeds from the sale are income in respect of a decedent reportable by her son, he must report ordinary income from depreciation.

Example 2. The trustee of a trust created by a will transfers depreciable property to a beneficiary in satisfaction of a specific bequest of \$10,000. If the property had a value of \$9,000 at the date used for estate tax valuation purposes, the \$1,000 increase in value to the date of distribution is a gain realized by the trust. Ordinary income from depreciation must be reported by the trust on the transfer.

Like-Kind Exchanges and Involuntary Conversions

A like-kind exchange of your depreciable property or an involuntary conversion of the property into similar or related property will not result in your having to report ordinary income from depreciation unless money or property other than like-kind, similar, or related property is also received in the transaction. For information on

like-kind exchanges and involuntary conversions, see chapter 1.

Depreciable personal property. If you have a gain from either a like-kind exchange or an involuntary conversion of your depreciable personal property, the amount to be reported as ordinary income from depreciation is the amount figured under the rules explained earlier (see *Section 1245 Property*), limited to the **sum** of the following amounts.

- The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions.
- The fair market value of the like-kind, similar, or related property other than depreciable personal property acquired in the transaction.

Example 1. You bought a new machine for \$4,300 cash plus your old machine for which you were allowed a \$1,360 trade-in. The old machine cost you \$5,000 two years ago. You took depreciation deductions of \$3,950. Even though you deducted depreciation of \$3,950, the \$310 gain (\$1,360 trade-in allowance minus \$1,050 adjusted basis) is not reported because it is postponed under the rules for like-kind exchanges and you received only depreciable personal property in the exchange.

Example 2. You bought office machinery for \$1,500 two years ago and deducted \$780 depreciation. This year a fire destroyed the machinery and you received \$1,200 from your fire insurance, realizing a gain of \$480 ($\$1,200 - \720 adjusted basis). You choose to postpone reporting gain, but replacement machinery cost you only \$1,000. Your taxable gain under the rules for involuntary conversions is limited to the remaining \$200 insurance payment. All your replacement property is depreciable personal property, so your ordinary income from depreciation is limited to \$200.

Example 3. A fire destroyed office machinery you bought for \$116,000. The depreciation deductions were \$91,640 and the machinery had an adjusted basis of \$24,360. You received a \$117,000 insurance payment, realizing a gain of \$92,640.

You immediately spent \$105,000 of the insurance payment for replacement machinery and \$9,000 for stock that qualifies as replacement property and you choose to postpone reporting the gain. \$114,000 of the \$117,000 insurance payment was used to buy replacement property, so the gain that must be included in income under the rules for involuntary conversions is the part not spent, or \$3,000. The part of the insurance payment (\$9,000) used to buy the nondepreciable property (the stock) also must be included in figuring the gain from depreciation.

The amount you must report as ordinary income on the transaction is \$12,000, figured as follows.

- 1) Gain realized on the transaction
($\$92,640$) limited to depreciation
($\$91,640$) \$91,640
- 2) Gain includible in income
(amount not spent) \$3,000

Plus: fair market value of property other than depreciable personal property (the stock) 9,000 12,000

Amount reportable as ordinary income (lesser of (1) or (2)) \$12,000

If, instead of buying \$9,000 in stock, you bought \$9,000 worth of depreciable personal property similar or related in use to the destroyed property, you would only report \$3,000 as ordinary income.

Depreciable real property. If you have a gain from either a like-kind exchange or involuntary conversion of your depreciable real property, ordinary income from additional depreciation is figured under the rules explained earlier (see *Section 1250 Property*), limited to the **greater** of the following amounts.

- The gain that must be reported under the rules for like-kind exchanges or involuntary conversions **plus** the fair market value of stock bought as replacement property in acquiring control of a corporation.
- The gain you would have had to report as ordinary income from additional depreciation had the transaction been a cash sale **minus** the cost (or fair market value in an exchange) of the depreciable real property acquired.

The ordinary income not reported for the year of the disposition is carried over to the depreciable real property acquired in the like-kind exchange or involuntary conversion as additional depreciation from the property disposed of. Further, to figure the applicable percentage of additional depreciation to be treated as ordinary income, the holding period starts over for the new property.

Example. The state paid you \$116,000 when it condemned your depreciable real property for public use. You bought other real property similar in use to the property condemned for \$110,000 (\$15,000 for depreciable real property and \$95,000 for land). You also bought stock for \$5,000 to get control of a corporation owning property similar in use to the property condemned. You choose to postpone reporting the gain. If the transaction had been a sale for cash only, under the rules described earlier, \$20,000 would have been reportable as ordinary income because of additional depreciation.

The ordinary income to be reported is \$6,000, which is the greater of the following amounts.

- 1) The gain that must be reported under the rules for involuntary conversions, \$1,000 (\$116,000 – \$115,000) **plus** the fair market value of stock bought as qualified replacement property, \$5,000, for a total of \$6,000.
- 2) The gain you would have had to report as ordinary income from additional depreciation (\$20,000) had this transaction been a cash sale **minus** the cost of the depreciable real property bought (\$15,000), or \$5,000.

The ordinary income not reported, \$14,000 (\$20,000 – \$6,000), is carried over to the depre-

ciable real property you bought as additional depreciation.

Basis of property acquired. If the ordinary income you have to report because of additional depreciation is limited, the total basis of the property you acquired is its fair market value (its cost, if bought to replace property involuntarily converted into money) minus the gain postponed.

If you acquired more than one item of property, allocate the total basis among the properties in proportion to their fair market value (their cost, in an involuntary conversion into money). However, if you acquired both depreciable real property and other property, allocate the total basis as follows.

- 1) Subtract the ordinary income because of additional depreciation that you do not have to report from the fair market value (or cost) of the depreciable real property acquired.
- 2) Add the fair market value (or cost) of the other property acquired to the result in (1).
- 3) Divide the result in (1) by the result in (2).
- 4) Multiply the total basis by the result in (3). This is the basis of the depreciable real property acquired. If you acquired more than one item of depreciable real property, allocate this basis amount among the properties in proportion to their fair market value (or cost).
- 5) Subtract the result in (4) from the total basis. This is the basis of the other property acquired. If you acquired more than one item of other property, allocate this basis amount among the properties in proportion to their fair market value (or cost).

Example 1. In 1986, low-income housing property that you acquired and placed in service in 1981 was destroyed by fire and you received a \$90,000 insurance payment. The property's adjusted basis was \$38,400, with additional depreciation of \$14,932. On December 1, 1986, you used the insurance payment to acquire and place in service replacement low-income housing property.

Your realized gain from the involuntary conversion was \$51,600 (\$90,000 – \$38,400). You chose to postpone reporting the gain under the involuntary conversion rules. Under the rules for depreciation recapture on real property, the ordinary gain was \$14,932, but you did not have to report any of it because of the limit for involuntary conversions.

The basis of the replacement low-income housing property was its \$90,000 cost minus the \$51,600 gain you postponed, or \$38,400. The \$14,932 ordinary gain you did not report is treated as additional depreciation on the replacement property. When you dispose of the property, your holding period for figuring the applicable percentage of additional depreciation to report as ordinary income will have begun December 2, 1986, the day after you acquired the property.

Example 2. John Adams received a \$90,000 fire insurance payment for depreciable real property (office building) with an adjusted basis of \$30,000. He uses the whole payment to buy property similar in use, spending \$42,000

for depreciable real property and \$48,000 for land. He chooses to postpone reporting the \$60,000 gain realized on the involuntary conversion. Of this gain, \$10,000 is ordinary income from additional depreciation but is not reported because of the limit for involuntary conversions of depreciable real property. The basis of the property bought is \$30,000 (\$90,000 – \$60,000), allocated as follows.

- 1) The \$42,000 cost of depreciable real property minus \$10,000 ordinary income not reported is \$32,000.
- 2) The \$48,000 cost of other property (land) plus the \$32,000 figured in (1) is \$80,000.
- 3) The \$32,000 figured in (1) divided by the \$80,000 figured in (2) is 0.4.
- 4) The basis of the depreciable real property is \$12,000. This is the \$30,000 total basis multiplied by the 0.4 figured in (3).
- 5) The basis of the other property (land) is \$18,000. This is the \$30,000 total basis minus the \$12,000 figured in (4).

The ordinary income that is not reported (\$10,000) is carried over as additional depreciation to the depreciable real property that was bought and may be taxed as ordinary income on a later disposition.

Multiple Properties

If you dispose of both depreciable property and other property in one transaction and realize a gain, you must allocate the amount realized between the two types of property in proportion to their respective fair market values to figure the part of your gain to be reported as ordinary income from depreciation. Different rules may apply to the allocation of the amount realized on the sale of a business that includes a group of assets. See chapter 2.

In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the depreciable property and other property, any arm's-length agreement between them will establish the allocation.

In the absence of an agreement, the allocation should be made by taking into account the appropriate facts and circumstances. These include, but are not limited to, a comparison between the depreciable property and all the other property being disposed of in the transaction. The comparison should take into account all the following facts and circumstances.

- The original cost and reproduction cost of construction, erection, or production.
- The remaining economic useful life.
- The state of obsolescence.
- The anticipated expenditures required to maintain, renovate, or modernize the properties.

Like-kind exchanges and involuntary conversions. If you dispose of and acquire both depreciable personal property and other property (other than depreciable real property) in a like-kind exchange or involuntary conversion, the amount realized is allocated in the following way. The amount allocated to the depreciable personal property disposed of is treated as consisting of, first, the fair market value of the depre-

depreciable personal property acquired and, second (to the extent of any remaining balance), the fair market value of the other property acquired. The amount allocated to the other property disposed of is treated as consisting of the fair market value of all property acquired that has not already been taken into account.

If you dispose of and acquire depreciable real property and other property in a like-kind exchange or involuntary conversion, the amount realized is allocated in the following way. The amount allocated to each of the three types of property (depreciable real property, depreciable personal property, or other property) disposed of is treated as consisting of, first, the fair market value of that type of property acquired and, second (to the extent of any remaining balance), any excess fair market value of the other types of property acquired. (If the excess fair market value is more than the remaining balance of the amount realized and is from both of the other two types of property, you can apply the unallocated amount in any manner you choose.)

Example. A fire destroyed your property with a total fair market value of \$50,000. It consisted of machinery worth \$30,000 and nondepreciable property worth \$20,000. You received an insurance payment of \$40,000 and immediately used it with \$10,000 of your own funds (for a total of \$50,000) to buy machinery with a fair market value of \$15,000 and nondepreciable property with a fair market value of \$35,000. The adjusted basis of the destroyed machinery was \$5,000 and your depreciation on it was \$35,000. You choose to postpone reporting your gain from the involuntary conversion. You must report \$9,000 as ordinary income from depreciation arising from this transaction, figured as follows.

- 1) The \$40,000 insurance payment must be allocated between the machinery and the other property destroyed in proportion to the fair market value of each. The amount allocated to the machinery is $30,000 / 50,000 \times \$40,000$, or \$24,000. The amount allocated to the other property is $20,000 / 50,000 \times \$40,000$, or \$16,000. Your gain on the involuntary conversion of the machinery is \$24,000 minus \$5,000 adjusted basis, or \$19,000.
- 2) The \$24,000 allocated to the machinery disposed of is treated as consisting of the \$15,000 fair market value of the replacement machinery bought and \$9,000 of the fair market value of other property bought in the transaction. All \$16,000 allocated to the other property disposed of is treated as consisting of the fair market value of the other property that was bought.
- 3) Your potential ordinary income from depreciation is \$19,000, the gain on the machinery, because it is less than the \$35,000 depreciation. However, the amount you must report as ordinary income is limited to the \$9,000 included in the amount realized for the machinery that represents the fair market value of property other than the depreciable property you bought.

4.

Reporting Gains and Losses

Introduction

This chapter explains how to report capital gains and losses and ordinary gains and losses from sales, exchanges, and other dispositions of property.

Although this discussion refers to Schedule D (Form 1040), the rules discussed here also apply to taxpayers other than individuals. However, the rules for property held for personal use usually will not apply to taxpayers other than individuals.

Topics

This chapter discusses:

- Information returns
- Schedule D (Form 1040)
- Form 4797

Useful Items

You may want to see:

Publication

- 550** Investment Income and Expenses
- 537** Installment Sales
- 954** Tax Incentives for Distressed Communities

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 1099-B** Proceeds From Broker and Barter Exchange Transactions
- 1099-S** Proceeds From Real Estate Transactions
- 4684** Casualties and Thefts
- 4797** Sales of Business Property
- 6252** Installment Sale Income
- 8824** Like-Kind Exchanges

See chapter 5 for information about getting publications and forms.

Information Returns

If you sell or exchange certain assets, you should receive an information return showing the proceeds of the sale. This information is also provided to the Internal Revenue Service.

Form 1099-B. If you sold stocks, bonds, commodities, etc., you should receive Form 1099-B or an equivalent statement. Whether or not you receive Form 1099-B, you must report

all taxable sales of stocks, bonds, commodities, etc., on Schedule D. For more information on figuring gains and losses from these transactions, see chapter 4 in Publication 550.

Form 1099-S. An information return must be provided on certain real estate transactions. Generally, the person responsible for closing the transaction must report on Form 1099-S sales or exchanges of the following types of property.

- Land (improved or unimproved), including air space.
- An inherently permanent structure, including any residential, commercial, or industrial building.
- A condominium unit and its related fixtures and common elements (including land).
- Stock in a cooperative housing corporation.

If you sold or exchanged any of the above types of property, the reporting person must give you a copy of Form 1099-S or a statement containing the same information as the Form 1099-S.

If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting it does not have to value that property or those services. In that case, the gross proceeds reported on Form 1099-S will be less than the sales price of the property you sold. Figure any gain or loss according to the sales price, which is the total amount you realized on the transaction.

Schedule D (Form 1040)

Use Schedule D to report sales, exchanges, and other dispositions of capital assets.



Before completing Schedule D (Form 1040), you may have to complete other forms as shown below.

- For a sale, exchange, or involuntary conversion of business property, complete Form 4797.
- For a like-kind exchange, complete Form 8824. (See Reporting the exchange under Like-Kind Exchanges in chapter 1.)
- For an installment sale, complete Form 6252. (See Publication 537.)
- For an involuntary conversion due to casualty or theft, complete Form 4684. (See Publication 547, Casualties, Disasters, and Thefts.)
- For a disposition of an interest in, or property used in, an activity to which the at-risk rules apply, complete Form 6198, At-Risk Limitations. (See Publication 925, Passive Activity and At-Risk Rules.)
- For a disposition of an interest in, or property used in, a passive activity, complete Form 8582, Passive Activity Loss Limitations. (See Publication 925.)

Personal-use property. Report gain on the sale or exchange of property held for personal

use (such as your home) on Schedule D. Loss from the sale or exchange of property held for personal use is not deductible. But if you had a loss from the sale or exchange of real estate held for personal use for which you received a Form 1099-S, report the transaction on Schedule D, even though the loss is not deductible. Complete columns (a) through (e) and enter -0- in column (f).

Long and Short Term

Where you report a capital gain or loss depends on how long you own the asset before you sell or exchange it. The time you own an asset before disposing of it is the holding period.

If you hold a capital asset 1 year or less, the gain or loss from its disposition is short term. Report it in Part I of Schedule D. If you hold a capital asset longer than 1 year, the gain or loss from its disposition is long term. Report it in Part II of Schedule D (Form 1040).

Table 4-1. Do I Have a Short-Term or Long-Term Gain or Loss?

IF you hold the property...	THEN you have a...
1 year or less,	Short-term capital gain or loss.
More than 1 year,	Long-term capital gain or loss.

These distinctions are essential to correctly arrive at your net capital gain or loss. Capital losses are allowed in full against capital gains plus up to \$3,000 of ordinary income. The tax rate for capital gains is explained later under *Capital Gains Tax Rates*.

Holding period. To figure if you held property longer than 1 year, start counting on the day following the day you acquired the property. The day you disposed of the property is part of your holding period.

Example. If you bought an asset on June 19, 2002, you should start counting on June 20, 2002. If you sold the asset on June 19, 2003, your holding period is not longer than 1 year, but if you sold it on June 20, 2003, your holding period is longer than 1 year.

Patent property. If you dispose of patent property, you generally are considered to have

held the property longer than 1 year, no matter how long you actually held it. For more information, see *Patents* in chapter 2.

Inherited property. If you inherit property, you are considered to have held the property longer than 1 year, regardless of how long you actually held it.

Installment sale. The gain from an installment sale of an asset qualifying for long-term capital gain treatment in the year of sale continues to be long term in later tax years. If it is short term in the year of sale, it continues to be short term when payments are received in later tax years.



The date the installment payment is received determines the capital gains rate that should be applied not the date the asset was sold under an installment contract.

Nontaxable exchange. If you acquire an asset in exchange for another asset and your basis for the new asset is figured, in whole or in part, by using your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Example. You bought machinery on December 4, 2002. On June 4, 2003, you traded this machinery for other machinery in a nontaxable exchange. On December 5, 2003, you sold the machinery you got in the exchange. Your holding period for this machinery began on December 5, 2002. Therefore, you held it longer than 1 year.

Corporate liquidation. The holding period for property you receive in a liquidation generally starts on the day after you receive it if gain or loss is recognized.

Profit-sharing plan. The holding period of common stock withdrawn from a qualified contributory profit-sharing plan begins on the day following the day the plan trustee delivered the stock to the transfer agent with instructions to reissue the stock in your name.

Gift. If you receive a gift of property and your basis in it is figured using the donor's basis, your holding period includes the donor's holding pe-

riod. For more information on basis, see Publication 551, *Basis of Assets*.

Real property. To figure how long you held real property, start counting on the day after you received title to it or, if earlier, the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Repossession. If you sell real property but keep a security interest in it and then later repossess it, your holding period for a later sale includes the period you held the property before the original sale, as well as the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

Nonbusiness bad debts. Nonbusiness bad debts are short-term capital losses. For information on nonbusiness bad debts, see chapter 4 of Publication 550.

Net Gain or Loss

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

Net short-term capital gain or loss. Combine your short-term capital gains and losses, including your share of short-term capital gains or losses from partnerships, S corporations, and fiduciaries and any short-term capital loss carryover. Do this by adding all your short-term capital gains. Then add all your short-term capital losses. Subtract the lesser total from the other. The result is your net short-term capital gain or loss.

Net long-term capital gain or loss. Follow the same steps to combine your long-term capital gains and losses. Include the following items.

- Net section 1231 gain from Part I, Form 4797, after any adjustment for nonrecaptured section 1231 losses from prior tax years.
- Capital gain distributions from regulated investment companies (mutual funds) and real estate investment trusts.
- Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
- Any long-term capital loss carryover.

The result from combining these items with other long-term capital gains and losses is your net long-term capital gain or loss.

Net gain. If the total of your capital gains is more than the total of your capital losses, the difference is taxable. However, the part that is not more than your net capital gain may be taxed at a rate that is lower than the rate of tax on your ordinary income. See *Capital Gains Tax Rates*, later.

Net loss. If the total of your capital losses is more than the total of your capital gains, the

Table 4-2. Holding Period for Different Types of Acquisitions

Type of acquisition:	When your holding period starts:
Stocks and bonds bought on a securities market	Day after trading date you bought security. Ends on trading date you sold security.
U.S. Treasury notes and bonds	If bought at auction, day after notification of bid acceptance. If bought through subscription, day after subscription was submitted.
Nontaxable exchanges	Day after date you acquired old property.
Gift	If your basis is giver's adjusted basis, same day as giver's holding period began. If your basis is FMV, day after date of gift.
Real property bought	Generally, day after date you received title to the property.
Real property repossessed	Day after date you originally received title to the property, but does not include time between the original sale and date of repossession.

Table 4-3. What Is Your Maximum Capital Gains Rate?

IF your net capital gain is from...	THEN your maximum capital gains rate is...
Collectibles gain	28%
Gain on qualified small business stock equal to the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain, ¹ and the regular tax rate that would apply is 25% or higher	20% for sales or other dispositions before May 6, 2003
	15% for sales or other dispositions after May 5, 2003 (and installment payments received after that date)
Other gain, ¹ and the regular tax rate that would apply is lower than 25%	8%² or 10% for sales or other dispositions before May 6, 2003
	5% for sales and other dispositions after May 5, 2003 (and installment payments received after that date)
¹ Other gain means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.	
² The rate is 8% only for qualified 5-year gain.	

difference is deductible. But there are limits on how much loss you can deduct and when you can deduct it. See *Treatment of Capital Losses*, next.

Treatment of Capital Losses

If your capital losses are more than your capital gains, you must deduct the difference even if you do not have ordinary income to offset it. The yearly limit on the amount of the capital loss you can deduct is \$3,000 (\$1,500 if you are married and file a separate return).

Capital loss carryover. Generally, you have a capital loss carryover if either of the following situations applies to you.

- Your net loss on line 17 of Schedule D is more than the yearly limit.
- The amount shown on line 38, Form 1040 (your taxable income without your deduction for exemptions), is less than zero.

If either of these situations applies to you for 2003, see *Capital Losses* under *Reporting Capital Gains and Losses* in chapter 4 of Publication 550 to figure the amount you can carry over to 2004.

TIP *To figure your capital loss carryover from 2003 to 2004, you will need a copy of your 2003 Form 1040 and Schedule D.*

In 2004, you will treat the carryover loss as if it occurred in that year. It will be combined with any capital gains and losses you have in 2004, and any net loss will be subject to the limit for that year. Any loss not used in 2004 will be carried over to 2005.

Example. Bob and Gloria Sampson sold property in 2003. The sale resulted in a capital loss of \$7,000. The Sampsons had no other capital transactions. On their joint 2003 return,

the Sampsons deduct \$3,000, the yearly limit. They had taxable income of \$2,000. The unused part of the loss, \$4,000 (\$7,000 – \$3,000), is carried over to 2004.

If the Sampsons' capital loss had been \$2,000, it would not have been more than the yearly limit. Their capital loss deduction would have been \$2,000. They would have no carryover to 2004.

Short-term and long-term losses. When you carry over a loss, it retains its original character as either long term or short term. A short-term loss you carry over to the next tax year is added to short-term losses occurring in that year. A long-term loss you carry over to the next tax year is added to long-term losses occurring in that year. A long-term capital loss you carry over to the next year reduces that year's long-term gains before its short-term gains.

If you have both short-term and long-term losses, your short-term losses are used first against your allowable capital loss deduction. If, after using your short-term losses, you have not reached the limit on the capital loss deduction, use your long-term losses until you reach the limit. This computation of your short-term capital loss carryover or your long-term capital loss carryover would be made on the *Capital Loss Carryover Worksheet* provided in the *2004 Instructions for Schedule D (Form 1040)*.

Joint and separate returns. On a joint return, the capital gains and losses of a husband and wife are figured as the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to \$1,500. Neither you nor your spouse can deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed jointly and are now filing separately, any capital loss carryover

from the joint return can be deducted only on the return of the spouse who actually had the loss.

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The yearly limit discussed earlier still applies in this situation. Even if the loss is greater than the limit, the decedent's estate cannot deduct the difference or carry it over to following years.

Corporations. A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has a net capital loss, it cannot be deducted in the current tax year. It must be carried to other tax years and deducted from capital gains occurring in those years. For more information, see Publication 542.

Capital Gains Tax Rates

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gains rates.

The term *net capital gain* means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

You will need to use Part IV of Schedule D (Form 1040), and the Schedule D Tax Worksheet in certain cases, to figure your tax using the capital gains rates if both of the following are true.

- Both lines 16 and 17 of Schedule D are gains.
- Your taxable income on Form 1040, line 40, is more than zero.

For 2003, the maximum capital gains tax rates are 5%, 8%, 10%, 15%, 20%, 25%, or 28%. See Table 4-3.

TIP *If you figure your tax using the maximum capital gains rates and the regular tax computation results in a lower tax, the regular tax computation applies.*

Using the Capital Gains Rates

The part of a net capital gain subject to each rate is determined by first netting long-term capital gains with long-term capital losses in the following tax rate groups.

- 1) A 28% group, consisting of all the following gains and losses.
 - a) Collectibles gains and losses.
 - b) The part of the gain on qualified small business stock equal to the section 1202 exclusion.
 - c) Any long-term capital loss carryover.
- 2) A 25% group, consisting of unrecaptured section 1250 gain.
- 3) A 20% group, consisting of gains and losses not in the 28% or 25% group. The 20% group is lowered to 15% after May 5, 2003.

If any group has a net loss, the following rules apply.

- A net loss from the 28% group reduces any gain from the 25% group, and then any net gain from the 20% (15% after May 5, 2003) group.
- A net loss from the 20% (15% after May 5, 2003) group reduces any net gain from the 28% group, and then any gain from the 25% group.

If you have a net short-term capital loss, it reduces any net gain from the 28% group, then any gain from the 25% group, and finally any net gain from the 20% (15% after May 5, 2003) group.

The resulting net gain (if any) from each group is subject to the tax rate for that group. (The 10% (5% after May 5, 2003) rate applies to a net gain from the 20% (15% after May 5, 2003) group to the extent that, if there were no capital gains rates, the net capital gain would be taxed at the 15% regular tax rate.)

Collectibles gain or loss. This is gain or loss from the sale or exchange of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held longer than 1 year. Collectibles gain includes gain from the sale of an interest in a partnership, S corporation, or trust attributable to unrealized appreciation of collectibles.

Gain on qualified small business stock. If you realized a gain from qualified small business stock you held longer than 5 years, you exclude up to one-half of your gain from your income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Sales of Small Business Stock* in chapter 1.

Unrecaptured section 1250 gain. This is the part of any long-term capital gain on section 1250 property (real property) that is due to depreciation minus any net loss in the 28% group. Unrecaptured section 1250 gain cannot be more than the net section 1231 gain or include any gain otherwise treated as ordinary income. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and net section 1231 gain, see chapter 3.

Qualified 5-Year Gain

The 10% capital gains rate is lowered to 8% for **qualified 5-year gain** before May 6, 2003. Qualified 5-year gain is long-term capital gain from the sale of property you held longer than 5 years that would otherwise be subject to the 10% or 20% capital gains rate.



After May 5, 2003, the 8% maximum capital gains tax rate for qualified 5-year gain has been eliminated for sales and other dispositions (and installment payments received after that date).

Elimination of 18% rate. In 2006, the 20% rate was scheduled to be lowered to 18% for qualified 5-year gain from property with a holding period that began after 2000. The 18% rate and the 5-year holding period have been eliminated. The new 15% rate applies to gain on property held for more than 1 year.

Taxpayers who owned certain assets on January 1, 2001, could have elected to treat those assets as sold and repurchased on the

same date, if they paid tax for 2001 on any resulting gain. The purpose of the election was to make any future gain on the asset eligible for the 18% rate. That election is irrevocable. Thus, if you made the election, you may **not** amend your 2001 income tax return to get a refund of the tax you paid on the resulting gain.

Net Capital Gain From Disposition of Investment Property

If you choose to include any part of a net capital gain from a disposition of investment property in investment income for figuring your investment interest deduction, you must reduce the net capital gain eligible for the capital gain tax rates by the same amount. You make this choice on Form 4952, *Investment Interest Expense Deduction*, line 4g. For information on making this choice, see the instructions for Form 4952. For information on the investment interest deduction, see chapter 3 in Publication 550.

Form 4797

Use Form 4797 to report gain or loss from a sale, exchange, or involuntary conversion of property used in your trade or business or that is depreciable or amortizable. You can use Form 4797 with Form 1040, 1065, 1120, or 1120S.

Section 1231 gains and losses. Show any section 1231 gains and losses in Part I. Carry a net gain to Schedule D (Form 1040) as a long-term capital gain. Carry a net loss to Part II of Form 4797 as an ordinary loss.

If you had any nonrecaptured net section 1231 losses from the preceding 5 tax years, reduce your net gain by those losses and report the amount of the reduction as an ordinary gain in Part II. Report any remaining gain on Schedule D (Form 1040). See *Section 1231 Gains and Losses* in chapter 3.

Ordinary gains and losses. Show any ordinary gains and losses in Part II. This includes a net loss or a recapture of losses from prior years figured in Part I of Form 4797. It also includes ordinary gain figured in Part III.

Ordinary income from depreciation. Figure the ordinary income from depreciation on personal property and additional depreciation on real property (as discussed in chapter 3) in Part III. Carry the ordinary income to Part II of Form 4797 as an ordinary gain. Carry any remaining gain to Part I as section 1231 gain, unless it is from a casualty or theft. Carry any remaining gain from a casualty or theft to Form 4684.

Example

Jane Smith is single. At the beginning of 2003, she owned and operated Jane's Dress Shop at 25 Main Street, Smalltown, Virginia. On March 16, she traded the land and building where she operated her dress shop for other land and a building around the corner at 97 Oak Street. She then opened the J. Smith Hardware Store. Jane also sold all the equipment she had used in her

dress shop, as well as a vacant lot across the street from the shop used for customer parking. She reports these transactions as shown in the filled-in Form 4797 and Form 8824 at the end of this chapter.

Form 4797

Jane sold the equipment she used in her dress shop for \$3,000. She originally paid \$6,000 for it on January 20, 1986, and had fully depreciated it. She realized a gain of \$3,000. The gain was less than the \$6,000 depreciation taken, so all her gain is ordinary income from depreciation. This amount is reported in Part III of Form 4797 and entered in Part II on line 13.

The adjusted basis of the customer parking lot (acquired in 1980) was \$6,000 and its sales price was \$8,000. Jane reports her \$2,000 gain from the sale in Part I of Form 4797.

Jane had a nonrecaptured net section 1231 loss of \$1,200. She shows this loss in Part I on line 8. The net section 1231 gain of \$2,000 is more than the nonrecaptured loss, so that gain is treated as ordinary gain only up to the loss. Therefore, the loss of \$1,200 on line 8 is entered as an ordinary gain in Part II of Form 4797 on line 12. The loss is also subtracted from the \$2,000 gain on line 7. The \$800 balance is entered on line 9.

Form 8824

Jane entered into a like-kind exchange by trading her business real property for other business real property, so she must report the transaction on Form 8824 and attach the form to her tax return.

On lines 16 and 17 of Form 8824, Jane enters the fair market value of her new property, \$120,000, consisting of \$95,000 for the building and \$25,000 for the land. On line 18, she enters the adjusted basis of the old property, \$100,000, consisting of \$17,687 for the building and \$82,313 for the land. Her realized gain on line 19 is \$20,000. Under the like-kind exchange rules, this gain is not recognized. Jane enters "-0-" on line 20.

However, because there is additional depreciation of \$4,405 on the old building, Jane must determine whether any of her gain has to be recognized as ordinary income under the recapture rules. The old building has an FMV of \$90,000. Had the transaction been a cash sale, Jane's realized gain on the building would have been \$72,313 (\$90,000 - \$17,687). The additional depreciation is less than that amount, so her ordinary income due to the additional depreciation would have been \$4,405. That amount is less than the \$95,000 fair market value of the new building, so there is no ordinary income recognized on the exchange. The \$4,405 ordinary income that does not have to be reported is carried over to the new building as additional depreciation. Jane enters "-0-" on line 21 of Form 8824 and line 16 of Form 4797.

All of Jane's \$20,000 gain is deferred (line 24). The basis of her new property (line 25) is \$100,000, the same as the adjusted basis of her old property. Of that amount, \$79,167 [(\$95,000 ÷ \$120,000) × \$100,000] is allocated to the building and \$20,833 [(\$25,000 ÷ \$120,000) × \$100,000] is allocated to the land.

Summary

The entries in Part II, Form 4797, show an ordinary gain of \$4,200 that is carried to line 14, Form 1040.

The entries in Part I, Form 4797, result in a long-term capital gain of \$800 from section 1231 transactions. This is carried to line 11, Schedule D (Form 1040), column (f).

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ **Attach to your tax return.** ▶ **See separate instructions.**

Name(s) shown on return <i>Jane Smith</i>	Identifying number <i>458-00-0327</i>
--	--

1 Enter the gross proceeds from sales or exchanges reported to you for 2003 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) **1**

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (See instructions.)

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) for entire year. Subtract (f) from the sum of (d) and (e)	(h) Post-May 5, 2003, gain or (loss)* (see below)
<i>2 Customer parking lot</i>	<i>10-1-80</i>	<i>3-16-03</i>	<i>8,000</i>	<i>-0-</i>	<i>6,000</i>	<i>2,000</i>	
3 Gain, if any, from Form 4684, line 39							3
4 Section 1231 gain from installment sales from Form 6252, line 26 or 37							4
5 Section 1231 gain or (loss) from like-kind exchanges from Form 8824							5
6 Gain, if any, from line 32, from other than casualty or theft							6
7 Combine lines 2 through 6 in columns (g) and (h). Enter the gain or (loss) here and on the appropriate line as follows:						<i>2,000</i>	7
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 6, or Form 1120S, Schedule K, line 5. Skip lines 8, 9, 11, and 12 below.							
All others. If line 7, column (g), is zero or a loss, enter that amount on line 11 below and skip lines 8, 9, and 12. If line 7, column (g), is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain or (loss) in each column as a long-term capital gain or (loss) on Schedule D and skip lines 8, 9, 11, and 12 below.							
8 Nonrecaptured net section 1231 losses from prior years (see instructions)						<i>1,200</i>	8
9 Subtract line 8 from line 7. If line 9, column (g), is zero or less, enter -0- in column (g). If line 9, column (g), is more than zero, enter the amount from line 8, column (g), on line 12 below and include the gain or (loss) in each column of line 9 as a long-term capital gain or (loss) on Schedule D (see instructions)						<i>800</i>	9

*Corporations (other than S corporations) should not complete column (h). Partnerships and S corporations must complete column (h). All others must complete column (h) only if line 7, column (g), is a gain and the amount, if any, on line 8, column (g), does not equal or exceed the gain on line 7, column (g). Include in column (h) all gains and losses from column (g) from sales, exchanges, or conversions (including installment payments received) after May 5, 2003. However, do not include gain attributable to unrecaptured section 1250 gain.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 17 (include property held 1 year or less):

11 Loss, if any, from line 7, column (g)							11 ()
12 Gain, if any, from line 7, column (g), or amount from line 8, column (g), if applicable						<i>1,200</i>	12
13 Gain, if any, from line 31						<i>3,000</i>	13
14 Net gain or (loss) from Form 4684, lines 31 and 38a							14
15 Ordinary gain from installment sales from Form 6252, line 25 or 36							15
16 Ordinary gain or (loss) from like-kind exchanges from Form 8824						<i>-0-</i>	16
17 Recapture of section 179 expense deduction for partners and S corporation shareholders for property dispositions from 2002-2003 fiscal year partnerships and S corporations (see instructions)							17
18 Combine lines 10 through 17. Enter the gain or (loss) here and on the appropriate line as follows:						<i>4,200</i>	18
a For all except individual returns. Enter the gain or (loss) from line 18 on the return being filed.							
b For individual returns:							
(1) If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 27, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 22. Identify as from "Form 4797, line 18b(1)." See instructions							
							18b(1)
(2) Redetermine the gain or (loss) on line 18 excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 14							
						<i>4,200</i>	18b(2)

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Store equipment	1-20-86	3-16-03
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ►		Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 before completing.)	20	3,000			
21 Cost or other basis plus expense of sale	21	6,000			
22 Depreciation (or depletion) allowed or allowable	22	6,000			
23 Adjusted basis. Subtract line 22 from line 21	23	-0-			
24 Total gain. Subtract line 23 from line 20	24	3,000			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a	6,000			
b Enter the smaller of line 24 or 25a	25b	3,000			
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the smaller of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the smaller of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see instructions)	28a				
b Enter the smaller of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the smaller of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	3,000
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	3,000
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6, column (g), and if applicable, column (h)	32	-0-

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (See instructions.)

	(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33	
34 Recomputed depreciation. See instructions	34	
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35	

Like-Kind Exchanges
(and section 1043 conflict-of-interest sales)

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return.

Name(s) shown on tax return

Jane Smith

Identifying number

458-00-0327

Part I Information on the Like-Kind Exchange

Note: If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.

- 1 Description of like-kind property given up ▶ Commercial building and land 25 Main Street, Smalltown, VA 20000
- 2 Description of like-kind property received ▶ Commercial building and land 97 Oak Street, Smalltown, VA 20000
- 3 Date like-kind property given up was originally acquired (month, day, year) 3 1 / 20 / 86
- 4 Date you actually transferred your property to other party (month, day, year) 4 3 / 16 / 03
- 5 Date like-kind property you received was identified by written notice to another party (see instructions for 45-day written notice requirement) (month, day, year) 5 3 / 16 / 03
- 6 Date you actually received the like-kind property from other party (month, day, year) (see instructions) 6 3 / 16 / 03
- 7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary) (see instructions)? If "Yes," complete Part II. If "No," go to Part III Yes No

Part II Related Party Exchange Information

- 8 Name of related party Relationship to you Related party's identifying number
Address (no., street, and apt., room, or suite no., city or town, state, and ZIP code)
- 9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party directly or indirectly (such as through an intermediary) sell or dispose of any part of the like-kind property received from you in the exchange? Yes No
- 10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? Yes No
If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is not the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 unless one of the exceptions on line 11 applies.
- 11 If one of the exceptions below applies to the disposition, check the applicable box:
 - a The disposition was after the death of either of the related parties.
 - b The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.
 - c You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as its principal purpose. If this box is checked, attach an explanation (see instructions).

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred and received (a) more than one group of like-kind properties or (b) cash or other (not like-kind) property, see Reporting of multi-asset exchanges in the instructions.

Note: Complete lines 12 through 14 only if you gave up property that was not like-kind. Otherwise, go to line 15.

12	Fair market value (FMV) of other property given up	12			
13	Adjusted basis of other property given up	13			
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale	14			
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred (see instructions)	15		-0-	
16	FMV of like-kind property you received	16		120,000	00
17	Add lines 15 and 16	17		120,000	00
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15 (see instructions)	18		100,000	00
19	Realized gain or (loss). Subtract line 18 from line 17	19		20,000	00
20	Enter the smaller of line 15 or line 19, but not less than zero	20		-0-	
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16 (see instructions)	21		-0-	
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies (see instructions)	22		-0-	
23	Recognized gain. Add lines 21 and 22	23		-0-	
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions	24		20,000	00
25	Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23.	25		100,000	00

5.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.


The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at **1-877-777-4778**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.
- Visit the website at **www.irs.gov/advocate**.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

 **Internet.** You can access the IRS website 24 hours a day, 7 days a week at **www.irs.gov** to:

- **E-file.** Access commercial tax preparation and e-file services available for free to eligible taxpayers.
- Check the amount of advance child tax credit payments you received in 2003.
- Check the status of your 2003 refund. Click on "Where's My Refund" and then on "Go Get My Refund Status." Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.

- Order IRS products online.
- See answers to frequently asked tax questions.
- Search publications online by topic or keyword.
- Figure your withholding allowances using our Form W-4 calculator.
- Send us comments or request help by email.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

You can also reach us using File Transfer Protocol at **ftp.irs.gov**.



Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703-368-9694** from your fax machine. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call **703-487-4608**.

Long-distance charges may apply.



Phone. Many services are available by phone.


- **Ordering forms, instructions, and publications.** Call **1-800-829-3676** to order current-year forms, instructions, and publications and prior-year forms and instructions. You should receive your order within 10 days.
- **Asking tax questions.** Call the IRS with your tax questions at **1-800-829-1040**.
- **Solving problems.** You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."
- **TTY/TDD equipment.** If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax or account questions or to order forms and publications.
- **TeleTax topics.** Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.
- **Refund information.** If you would like to check the status of your 2003 refund, call **1-800-829-4477** for automated refund information and follow the recorded instructions or call **1-800-829-1954**. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to

know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- **Products.** You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
 - **Services.** You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."
-  **Mail.** You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Use the address that applies to your part of the country.
- **Western part of U.S.:**
Western Area Distribution Center
Rancho Cordova, CA 95743-0001
 - **Central part of U.S.:**
Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903
 - **Eastern part of U.S. and foreign addresses:**
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) on the Internet at www.irs.gov/cdorders for \$22 (no handling fee) or call 1-877-233-6767 toll free to buy

the CD-ROM for \$22 (plus a \$5 handling fee). The first release is available in early January and the final release is available in late February.



CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide*, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a busi-

ness. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting the website at www.irs.gov/smallbiz.

