indebtedness, or any evidence of any interest in, or right to subscribe to or purchase, any of the foregoing.

(2) *Dealer in securities.* For definition of a *dealer in securities*, see the regulations under section 471.

(d) *Identification of security in dealer's records.* (1) A security is clearly identified in the dealer's records as a security held for investment when there is an accounting separation of the security from other securities, as by making appropriate entries in the dealer's books of account to distinguish the security from inventories and to designate it as an investment and by (i) indicating with such entries, to the extent feasible, the individual serial number of, or other characteristic symbol imprinted upon, the individual security, or (ii) adopting any other method of identification satisfactory to the Commissioner.

(2) In computing the 30-day period prescribed by section 1236(a), the first day of the period is the day following the date of acquisition. Thus, in the case of a security acquired on March 18, 1957, the 30-day period expires at midnight on April 17, 1957.

[T.D. 6500, 25 FR 12015, Nov. 26, 1960, as amended by T.D. 6726, 29 FR 5667, Apr. 29, 1964]

§ 1.1237–1 Real property subdivided for sale.

(a) *General rule*—(1) *Introductory.* This section provides a special rule for determining whether the taxpayer holds real property primarily for sale to customers in the ordinary course of his business under section 1221(1). This rule is to permit taxpayers qualifying under it to sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it. The rule is not applicable to dealers in real estate or to corporations, except a corporation making such sales in a taxable year beginning after December 3l, 1954, if such corporation qualifies under the provisions of paragraph (c)(5)(iv) of this section.

(2) *When subdividing and selling activities are to be disregarded.* When its conditions are met, section 1237 provides that if there is no other substantial evidence that a taxpayer holds real estate primarily for sale to customers in the ordinary course of his business, he shall not be considered a real estate dealer holding it primarily for sale merely because he has (i) subdivided the tract into lots (or parcels) and (ii) engaged in advertising, promotion, selling activities or the use of sales agents in connection with the sale of lots in such subdivision. Such subdividing and selling activities shall be disregarded in determining the purpose for which the taxpayer held real property sold from a subdivision whenever it is the only substantial evidence indicating that the taxpayer has ever held the real property sold primarily for sale to customers in the ordinary course of his business.

(3) *When subdividing and selling activities are to be taken into account.* When other substantial evidence tends to show that the taxpayer held real property for sale to customers in the ordinary course of his business, his activities in connection with the subdivision and sale of the property sold shall be taken into account in determining the purpose for which the taxpayer held both the subdivided property and any other real property. For example, such other evidence may consist of the taxpayer's selling activities in connection with other property in prior years during which he was engaged in subdividing or selling activities with respect to the subdivided tract, his intention in prior years (or at the time of acquiring the property subdivided) to hold the tract primarily for sale in his business, his subdivision of other tracts in the same year, his holding other real property for sale to customers in the same year, or his construction of a permanent real estate office which he could use in selling other real property. On the other hand, if the only evidence of the taxpayer's purpose in holding real property consisted of not more than one of the following, in the year in question, such fact would not be considered substantial other evidence:

(i) Holding a real estate dealer's license;

(ii) Selling other real property which was clearly investment property;

(iii) Acting as a salesman for a real estate dealer, but without any financial interest in the business; or

(iv) Mere ownership of other vacant real property without engaging in any selling activity whatsoever with respect to it.

If more than one of the above exists, the circumstances may or may not constitute substantial evidence that the taxpayer held real property for sale in his business, depending upon the particular facts in each case.

(4) *Section 1237 not exclusive.* (i) The rule in section 1237 is not exclusive in its application. Section 1237 has no application in determining whether or not real property is held by a taxpayer primarily for sale in his business if any requirement under the section is not met. Also, even though the conditions of section 1237 are met, the rules of section 1237 are not applicable if without regard to section 1237 the real property sold would not have been considered real property held primarily for sale to customers in the ordinary course of his business. Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. Furthermore, whether or not the conditions of section 1237 are met, the section has no application to losses realized upon the sale of realty from subdivided property.

(ii) If, owing solely to the application of section 1237, the real property sold is deemed not to have been held primarily for sale in the ordinary course of business, any gain realized upon such sale shall be treated as ordinary income to the extent provided in section 1237(b) (1) and (2) and paragraph (e) of this section. Any additional gain realized upon the sale shall be treated as gain arising from the sale of a capital asset or, if the circumstances so indicate, as gain arising from the sale of real property used in the trade or business as defined in section 1231 (b)(1). For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(5) *Principal conditions of qualification.* Before section 1237 applies, the taxpayer must meet three basic conditions, more fully explained later: He cannot have held any part of the tract at any time previously for sale in the ordinary course of his business, nor in the year of sale held any other real estate for sale to customers; he cannot make substantial improvements on the tract which increase the value of the lot sold substantially; and he must have owned the property 5 years, unless he inherited it. However, the taxpayer may make certain improvements if they are necessary to make the property marketable if he elects neither to add their cost to the basis of the property, or of any other property, nor to deduct the cost as an expense, and he has held the property at least 10 years. If the requirements of section 1237 are met, gain (but not more than 5 percent of the selling price of each lot) shall be treated as ordinary income in and after the year in which the sixth lot or parcel is sold.

(b) *Disqualification arising from holding real property primarily for sale*—(1) *General rule.* Section 1237 does not apply to any transaction if the taxpayer either:

(i) Held the lot sold (or the tract of which it was a part) primarily for sale in the ordinary course of his business in a prior year, or

(ii) Holds other real property primarily for sale in the ordinary course of his business in the same year in which such lot is sold.

Where either of these elements is present, section 1237 shall be disregarded in determining the proper treatment of any gain arising from such sale.

(2) *Method of applying general rule.* For purposes of this paragraph, in determining whether the lot sold was held primarily for sale in the ordinary course of business in a prior year, the principles of section 1237 shall be applied, whether or not section 1237 was effective for such prior year, if the sale of the lot occurs after December 31, 1953, or, in the case of a corporation meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Whether, on the other hand, the taxpayer holds other real property for sale in the ordinary course of his business in the same

year such lot was sold shall be determined without regard to the application of section 1237 to such other real property.

(3) *Attribution rules with respect to the holding of property.* The taxpayer is considered as holding property which he owns individually, jointly, or as a member of a partnership. He is not generally considered as holding property owned by members of his family, an estate or trust, or a corporation. See, however, paragraph (c)(5) (iv)(c) of this section for an exception to this rule. The purpose for which a prior owner held the lot or tract, or his activities, are immaterial except to the extent they indicate the purpose for which the taxpayer has held the lot or tract. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held. The principles of this subparagraph may be illustrated by the following example:

Example: A dealer in real property held a tract of land for sale to customers in the ordinary course of his business for 5 years. He then made a gift of it to his son. As a result of the operation of section 1223(2) the son will have held the property for the period of time required by section 1237. However, he will not qualify for the benefits of section 1237 because, there being no evidence to the contrary, the circumstances involved establish that the son holds the property for sale to customers, as did his father.

(c) *Disqualification arising from substantial improvements*—(1) *General rule.* Section 1237 will not apply if the taxpayer or certain others make improvements on the tract which are substantial and which substantially increase the value of the lot sold. Certain improvements are not substantial within the meaning of section 1237(a)(2) if they are necessary to make the lot marketable at the prevailing local price and meet the other conditions of section 1237(b)(3). See subparagraph (5) of this paragraph.

(2) *Improvements made or deemed to be made by the taxpayer.* Certain improvements made by the taxpayer or made under a contract of sale between the taxpayer and the buyer make section 1237 inapplicable.

(i) For the purposes of section 1237 (a)(2) the taxpayer is deemed to have made any improvements on the tract while he held it which are made by:

(*a*) The taxpayer's whole or half brothers and sisters, spouse, ancestors and lineal descendants.

(*b*) A corporation controlled by the taxpayer. A corporation is controlled by the taxpayer if he controls, as the result of direct ownership, constructive ownership, or otherwise, more than 50 percent of the corporation's voting stock.

(*c*) A partnership of which the taxpayer was a member at the time the improvements were made.

(*d*) A lessee if the improvement takes the place of a payment of rental income. See section 109 and the regulations thereunder.

(*e*) A Federal, State, or local government, or political subdivision thereof, if the improvement results in an increase in the taxpayer's basis for the property, as it would, for example, from a special tax assessment for paving streets.

(ii) The principles of subdivision (i) of this subparagraph may be illustrated by the following example:

Example: A held a tract of land for 3 years during which he made substantial improvements thereon which substantially enhanced the value of every lot on the tract. A then made a gift of the tract to his son. The son made no further improvements on the tract but held it for 3 years and then sold several lots therefrom. The son is not entitled to the benefits of section 1237 since under section 1237(a)(2) he is deemed to have made the substantial improvements made by his father, and under section 1223(2) he is treated as having held the property for the period during which his father held it. Thus, the disqualifying improvements are deemed to have been made by the son while the tract was held by him. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(iii) The taxpayer is also charged with making any improvements made pursuant to a contract of sale entered into between the taxpayer and the buyer. Therefore, the buyer, as well as the taxpayer, may make improvements which prevent the application of section 1237.

(*a*) If a contract of sale obligates either the taxpayer or the buyer to make a substantial improvement which would substantially increase the value of the lot, the taxpayer may not claim the application of section 1237 unless

the obligation to improve the lot ceases (for any reason other than that the improvement has been made) before or within the period, prescribed by section 6511, within which the taxpayer may file a claim for credit or refund of an overpayment of his tax on the gain from the sale of the lot. The following example illustrates this rule:

Example: In 1956, A sells several lots from a tract he has subdivided for sale. Section 1237 would apply to the sales of these lots except that in the contract of sale, A agreed to install sewers, hard surface roads, and other utilities which would increase the value of the lots substantially. If in 1957, instead of requiring the improvements, the buyer releases A from this obligation, A may then claim the application of section 1237 to the sale of lots in 1956 in computing his income tax for 1956, since the period of limitations in which A may file a claim for credit or refund of an overpayment of his 1956 income tax has not expired.

(*b*) An improvement is made pursuant to a contract if the contract imposes an obligation on either party to make the improvement, but not if the contract merely places restrictions on the improvements, if any, either party may make. The following example illustrates this rule:

Example: B sells several lots from a tract which he has subdivided. Each contract of sale prohibits the purchaser from building any structure on his lot except a personal residence costing $15,000 or more. Even if the purchasers build such residences, that does not preclude B from applying section 1237 to the sales of such lots, since the contracts did not obligate the purchasers to make any improvements.

(iv) Improvements made by a bona fide lessee (other than as rent) or by others not described in section 1237(a)(2) do not preclude the use of section 1237.

(3) *When improvements substantially enhance the value of the lot sold.* Before a substantial improvement will preclude the use of section 1237, it must substantially enhance the value of the lot sold.

(i) The increase in value to be considered is only the increase attributable to the improvement or improvements. Other changes in the market price of the lot, not arising from improvements made by the taxpayer, shall be disregarded. The difference between the value of the lot, including improvements, when the improvement has been completed and an appraisal of its value if unimproved at that time, will disclose the value added by the improvements.

(ii) Whether improvements have substantially increased the value of a lot depends upon the circumstances in each case. If improvements increase the value of a lot by 10 percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than 10 percent, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.

(iii) Improvement may increase the value of some lots in a tract without equally affecting other lots in the same tract. Only the lots whose value was substantially increased are ineligible for application of the rule established by section 1237.

(4) *When an improvement is substantial.* To prevent the application of section 1237, the improvement itself must be substantial in character. Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements.

(5) *Special rules relating to substantial improvements.* Under certain conditions a taxpayer, including a corporation to which subdivision (iv) of this subparagraph applies, may obtain the benefits of section 1237 whether or not substantial improvements have been made. In addition, an individual taxpayer may, under certain circumstances elect to have substantial improvements treated as necessary and not substantial.

(i) *When an improvement is not considered substantial.* An improvement will not be considered substantial if all of the following conditions are met:

(*a*) The taxpayer has held the property for 10 years. The full 10-year period must elapse, whether or not the taxpayer inherited the property. Although the taxpayer must hold the property 10 years, he need not hold it for 10 years after subdividing it. See paragraph (d) of this section for rules relating to the determination of the period for which the property is held.

(*b*) The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, sub-surface, or both) or roads, including hard surface roads, curbs, and gutters.

(*c*) The district director with whom the taxpayer must file his return is satisfied that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.

(*d*) The taxpayer elects, as provided in subdivision (iii) of this subparagraph, not to adjust the basis of the lot sold or any other property held by him for any part of the cost of such improvement attributable to such lot and not to deduct any part of such cost as an expense.

(ii) *Meaning of similar building site.* A *similar building site* is any real property in the immediate vicinity whose size, terrain, and other characteristics are comparable to the taxpayer's property. For the purpose of determining whether a tract is marketable at the prevailing local price for similar building sites, the taxpayer shall furnish the district director with sufficient evidence to enable him to compare (*a*) the value of the taxpayer's property in an unimproved state with (*b*) the amount for which similar building sites, improved by the installation of water, sewer, or drainage facilities or roads, have recently been sold, reduced by the present cost of such improvements. Such comparison may be made and expressed in terms of dollars per square foot, dollars per acre, or dollars per front foot, or in any other suitable terms depending upon the practice generally followed by real estate dealers in the taxpayer's locality. The taxpayer shall also furnish evidence, where possible, of the best bona fide offer received for the tract or a lot thereof just before making the improvement, to assist the district director in determining the value of the tract or lot if it had been sold in its unimproved state. The operation of this subdivision and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. A has been offered $500 per acre for a tract without roads, water, or sewer facilities which he has owned for 15 years. The adjacent tract has been subdivided and improved with water facilities and hard surface roads, and has sold for $4,000 per acre. The estimated cost of roads and water facilities on the adjacent tract is $2,500 per acre. The prevailing local price for similar building sites in the vicinity would be $1,500 per acre (i.e., $4,000 less $2,500). If A installed roads and water facilities at a cost of $2,500 per acre, his tract would sell for approximately $4,000 per acre. Under section 1237(b)(3) the installation of roads and water facilities does not constitute a substantial improvement if A elects to disregard the cost of such improvements ($2,500 per acre) in computing his cost or other basis for the lots sold from the tract, and in computing his basis for any other property owned by him.

Example 2. Assume the same facts as in example (1) of this subdivision, except that A can obtain $1,600 per acre for his property without improvements. The installation of any substantial improvements would not constitute a necessary improvement under section 1237(b)(3), since the prevailing local price could have been obtained without any improvement.

Example 3. Assume the same facts as in example (1) of this subdivision, except that the adjacent tract has also been improved with sewer facilities, the present cost of which is $1,200 per acre. The installation of the substantial improvements would not constitute a necessary improvement under section 1237(b)(3) on A's part, since the prevailing local price ($4,000 less the sum of $1,200 plus $2,500, or $300) could have been obtained by A without any improvement.

(iii) *Manner of making election.* The election required by section 1237(b)(3)(C) shall be made as follows:

(*a*) The taxpayer shall submit:

(*1*) A plat showing the subdivision and all improvements attributable to him.

(*2*) A list of all improvements to the tract, showing:

(*i*) The cost of such improvements.

(*ii*) Which of the improvements, without regard to the election, he considers *substantial* and which he considers not *substantial.*

(*iii*) Those improvements which are substantial to which the election is to apply, with a fair allocation of their cost to each lot they affect, and the amount by which they have increased the values of such lots.

(*iv*) The date on which each lot was acquired and its basis for determining gain or loss, exclusive of the cost of any improvements listed in subdivision (iii) of this subdivision.

(*3*) A statement that he will neither deduct as an expense nor add to the basis of any lot sold, or of any other property, any portion of the cost of any substantial improvement which substantially increased the value of any lot in the tract and which either he listed pursuant to (*a*)(*2*)(iii) of this subdivision or which the district director deems substantial.

(*b*) The election and the information required under (*a*) of this subdivision shall be submitted to the district director:

(*1*) With the taxpayer's income tax return for the taxable year in which the lots subject to the election were sold, or

(*2*) In the case of a return filed prior to August 14, 1957, either with a timely claim for refund, where the benefits of section 1237 have not been claimed on such return, or, independently, before November 13, 1957, where such benefits have been claimed, or

(*3*) If there is an obligation to make disqualifying improvements outstanding when the taxpayer files his return, with a formal claim for refund at the time of the release of the obligation, if it is then still possible to file a timely claim.

(*c*) Once made, the election as to the necessary improvement costs attributable to any lot sold shall be irrevocable and binding on the taxpayer unless the district director assesses an income tax as to such lot as if it were held for sale in the ordinary course of taxpayer's business. Under such circumstances, in computing gain, the cost or other basis shall be computed without regard to section 1237.

(iv) *Exceptions with respect to necessary* improvements and certain corporations. For taxable years beginning after December 31, 1954, individual taxpayers and certain corporations may obtain the benefits of section 1237 without complying with the provisions of subdivisions (i) (*c*) and (*d*), (ii), and (iii) of this subparagraph if the requirements of section 1237 are otherwise met and if:

(*a*) The property in question was acquired by the taxpayer through the foreclosure of a lien thereon,

(*b*) The lien foreclosed secured the payment of an indebtedness to the taxpayer or (in the case of a corporation) secured the payment of an indebtedness to a creditor who has transferred the foreclosure bid to the taxpayer in exchange for all of the stock of the corporation and other consideration, and

(*c*) In the case of a corporate taxpayer, no shareholder of the corporation holds real property for sale to customers in the ordinary course of his trade or business or holds a controlling interest in another corporation which actually so holds real property, or which, but for the application of this subdivision, would be considered to so hold real property.

Thus, in the case of such property, it is not necessary for the taxpayer to satisfy the district director that the property would not have brought the prevailing local price without improvements or to elect not to add the cost of the improvements to his basis. In addition, if 80 percent or more of the real property owned by a taxpayer is property to which this subdivision applies, the requirements of (*a*) and (*b*) of this subdivision need not be met with respect to property adjacent to such property which is also owned by the taxpayer.

(d) *Holding period required*—(1) *General rules.* To apply section 1237, the taxpayer must either have inherited the lot sold or have held it for 5 years. Generally, the provisions of section 1223 are applicable in determining the period for which the taxpayer has held the property. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A held a tract of land for 3 years under circumstances otherwise qualifying for section 1237 treatment. He made a gift of the tract to B at a time when the fair market value of the tract exceeded A's basis for the tract. B held the tract for 2 more years under similar circumstances. B then sold 4

lots from the tract. B is entitled to the benefits of section 1237 since under section 1223(2) he held the lots for 5 years and all the other requirements of section 1237 are met.

Example 2. C purchased all the stock in a corporation in 1955. The corporation purchased an unimproved tract of land in 1957. In 1961 the corporation was liquidated under section 333 and C acquired the tract of land. For purposes of section 1237, C's holding period commenced on the date the corporation actually acquired the land in 1957 and not on the date C purchased the stock.

(2) *Rules relating to property acquired upon death.* If the taxpayer inherited the property there is no 5-year holding period required under section 1237. However, any holding period required by any other provision of the Code, such as section 1222, is nevertheless applicable. For purposes of section 1237, neither the survivor's one-half of community property, nor property acquired by survivorship in a joint tenancy, is property acquired by devise or inheritance. The holding period for the surviving joint tenant begins on the date the property was originally acquired.

(e) *Tax consequences if section 1237 applies*—(1) *Introductory.* Where there is no substantial evidence other than subdivision and related selling activities that real property is held for sale in the ordinary course of taxpayer's business and section 1237 applies, section 1237(b)(1) provides a special rule for computing taxable gain. For the relationship between sections 1237 and 1231, see paragraph (f) of this section.

(2) *Characterization of gain and its relation to selling expenses.* (i) When the taxpayer has sold less than 6 lots or parcels from the same tract up to the end of his taxable year, the entire gain will be capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) In computing the number of lots or parcels sold, two or more contiguous lots sold to a single buyer in a single sale will be counted as only one parcel. The following example illustrates this rule:

Example: A meets all the conditions of section 1237 in subdividing and selling a single tract. In 1956 he sells 4 lots to B, C, D, and E. In the same year F buys 3 adjacent lots. Since A has sold only 5 lots or parcels from the tract, any gain A realizes on the sales will be capital gain.

(ii) If the taxpayer has sold the sixth lot or parcel from the same tract within the taxable year, then the amount, if any, by which 5 percent of the selling price of each lot exceeds the expenses incurred in connection with its sale or exchange, shall, to the extent it represents gain, be ordinary income. Any part of the gain not treated as ordinary income will be treated as capital gain. (Where the land is used in a trade or business, see paragraph (f) of this section.) Five percent of the selling price of each lot sold from the tract in the taxable year the sixth lot is sold and thereafter is, to the extent it represents gain, considered ordinary income. However, all expenses of sale of the lot are to be deducted first from the 5 percent of the gain which would otherwise be considered ordinary income, and any remainder of such expenses shall reduce the gain upon the sale or exchange which would otherwise be considered capital gain. Such expenses cannot be deducted as ordinary business expenses from other income. The 5-percent rule applies to all lots sold from the tract in the year the sixth lot or parcel is sold. Thus, if the taxpayer sells the first 6 lots of a single tract in one year, 5 percent of the selling price of each lot sold shall be treated as ordinary income and reduced by the selling expenses. On the other hand, if the taxpayer sells the first 3 lots of a single tract in 1955, and the next 3 lots in 1956, only the gain realized from the sales made in 1956 shall be so treated. For the effect of a 5-year interval between sales, see paragraph (g)(2) of this section. The operation of this subdivision may be illustrated by the following examples:

Example 1. Assume the selling price of the sixth lot of a tract is $10,000, the basis of the lot in the hands of the taxpayer is $5,000, and the expenses of sale are $750. The amount of gain realized by the taxpayer is $4,250, of which the amount of ordinary income attributable to the sale is zero, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	500	
Expenses of sale	750	
Amount of gain realized treated as ordinary income		0
Excess over basis		5,000

5 percent of selling price	500	
Excess of expenses over 5 percent of selling price	250	
		750
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,250

Example 2. Assume the same facts as in Example 1, except that the expenses of sale of such sixth lot are $300. The amount of gain realized by the taxpayer is $4,700, of which the amount of ordinary income attributable to the sale is $200, computed as follows:

Selling price		$10,000
Basis		5,000
Excess over basis		5,000
5 percent of selling price	$500	
Expenses of sale	300	
Amount of gain realized treated as ordinary income		200
Excess over basis		5,000
5 percent of selling price	500	
Excess of expenses over 5 percent of selling price	0	
		500
Amount of gain realized from sale of property not held for sale in ordinary course of business		4,500

(iii) In the case of an exchange, the term *selling price* shall mean the fair market value of property received plus any sum of money received in exchange for the lot. See section 1031 for those exchanges in which no gain is recognized. For the purpose of subsections (b) and (c) of section 1237 and paragraphs (e) and (g) of this section, an exchange shall be treated as a sale or exchange whether or not gain or loss is recognized with respect to such exchange.

(f) *Relationship of section 1237 and section 1231.* Application of section 1237 to a sale of real property may, in some cases, result in the property being treated as real property used in the trade or business, as described in section 1231(b)(1). Thus, assuming section 1237 is otherwise applicable, if the lot sold would be considered property described in section 1231(b)(1) except for the fact that the taxpayer subdivided the tract of which it was a part, then evidence of such subdivision and connected sales activities shall be disregarded and the lot sold shall be considered real property used in the trade or business. Under such circumstances, any gain or loss realized from the sale shall be treated as gain or loss arising from the sale of real property used in the trade or business.

(g) *Definition of tract*—(1) *Aggregation of properties.* For the purposes of section 1237, the term *tract* means either (i) a single piece of real property or (ii) two or more pieces of real property if they were contiguous at any time while held by the taxpayer, or would have been contiguous but for the interposition of a road, street, railroad, stream, or similar property. Properties are contiguous if their boundaries meet at one or more points. The single piece of contiguous properties need not have been conveyed by a single deed. The taxpayer may have assembled them over a period of time and may hold them separately, jointly, or as a partner, or in any combination of such forms of ownership.

(2) *When a subdivision will be considered a new tract.* If the taxpayer sells or exchanges no lots from the tract for a period of 5 years after the sale or exchange of at least 1 lot in the tract, then the remainder of the tract shall be deemed a new tract for the purpose of counting the number of lots sold from the same tract under section 1237(b)(1). The pieces in the new tract need not be contiguous. The 5-year period is measured between the dates of the sales or exchanges.

(h) *Effective date.* This section shall apply only to gain realized on sales made after December 31, 1953, or, in the case of a person meeting the requirements of paragraph (c)(5)(iv) of this section, if the sale of the lot occurs in a taxable year beginning after December 31, 1954. Pursuant to section 7851(a)(1)(C), the regulations prescribed in this section (other than subdivision (iv) of paragraph (c)(5)) shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and to taxable years beginning after December 31, 1953, and ending before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939. Irrespective of whether the taxable year involved is subject to the Internal Revenue Code of 1939 or the Internal Revenue Code of 1954, sales or exchanges made before January 1, 1954, shall be taken into account to determine whether: (1) No

sales or exchanges have been made for 5 years, under section 1237(c), and (2) more than 5 lots or parcels have been sold or exchanged from the same tract, under section 1237(b)(1). Thus, if the taxpayer sold 5 lots from a single tract in 1950, and another lot is sold in 1954, the lot sold in 1954 constitutes the *sixth lot* sold from the original tract. On the other hand, if the first 5 lots were sold in 1948, the sale made in 1954 shall be deemed to have been made from a new tract.

[T.D. 6500, 25 FR 12016, Nov. 26, 1960]

§ 1.1238–1 Amortization in excess of depreciation.

(a) *In general.* Section 1238 provides that if a taxpayer is entitled to a deduction for amortization of an emergency facility under section 168, and if the facility is later sold or exchanged, any gain realized shall be considered as ordinary income to the extent that the amortization deduction exceeds normal depreciation. Thus, under section 1238 gain from a sale or exchange of property shall be considered as ordinary income to the extent that its adjusted basis is less than its adjusted basis would be if it were determined without regard to section 168. If an entire facility is certified under section 168(e), the taxpayer may use allowances for depreciation based on any rate and method which would have been proper if the basis of the facility were not subject to amortization under section 168, in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. If only a portion of a facility is certified under section 168(e), allowances for depreciation based on the rate and method properly used with respect to the uncertified part of the facility are used in determining what the adjusted basis of the facility would be if it were determined without regard to section 168. The principles of this paragraph may be illustrated by the following examples:

Example 1. On December 31, 1954, a taxpayer making his income tax returns on a calendar year basis acquires at a cost of $20,000 an emergency facility (used in his business) 50 percent of the adjusted basis of which has been certified under section 168(e). The facility would normally have a useful life of 20 years and a salvage value of $2,000 allocable equally between the certified and uncertified portions. Under section 168 the taxpayer elects to begin the 60-month amortization period on January 1, 1955. He takes amortization deductions with respect to the certified portion in the amount of $4,000 for the years 1955 and 1956 (24 months). On December 31, 1956, he sells the facility for a price of $19,000 which is allocable equally between the certified and uncertified portions. The adjusted basis of the certified portion on that date is $6,000 ($10,000 cost, less $4,000 amortization). With respect to the uncertified portion, the straight line method of depreciation is used and a deduction for depreciation in the amount of $450 is claimed and allowed for the year 1955. The adjusted basis of the uncertified portion on January 1, 1956, is $9,550 ($10,000 cost, less $450 depreciation). The depreciation allowance for the uncertified portion for the year 1956 would be limited to $50, the amount by which the adjusted basis of such portion at the beginning of the year exceeded its aliquot portion of the sales price. Thus, on December 31, 1956, the adjusted basis of the uncertified portion would be $9,500. Without regard to section 168, and using the rate and method the taxpayer properly applied to the uncertified portion of the facility, the adjusted basis of the certified portion on December 31, 1956, would be $9,500, computed in the same manner as the adjusted basis of the uncertified portion. The difference between the facility's actual adjusted basis ($15,500) and its adjusted basis determined without regard to section 168 ($19,000), is $3,500. Accordingly, the entire $3,500 gain on the sale of the facility ($19,000 sale price, less $15,500 adjusted basis) is treated as ordinary income.

Example 2. Assume that the entire facility in example (1) had been certified under section 168(e) and that, therefore, the adjusted basis of the facility on December 31, 1956, is $12,000. Assume further that the taxpayer adopts straight line depreciation as a proper method of depreciation for determining the adjusted basis of the facility without regard to section 168. Thus, the adjusted basis, without regard to section 168, would be $19,000. This amount is $7,000 more than the $12,000 adjusted basis under section 168. Hence, the entire $7,000 gain on the sale of the facility ($19,000 sale price less $12,000 adjusted basis) is treated as ordinary income.

(b) *Substituted basis.* If a taxpayer acquires other property in an exchange for an emergency facility with respect to which amortization deductions have been allowed or allowable, and if the basis in his hands of the other property is determined by reference to the basis of the emergency facility, then the