(3) *Treatment of gain not recognized under section 1251(c)(1).* For treatment of gain not recognized under section 1251(c)(1), the principles of paragraph (f) §1.1251–6 shall be applicable. Thus section 1251 does not prevent gain which is not recognized under section 1251 from being considered as gain under another provision of the Code, such as for example, section 1252(a)(1) (relating to treatment of gain from disposition of farm land). See example (1) of paragraph (e) of §1.1252–1.

(4) *Exempt income.* With regard to exempt income, the principles of paragraph (e) of §1.1245–6 shall be applicable.

(5) *Normal retirement of asset in multiple asset account.* Section 1251(c)(1) does not require recognition of gain upon normal retirements of farm recapture property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of §1.167(a)–8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

(6) *Installment method*—(i) *In general.* Gain from a disposition to which section 1251(c)(1) applies may be reported under the installment method if such method is otherwise available under section 453 of the Code. In such case, the income (other than interest) on each installment payment shall be deemed to consist of gain to which section 1251(c)(1) applies until all such gain has been reported, and the remaining portion (if any) of such income shall be deemed to consist of gain to which section 1251(c)(1) does not apply. For treatment of amounts as interest on certain deferred payments, see section 483. For adjustments in the excess deductions account, see paragraph (c)(1)(ii) of §1.1251–2.

(ii) *Special rule.* If a taxpayer disposes of property used in the trade or business of farming which qualifies as both section 1245 property as well as farm recapture property and elects to report the gain from such disposition under the installment method, then the income (other than interest) on each installment payment shall (*a*) first be deemed to consist of gain to which section 1245(a)(1) applies until all such gain has been reported, (*b*) The remaining portion (if any) of such income shall be deemed to consist of gain to which section 1251(e)(1) applies until all such gain has been reported, and (*c*) finally the remaining portion (if any) of such income shall be deemed to consist of gain to which neither section 1245(a)(1) nor 1251 (c)(1) applies. See paragraph (d)(3) of §1.1252–1 with respect to the installment method in regard to the disposition of property which is both farm recapture property as well as farm land (as defined in section 1252(a)(2) and paragraph (a)(3)(i) of §1.1252–1).

[T.D. 7418, 41 FR 18814, May 7, 1976; 41 FR 23669, June 11, 1976]

§1.1251–2 Excess deductions account.

(a) *Establishment and maintenance of account*—(1) *General rule.* With respect to any taxable year beginning after December 31, 1969, any taxpayer who:

(i) Has a farm net loss (as defined in section 1251(e)(2) and in paragraph (b) of §1.1251–3) for such a taxable year, or

(ii) Has an excess deductions account balance as of the close of such a taxable year

shall establish (if not previously established) and maintain for purposes of section 1251 an excess deductions account. See section 1251(b)(1). Once an excess deductions account is established (or succeeded to under paragraph (e) of this section in the case of certain corporate transactions and gifts) all entries (including the entries prescribed by paragraph (f) of this section with respect to married taxpayers who file joint returns) with respect to the account must be part of the taxpayer's permanent records for all taxable years for which the account must be maintained. For purposes of applying section 1251 and this section, the term *taxpayer* in the case of a partnership means each partner of such partnership and in the case of an estate or trust means the estate or trust regardless of whether it is taxable under subpart A or E, subchapter J, chapter 1 of the Code.

(2) *Distributions from estate or trust.* If farm recapture property is distributed from an estate or trust in a transaction to which section 1251(d) (1) or (2) (relating to exceptions for gifts and transfers

at death) applies, then the excess deductions account balance of the estate or trust shall be succeeded to by the distributee in the amount, if any, and manner prescribed in paragraph (e)(2) of this section. For purposes of the preceding sentence only, the rules of paragraph (e)(2) of this section shall be applied by treating each distribution as a gift at the time made. Thus; for example, if all of the farm recapture property of an estate or trust is distributed to a distributee on the date the estate or trust terminates, the distributee will succeed on that date to the excess deductions account balance of the estate or trust.

(3) *Exception.* A taxpayer is not required to maintain an excess deductions account under subparagraph (1) of this paragraph for a taxable year if:

(i) For such taxable year there would be no additions to the taxpayer's excess deductions account, and

(ii) For the immediately preceding taxable year the balance in the taxpayer's excess deductions account was reduced to zero by reason of section 1251 (b)(3) (relating to subtractions from the account) or section 1251(b)(5) (relating to transfer of account).

(b) *Additions to account*—(1) *General rule.* For each taxable year, there shall be added to the excess deductions account an amount equal to the taxpayer's farm net loss. See section 1251(b)(2)(A).

(2) *Exceptions.* In the case of an individual and, in the case of an electing small business corporation (as defined in section 1371(b)), subparagraph (1) of this paragraph shall apply for a taxable year:

(i) Only if the taxpayer's nonfarm adjusted gross income (as defined in paragraph (d) of §1.1251–3) for such year exceeds $50,000, and

(ii) Only to the extent the taxpayer's farm net loss for such year exceeds $25,000.

The limitations of this subparagraph apply to a person (other than a trust) to whom the tax rates set forth in section 1 are applicable and as prescribed in subparagraph (3) of this paragraph in respect of an electing small business corporation.

(3) *Electing small business corporation*—(i) *Taxable years ending before December 11, 1971.* For taxable years ending before December 11, 1971, in the case of an electing small business corporation (as defined in section 1371(b):

(*a*) For purposes of subparagraph (2) of this paragraph, the term *the taxpayer* means such corporation or any one of its shareholders, and the term *such year,* in the case of a shareholder, means his taxable year with which or within which the taxable year of the corporation ends (see paragraph (d)(2) of §1.1251–3 for special rules relating to the computation of nonfarm adjusted gross income of a shareholder of an electing small business corporation), and

(*b*) The limitations in subparagraph (2) of this paragraph shall not apply to the corporation for a taxable year if on any day of such year there is a taxpayer who is a shareholder having, for his taxable year with which or within which the taxable year of such corporation ends, a farm net loss (as defined in paragraph (b) of §1.1251–3).

For purposes of determining whether a shareholder of such corporation has a farm net loss, there shall not be taken into account his pro rata share of farm net income or loss of any other electing small business corporation for such corporation's taxable year ending with or within his taxable year.

(*c*) The provisions of this subdivision (i) do not apply for purposes of determining whether the shareholder must make an addition to his excess deductions account and the amount of such addition.

(ii) *Taxable years ending after December 10, 1971.* [Reserved]

(4) *Married individuals*—(i) *Lower limitations for separate returns.* If married taxpayers file separate returns, then for purposes of this paragraph each spouse shall be treated as a separate individual. However, in such case, (*a*) the amount specified in subparagraph (2)(i) of this paragraph shall be $25,000 in lieu of $50,000, and (*b*) the amount specified in subparagraph (2)(ii) of this paragraph shall be $12,500 in lieu of $25,000. The lower limitations in the preceding sentence shall not apply if the spouse of the taxpayer does not have any nonfarm adjusted gross income for the taxable year. See section 1251(b)(2)(C).

(ii) *Joint return.* If married taxpayers for a taxable year file a joint return under section 6013, then for purposes of this paragraph they shall for such taxable year be treated as a single taxpayer. For rules applicable to establishing, maintaining, and allocating a joint excess deductions account, see paragraph (f) of this section.

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

Example 1. For 1971, the M Corporation which uses the claendar year as its taxable year and which is not an electing small business corporation has a farm net loss of $40,000 and nonfarm taxable income of $45,000. Since subparagraph (2) of this paragraph does not apply to M, it is required to make a $40,000 addition to its excess deductions account.

Example 2. For 1971, A, an unmarried individual who uses the calendar year as his taxable year, has a farm net loss of $33,000 and nonfarm adjusted gross income of $65,000. Under subparagraph (2) of this paragraph, A is required to make an addition of $8,000 to his excess deductions account (that is, the excess of the farm net loss, $33,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph). If, however, A were a trust, the limitation in subparagraph (2) of this paragraph would not apply and such trust would be required to add $33,000 (the amount of the entire farm net loss) to its excess deductions account.

Example 3. H and W each use the calendar year as the taxable year. For 1971, H, a married taxpayer who files a separate return, has a farm net loss of $45,000 and nonfarm adjusted gross income of $60,000. H's spouse W does not have any nonfarm adjusted gross income for 1971. Thus, the lower limitations in subparagraph (4)(i) of this paragraph do not apply. Accordingly, H is required to make an addition of $20,000 to his excess deductions account (that is, the excess of the farm net loss, $45,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph).

Example 4. Assume the same facts as in example (3), except that for 1971 W has a farm net loss of $10,000 and nonfarm adjusted gross income of $30,000. Thus, the lower limitations in subparagraph (4)(i) of this paragraph do apply and H is required to make an addition of $32,500 to his excess deductions account (that is, the excess of his farm net loss, $45,000, over the $12,500 amount referred to in subparagraph (4)(i)(*b*) of this paragraph). Since, however, W did not have a farm net loss in excess of $12,500, she would not be required to make an addition to her excess deductions account. For the result if H and W were to file a joint return, see example (1) of paragraph (f)(6) of this section.

Example 5. For 1970, the M Corporation, which uses the calendar year as its taxable year and which is an electing small business corporation, has a farm net loss of $35,000 and nonfarm adjusted gross income of $60,000. A, B, and C, the sole equal shareholders of M, are cash method taxpayers and each uses a fiscal year ending on March 31. For the taxable year ending March 31, 1971, A has a farm net loss of $5,000. Thus, as M's taxable year ends within the taxable year of A during which A has a farm net loss, the limitations in subparagraph (2) of this paragraph do not apply with respect to M for 1970. See subparagraph (1) of this paragraph, to add $35,000 to its excess deductions account.

Example 6. Assume the same facts as in example (5), except that A's farm net loss occurred in his fiscal year ending March 31, 1970, and no shareholder of M has a farm net loss for the fiscal year ending March 31, 1971. Thus, the limitations in subparagraph (2) of this paragraph do apply with respect to M for 1970, and accordingly M is required to add $10,000 to its excess deductions account for 1970 (that is, the excess of M's farm net loss $35,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph).

Example 7. Assume the same facts as in example (6), except that M has $45,000 of nonfarm adjusted gross income for 1970 and A, for his taxable year ending March 31, 1971, has $40,000 of nonfarm adjusted gross income, computed without regard to his interest in M. Assume the M paid no dividends. Since, under paragraph (d)(2) of §1.1251–3, A's income from M under section 1373(b) is computed on the basis of M's nonfarm adjusted gross income, A's gross income from M is $15,000 (⅓ of $45,000), and A's total nonfarm adjusted gross income is $55,000. Accordingly, M would be required to add $10,000 to its excess deductions account for 1970 for the reasons stated in example (6).

Example 8. Assume the same facts as in example (7). Assume further that A is one of two equal shareholders in N, another electing small business corporation with a taxable year ending on January 31, and that N for its taxable year ending on January 31, 1971, has a $42,000 nonfarm loss and farm net income of $23,000. Assume that N paid no dividends. Thus, A for purposes of subparagraph (2)(i) of this paragraph, would only have a total of $34,000 of nonfarm adjusted gross income ($55,000) computed per example (7) minus $21,000 (A's share of N's nonfarm net operating loss (½ of $42,000) computed in accordance with paragraph (d)(2) of §1.1251–3)). Assuming that no other shareholder of M has nonfarm adjusted gross income in excess of $50,000, by reason of the $50,000 limitation in subparagraph (2)(i) of this paragraph, M makes no addition for 1971 to its excess deductions account. (N would make no addition to its excess deductions account as it does

not have a farm net loss.) If, however, N were to have a nonfarm loss of only $8,000, A for purposes of subparagraph (2)(i) of this paragraph would have a total of $51,000 of nonfarm adjusted gross income ($51,000 of nonfarm adjusted gross income ($55,000, minus ½ of N's nonfarm loss of $8,000)). Hence, with respect to M the result would be the same as in example (7) (and N would make no addition to its excess deductions account since it does not have a farm net loss).

Example 9. D and E are equal individual shareholders in corporations X, Y, and Z, the stock of each corporation having recently been purchased from a different unrelated person. X, Y, and Z are electing small business corporations. D, E, and the corporations all use the calendar year as the taxable year. For 1970, the farm net income of D and E (determined without regard to their respective pro rata shares of the farm net income or loss of X, Y, and Z) are $100,000 and zero, respectively. For 1970, the farm net income or loss of the corporations are losses of $80,000 and $20,000 for X and Z, respectively, and income of $60,000 for Y. For 1970, the determinations under subparagraph (3)(ii) of this paragraph as to whether a shareholder of corporation X or Z (no determination is necessary with respect to Y since Y does not have a farm net loss) has a farm net loss are made as follows:

DETERMINATIONS AS TO WHETHER D OR E HAS A FARM NET LOSS

	As to X		As to Z	
	D	E	D	E
Farm net income (determined without regard to X, Y, and Z)	$100,000	$0	$100,000	$0
Pro rata (½) share of corporation's farm net income (or loss):				
Of X			(40,000)	(40,000)
Of Y	30,000	30,000	30,000	30,000
Of Z	(10,000)	(10,000)		
Farm net income (or loss) for purposes of determination	$120,000	$20,000	$90,000	($10,000)

Accordingly, since the determination as to X indicates that neither D nor E has a farm net loss, the limitations of subparagraph (2) of this paragraph apply to X. Thus, assuming that X, D, or E has nonfarm adjusted gross income in excess of $50,000, X will add $55,000 to its excess deductions account, i.e., the excess of the farm net loss, $80,000, over the $25,000 amount referred to in subparagraph (2)(ii) of this paragraph. Since, however, the determination as to Z indicates that E has a farm net loss, such limitations do not apply to Z. Thus, the addition for 1970 to Z's excess deductions account is the entire amount of its farm net loss, $20,000.

(c) *Subtractions from account*—(1) *General rule.* Under section 1251(b)(3), if there is any amount in the excess deductions account at the close of a taxable year (determined after making any addition required under paragraph (b) of this section for such year but before making any reduction under this paragraph for such year), then the excess deductions account shall be reduced (but not below zero) by subtracting:

(i) An amount equal to (*a*) the farm net income (as defined in section 1251(e)(3) and in paragraph (c) of § 1.1251–3) for such year, plus (*b*) the amount (as determined in subparagraph (3) of this paragraph) necessary to adjust the account for deductions for any taxable year which did not result in a reduction of the taxpayer's tax under subtitle A of the Code for such taxable year or any preceding taxable year, and

(ii) After making any addition to the excess deductions account under paragraph (b) of this section and any reduction under subdivision (i) of this subparagraph for the taxable year, an amount equal to the sum of the amounts recognized as ordinary income solely by reason of the application of section 1251(c)(1). See section 1251(b)(3)(B). Thus, no amount shall be subtracted under this subdivision for gain recognized by reason of the application of section 1245(a)(1) or 1252(a)(1). For effect on computation of farm net loss or income of gain recognized under section 1245(a)(1) upon a disposition of farm recapture property, see paragraph (b)(2) of § 1.1251–3. In the case of an installment sale of farm recapture property, the taxpayer's excess deductions account shall be reduced under this subdivision in the year of such sale by an amount equal to the gain (computed in the year of sale) to be recognized as ordinary income under section 1251(c)(1).

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples in which it is assumed that there is no subtraction for lack of tax benefit under subparagraph (3) of this paragraph:

Example 1. Assume the same facts as in example (3) of paragraph (b)(6) of § 1.1251–1. M's excess deductions account balance as of the close of 1975 is computed, in accordance with the additional facts assumed, in the table below:

M'S EXCESS DEDUCTIONS ACCOUNT

(1) Balance January 1, 1975		$26,000
(2) Additions for 1975		0
(3) Subtotal		26,000
(4) Subtractions for 1975 (farm net income [1])		1,000
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(c)(1) for 1975		25,000
(6) Subtraction for disposition of farm recapture property:.		
(a) Gain from disposition of land to which section 1251(c)(1) applies (computed before applying limitation	$13,000	
(b) Gain from disposition of breeding herd to which section 1251(c)(1) applies (computed before applying limitation)	14,000	
(c) Sum of lines (a) and (b)	27,000	
(d) Excess deductions account limitation (amount in line (5))	25,000	
(e) Gain recognized as ordinary income under section 1251(c)(1) (lower of line (6)(c) or line (6)(d)		25,000
(7) Balance December 31, 1975		0

[1] Computed by treating the section 1245 gain of $6,000 under paragraph (b)(1)(ii) of § 1.1251–3 as gross income derived from the trade or business of farming.

For allocation of the $25,000 of gain recognized as ordinary income to the land and herd, and for treatment of the gain recognized in excess of $25,000 see example (3) of paragraph (b)(6) of § 1.1251–1.

Example 2. A is an unmarried individual who uses the calendar year as his taxable year. In 1971, A makes a single disposition of farm recapture property (other than land) realizing a gain of $46,000 of which $15,000 is recognized as ordinary income under section 1245(a)(1). The gain to which section 1251(c)(1) applies (computed before applying the excess deductions account limitation in section 1251(c)(2)(A) and paragraph (b)(4)(i) of § 1.1251–1) is $31,000 (i.e., $46,000 minus $15,000). The treatment of the gain realized on the disposition in excess of the $15,000 recognized as ordinary income under section 1245(a)(1) and the balance in A's excess deductions account as of the close of 1971 is computed, in accordance with the facts assumed, in the table below:

A'S EXCESS DEDUCTIONS ACCOUNT

(1) Balance January 1, 1971		$50,000
(2) Additions for 1971:		
(a) Farm net loss for 1971 [1]	$5,000	
(b) Less amount in paragraph (b)(2)(ii) of this section	25,000	
(c) Total additions for 1971		0
(3) Subtotal		50,000
(4) Subtractions for 1971		0
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(c)(1) for 1971		50,000
(6) Subtraction for dispositions of farm recapture property:		
(a) Gain to which section 1251(c)(1) applies (computed before applying limitation)	31,000	
(b) Limitation (amount in line (5)	50,000	
(c) Gain recognized as ordinary income under section 1251(c)(1) lower of line 6(a) or line 6(b)		31,000

A'S EXCESS DEDUCTIONS ACCOUNT—Continued	
(7) Balance December 31, 1971	19,000

[1] Computed by treating the section 1245 gain of $15,000 under paragraph (b)(1)(ii) of § 1.1251–3 as gross income derived from the trade or business of farming.

(3) *Amount necessary to adjust the excess deductions account with respect to deductions which did not result in a reduction of the taxpayer's tax*—(i) *In general.* Under section 1251(b)(3)(A), a subtraction is made from the excess deductions account to adjust the account for deductions that did not result in a reduction of the taxpayer's tax for the taxable year or any preceding taxable year. The amounts to be subtracted are determined under subdivisions (ii) and (iii) of this subparagraph in accordance with the rules in subdivision (iv) of this subparagraph. This subtraction shall be made before determining the amount of gain to which section 1251(c) applies. The amount subtracted under subdivision (ii) of this subparagraph is a temporary subtraction made solely to determine the amount in the excess deductions account for purposes of the limitation in section 1251(c)(2).

(ii) *Temporary subtraction.* The amount temporarily subtracted from the excess deductions account for a taxable year is the sum of the farm portion of (*a*) any net operating loss for such taxable year which does not reduce taxable income (computed without regard to the deduction under section 172(a)) in a prior year, and (*b*) any net operating loss from a prior taxable year which is carried to such taxable year but which does not reduce taxable income (computed without regard to the deduction under section 172(a)) in such taxable year.

(iii) *Permanent subtraction.* The amount permanently subtracted from the excess deductions account for a taxable year is the excess of the farm portion of any net operating loss which may be carried to the preceding year (reducing by the portion of such loss which reduced taxable income (computed without regard to the deduction under section 172(a)) for such preceding year) over the amount of such loss which may be carried to the taxable year, but the subtraction shall not be made earlier than the taxable year in which the excess deductions account is increased by reason of such loss.

(iv) *Rules of application.* For purposes of this subparagraph, the following rules shall apply:

(*a*) The farm portion of a net operating loss is that portion of such loss attributable to the trade or business of farming. Such portion and the remaining portion (hereinafter referred to as the nonfarm loss) shall be absorbed pro rata. If a farm net loss is not added to the excess deductions account in the year in which such loss occurs, the net operating loss (if any) for such year shall be treated as a nonfarm loss.

(*b*) In the case of an individual (other than a trust), the farm portion of a net operating loss shall be decreased by an amount, if any, equal to the excess of $25,000 (or the amount determined under paragraph (b)(2)(ii) of this section) over the nonfarm adjusted gross income. Such amount shall be added to the nonfarm portion of such net operating loss.

(*c*) The amounts considered as reducing taxable income under subdivision (ii) of this subparagraph in the taxable year shall be determined on the basis of a tentative computation of taxable income for such year in which the gain realized from the disposition of property to which section 1251(c)(1) applied shall be computed without regard to the excess deductions account limitation.

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

Example: A is an unmarried individual who uses the calendar year as his taxable year. For the years 1970 through 1974, A's items of income and deductions are as shown in the table below. A's personal deductions are disregarded. A had no income or loss for any year prior to 1970. Based upon such amounts and the computations shown below, A must recognize as ordinary income under section 1251(c)(1), $35,325 for 1971, $10,000 for 1972, $3,925 for 1973, and $150,000 for 1974.

Amounts assumed	1970	1971	1972	1973	1974
(a) Farm net income	($250,000)	$20,000	$5,000	($75,000)	($10,000)
(b) Nonfarm income	55,000	(82,000)	30,000	10,000	200,000
(c) Gain which would be recognized as ordinary income under 1251(c) (computed without regard to the EDA limitation) (hereinafter referred to as *farm property disposition*)		88,000	10,000	2,000	150,000
(d) Personal exemption	625	675	750	750	750
(e) Net operating loss (NOL) (computed per section 172(c))	(195,000)			(45,000)	

I. COMPUTATIONS FOR 1971

1. Excess Deductions Account (EDA) Limitation for 1971:				
a. EDA on December 31, 1970:				
1970 Farm net loss			250,000	
Less			(25,000)	
			225,000	225,000
b. Less farm net income for 1971				(20,000)
c. EDA before temporary subtraction				205,000
d. Less temporary subtraction per subdivision (ii)(*b*):				
Aggregate farm NOL carryover to 1971			195,000	
Less tentative farm NOL deduction for 1971:				
Farm net income		20,000		
Nonfarm income		(82,000)		
Farm property disposition		88,000		
Exemption		(675)		
Tentative taxable income		25,325		
Tentative NOL reducing taxable income		25,325	(25,325)	
			169,675	(169,675)
e. EDA limitation for 1971				35,325
2. 1971 Taxable Income:				
a. Farm net income				20,000
b. Nonfarm income				($82,000)
c. Farm property disposition				88,000
d. Exemption				(675)
e. Section 1202 deduction:				
Farm property disposition			$88,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(e))			35,325	
Capital gain			52,675	
Less 50 percent deduction			26,337	(26,338)
f. 1971 Taxable income				(1,013)

II. COMPUTATIONS FOR 1972

1. Excess Deductions Account Limitation for 1972:				
a. EDA (line 1(c) above)				205,000
b. Less recapture in 1971				(35,325)
c. Less farm net income for 1972				(5,000)
d. Less permanent subtraction per subdivision (iii):				
1970 Farm NOL carryover to 1971			195,000	
Less 1970 farm NOL carryover to 1972 (computed per section 172(b)(2)):				
Farm NOL to 1971		$195,000		
Less 1971 taxable income computed per section 172(b)(2):				
Farm net income	$20,000			
Nonfarm income	(82,000)			
Farm property disposition	88,000			
	26,000	(26,000)		
Farm NOL carryover to 1972	169,000	($169,000)		
			26,000	($26,000)
e. EDA before making temporary subtractions				138,675

Amounts assumed	1970	1971	1972	1973	1974
f. Less temporary subtraction per subdivision (ii)(*b*):					
Farm NOL carryover to 1972				169,000	
Farm net income			5,000		
Nonfarm income			30,000		
Farm recapture disposition			10,000		
Exemption			(750)		
Tentative taxable income			44,250		
Tentative NOL reducing taxable income			44,250	(44,250)	
				124,750	(124,750)
g. EDA limitation for 1972					13,925
2. Taxable Income for 1972:					
a. Farm net income					5,000
b. Nonfarm income					30,000
c. Farm property disposition					10,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				10,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				10,000	0
f. Taxable income before NOL deduction					44,250
g. Net operating loss deduction					(44,250)
h. Taxable income for 1972					0
III. COMPUTATIONS FOR 1973					
1. Excess Deductions Account Limitation for 1973:					
a. Line 1(e) above					138,675
b. Less recapture in 1972					(10,000)
c. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1972			169,000		
Less 1970 Farm NOL reducing taxable income in 1972			(44,250)		
			124,750	124,750	
Less 1970 Farm NOL carryover to 1973 computed per section 172(b)(2):					
Farm NOL to 1972			169,000		
1972 Taxable income computed per section 172(b)(2):					
Farm net income		$5,000			
Nonfarm income		30,000			
Farm recapture disposition		10,000			
		45,000	($45,000)		
Farm NOL carryover to 1973			124,000	($124,000)	
				750	($750)
d. EDA before making temporary subtractions					$127,925
e. Less temporary subtraction per subdivision (ii)(*a*)–zero (since 1973 farm loss treated as nonfarm addition to NOL per subdivision (iv)(*a*))					0
f. Less temporary subtraction per subdivision (ii)(*b*): Aggregate farm NOL carryover to 1973				$124,000	
Less tentative farm NOL deduction for 1973:					
Farm net income			($75,000)		
Nonfarm income			10,000		
Farm property disposition			30,000		
Exemption			(750)		
Tentative taxable income			(44,250)		
Tentative NOL reducing taxable income			0	0	
				124,000	(124,000)
g. EDA limitation for 1973					3,925
2. Taxable Income 1973:					
a. Farm net income					(75,000)
b. Nonfarm income					10,000

Amounts assumed	1970	1971	1972	1973	1974
c. Farm property disposition					20,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				20,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				3,925	
Capital gain				16,075	
Less 50 percent deduction				8,038	(8,037)
f. Taxable income for 1973					(53,787)
IV. COMPUTATIONS FOR 1974					
1. Excess Deductions Account Limitation for 1974:					
a. Line 1(d) above					127,925
b. Less recapture in 1973					(13,925)
c. Farm loss for 1974			10,000		
Plus farm NOL deduction (see § 1.1251–3(b)(3))			45,000		
			55,000	55,000	
Less				25,000	
				30,000	30,000
d. Less permanent subtraction per subdivision (iii):					
1970 Farm NOL carryover to 1973				124,000	
Less 1970 farm NOL carryover to 1974 per section 172(b)(2)				124,000	
				0	0
e. EDA before making temporary subtractions					154,000
f. Less temporary subtraction per subdivision (ii)(*b*):					
Aggregrate farm NOL carryover to 1974				124,000	
Less tentative farm NOL deduction in 1974:					
Farm net income			(10,000)		
Nonfarm income			200,000		
Farm property disposition			150,000		
Exemption			(750)		
Tentative taxable income			339,250		
Tentative NOL deduction			169,000		
Farm portion of tentative NOL deduction				124,000	
				0	0
g. EDA limitation for 1974					$154,000
2. Taxable Income 1974:					
a. Farm net income					(10,000)
b. Nonfarm income					200,000
c. Farm property disposition					150,000
d. Exemption					(750)
e. Section 1202 deduction:					
Farm property disposition				$150,000	
Less amount treated as ordinary income under section 1251(c) (lesser of amount of gain on line 1(g))				150,000	0
f. Taxable income before NOL deduction					339,250
g. Net operating loss deduction					(169,000)
h. Taxable income					170,250

(vi) *Electing small business corporation. (a)* In the case of an electing small business corporation, the amounts to be subtracted under subdivisions (ii) and (iii) of this subparagraph, shall be the sum of the amounts under such subdivisions computed with respect to each shareholder of the corporation for the taxable year of the shareholder with which or within which the taxable year of the corporation ends, by applying (*b*) of this subdivision (vi), in lieu of subdivision (iv)(*a*) of this subparagraph.

(*b*) For purposes of (*a*) of this subdivision, the farm portion of a shareholder's net operating loss is that portion of the net operating loss of such shareholder attributable to the corporation's farm net loss, and such portion and the remaining portion shall be considered to be absorbed pro rata. If a corporation's farm net loss is not added to its excess deduction account in the year in which such loss occurs, no portion of a shareholder's net operating loss for the taxable year of the shareholder with which or within which such taxable year of the corporation ends shall be attributable to such corporation's farm net loss.

(d) *Exception for taxpayers using certain accounting methods*—(1) *General rule.* Under section 1251(b)(4), except to the extent that a taxpayer has succeeded to an excess deductions account as provided in paragraph (e) of this section (relating to receipt of farm recapture property in certain corporate and gift transactions), additions to the account shall not be required by a taxpayer who elects to compute taxable income from the trade or business of farming (as defined in paragraph (e)(1) of § 1.1251–3:

(i) By using inventories for all property which may be inventoried except as to property to which subdivision (ii) of this subparagraph applies, and

(ii) In accordance with subparagraph (3) of this paragraph, by charging to capital account all expenditures paid or incurred which are properly chargeable to capital account including such expenditures which the taxpayer may, under chapter 1 of the Code or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not chargeable to capital account.

For rules as to procedure of making the election, effect of a change in method of accounting upon making the election, and conditions for revoking the election, see subparagraphs (4), (5), and (6), respectively, of this paragraph.

(2) *Inventories.* The absence of property which may be inventories shall not preclude a taxpayer from making an election under section 3251(b)(4). Any acceptable inventory method will satisfy the requirement of subparagraph (1)(i) of this paragraph.

(3) *Property chargeable to capital account*—(i) *In general.* Property subject to the capitalization requirement prescribed in subparagraph (1)(ii) of this paragraph includes all property described in section 1231(b) (1) and (3), without regard to any holding period therein provided, which is used in the trade or business of farming. Thus, for example, property subject to the capitalization requirement includes property used in the trade or business of farming of a character subject to the allowance for depreciation and real property so used regardless of the period held, and livestock used in the trade or business of farming which is held for draft, breeding, dairy, or sporting purposes regardless of the period held.

(ii) *Expenditures which must be capitalized.* Expenditures subject to the requirement of subparagraph (1)(ii) of this paragraph are all expenditures, whether direct or indirect, paid or incurred, which are properly chargeable to capital account. For examples of the meaning of the term *properly chargeable to capital account,* see §§ 1.61–4, 1.162–12, 1.263(a)–1, and 1.263(a)–2, and paragraph (a)(4) (ii) and (iii) of § 1.446–1. Other examples of expenditures referred to in subparagraph (1)(ii) of this paragraph are expenditures under sections 175 (relating to soil and water conservation), 180 (relating to fertilizer, etc.), 182 (relating to land clearing), and 266 (relating to certain carrying charges) which (without regard to section 1251) a taxpayer may treat or elect to treat as expenditures which are not chargeable to capital account. Thus, for example, with respect to developing a farm, ranch, orchard, or grove, amounts properly chargeable to capital account include amounts paid or incurred for upkeep, taxes, interest, and other carrying charges, water for irrigation, fertilizing, controlling undergrowth, and the cultivating and spraying of trees. For a further example, with respect to a produced animal, amounts properly chargeable to capital account for the animal include all expenditures paid or incurred for producing the animal, such as for stud, breeding, and veterinary services, as well as all amounts paid or incurred with respect to the

brood animal during the gestation period of the produced animal including all amounts paid or incurred for feed, maintenance, utilities, indirect overhead, depreciation, insurance, and carrying charges. Direct and indirect expenditures properly chargeable to capital account with respect to raising an animal may include, in addition to expenditures for feed, maintenance, etc., expenditures for training. Direct and indirect expenditures with respect to feed may include, in the case of a grazing operation, fees for the rental of grazing land, and the portion of all labor, taxes, interest, fencing costs, and carrying charges paid or incurred by the taxpayer allocable to grazing. For purposes of this subparagraph, reasonable allocations shall be made by the taxpayer of items between animals held for different purposes and as to each animal held. However, all amounts allocated to a brood animal during the period of gestation are, for purposes of this subparagraph, entirely chargeable to the capital of the produced animal.

(iii) *Unharvested crops.* With respect to unharvested crops to which section 1231(b)(4) applies, see section 268 and paragraph (g) of §1.1016–5 (relating, respectively, to disallowance of certain deductions and to adjustments to basis).

(iv) *Changes in character of property.* If, in a taxable year subsequent to the first taxable year to which an election under section 1251(b)(4) applies, property which was not subject to the requirements of subparagraph (1)(ii) of this paragraph becomes subject to such requirements, then the following rules shall apply:

(*a*) The adjusted basis of such property at the beginning of the taxable year in which it becomes subject to the requirements of subparagraph (1)(ii) of this paragraph shall be equal to the amount its adjusted basis would have been on such date had it been accounted for in accordance with such requirements (taking into account, if applicable, the depreciation which would have been allowed as determined by the taxpayer using a period, salvage value, and methods that would have been proper).

(*b*) At the beginning of the taxable year in which such property becomes subject to the requirements of subparagraph (1)(ii) of this paragraph:

(*1*) If such property was not included in the opening inventory, the amount equal to the excess of its adjusted basis as computed in (*a*) of this subdivision over its adjusted basis as of the close of the preceding taxable year, or

(*2*) If such property was included in the opening inventory, such opening inventory shall be reduced by the inventory value of such property included therein and the amount of the difference between the adjusted basis for the property computed in (*a*) of this subdivision and such inventory value,

Shall be added to gross income for such taxable year and shall be treated as gross income derived from the trade or business of farming under paragraph (b)(1)(ii) of §1.1251–3, except that if the difference in (*b)(2*) of this subdivision represents an excess of such inventory value over the adjusted basis for the property computed in (*a*) of this subdivision then such excess shall be subtracted from gross income for such taxable year and shall be treated as a deduction allowed which is directly connected with carrying on the trade or business of farming under paragraph (b)(1)(i) of §1.1251–3.

(*c*) If any deductions for depreciation are treated as amounts which would have been allowed in a prior taxable year or years for purposes of (*a*) of this subdivision, such deduction shall be treated as having been allowed for purposes of applying sections 1245 and 1250 in the same taxable year or years and thus included in the amount of adjustments reflected in adjusted basis within the meaning of paragraph (a)(1)(ii) of §1.1245–2 or depreciation adjustments within the meaning of paragraph (d)(1) of §1.1250–2 (as the case may be).

(*d*) For purposes of this subparagraph (3), if during a taxable year property becomes subject to the requirements of subparagraph (1)(ii) of this paragraph, it shall be considered subject to such requirements on each day it is held during such year.

(*e*) The adjusted basis under (*a*) of this subdivision of property of a character subject to the allowance for depreciation shall be its basis for which

deductions may be computed under section 167.

(v) *Example.* The provisions of subdivision (iv) of this subparagraph may be illustrated by the following example:

Example: On January 1, 1974, A, an individual taxpayer who in a previous year had elected under section 1251(b)(4) to compute income from the trade or business of farming by using inventories and by charging to capital account all items properly chargeable to capital under the rules of subdivision (ii) of this subparagraph, purchases a herd of six-month-old feeder calves for $13,000. During 1974, in connection with such herd, A incurred raising costs of $4,000 and carrying charges of $1,600 which would have been properly chargeable to capital account within the meaning of subparagraph (1)(ii) of this paragraph if the herd had not been included in inventory. A determines under his unit-livestock method that on December 31, 1974, the inventory value of the herd is $17,000. On March 1, 1975, A decides to use one-half of the herd for breeding purposes with such part of the herd becoming subject to the capitalization requirements. On January 1, 1975, the adjusted basis for the animals held for breeding purposes, computed under the provisions of subdivision (iv)(a) of this subparagraph, is $9,300 (that is, the aggregate of one-half of the purchase price of $13,000 for the entire herd of feeder calves, $6,500, one-half of the carrying charges of $1,600 incurred during 1974 in connection with the entire herd, $800, and one-half of the $4,000 of raising costs incurred during 1974 for the entire herd, $2,000). There is no adjustment for the depreciation which would have been allowed since no animal in the herd had reached an acceptable breeding age. Therefore, A as of January 1, 1975, must under the provisions of subdivision (iv)(*b)(2*) of this subparagraph subtract $8,500 from his opening inventory value of $17,000. However, A has not changed his method of accounting with respect to such animals. Under the provisions of subdivision (iv)(*b)(2*) of this subparagraph, A for 1975 will add $800 to his gross income (that is, the difference between the adjusted basis for the calves to be used for breeding purposes, $9,300, over the inventory value of such animals, $8,500). Such amount under the provisions of subdivision (iv)(*b*) shall be treated as gross income derived from the trade or business of farming under paragraph (b)(1) of § 1.1251–3.

(4) *Time and manner of making election*—(i) *In general.* The election under section 1251(b)(4) for any taxable year beginning after December 31, 1969, shall be filed within the time prescribed by law (including extensions thereof) for filing the return for such taxable year. Such election shall be made and filed by attaching a statement of such election signed by the taxpayer to the return for the first taxable year for which the election is made. The statement shall contain a declaration that the taxpayer is making an election under section 1251(b)(4) of the Code and that taxable income from the trade or business of farming is computed by using inventories for all property, which may be inventoried and by charging to capital account all expenditures paid or incurred which are properly chargeable to capital account (including such expenditures which the taxpayer may, under chapter 1 of the Code or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not properly chargeable to capital account). Additionally, the statement must contain the information prescribed by subparagraph (5) of this paragraph, if applicable.

(ii) *Joint return.* If for a taxable year taxpayers file a joint return under section 6013, the election referred to in subparagraph (1) of this paragraph must be made by both such taxpayers in accordance with the provisions of subdivision (i) of this subparagraph. If, however, in such case either of such taxpayers has for a previous taxable year made such an election, then only the taxpayer who has not made such election is required to comply with the provisions of subdivision (i) of this subparagraph. The taxpayer who previously made such an election shall attach a statement to the return specifying the taxable year for which the election was made and with whom the election was filed.

(5) *Change in method of accounting, etc.*—(i) *In general.* If, in order to comply with an election made under section 1251(b)(4), a taxpayer must change his method of accounting (in computing taxable income from the trade or business of farming) by placing in inventory a class of items not previously treated as in an inventory or by charging to capital account a class of items which had been consistently treated as an expense or as part of inventory (see paragraph (e)(2)(ii)(*b*) of § 1.446–1), the taxpayer will be deemed

to have obtained the consent of the Commissioner as to such change in method of accounting solely as to such items and there shall be taken into account in accordance with section 481 of the Code and the regulations thereunder those adjustments which are determined to be necessary by reason of such change solely as to such items in order to prevent amounts from being duplicated or omitted. For purposes of section 481(a)(2), such change in method of accounting with respect to only such items shall be treated as a change not initiated by the taxpayer and, thus, under paragraph (a)(2) of §1.481–1, no part of the adjustments required under section 481 with respect to such items shall be based on amounts which are taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(ii) *Additional information.* If, in order to comply with an election made under subparagraph (1) of this paragraph a taxpayer (or in the case of a joint return one or both taxpayers) changes his method of accounting, then in addition to the information required to be filed under subparagraph (4) of this paragraph the taxpayer must file on Form 3115 as part of such election all the information described in paragraph (e)(3) of §1.446–1 (relating to change in method of accounting), but the time prescribed in paragraph (e)(3) of §1.446–1 for filing Form 3115 shall not apply.

(iii) *Election made before May 7, 1976.* If an election referred to in subparagraph (1) of this paragraph was made before May 7, 1976, the taxpayer shall file not later than August 5, 1976, such information referred to in subparagraph (4) of this paragraph not previously required by applicable regulations to be filed in order to make such election, and, in addition, if subdivision (ii) of this subparagraph applies, the taxpayer shall file not later than August 5, 1976, on Form 3115 the information referred to in subdivision (ii) of this subparagraph with the district director, or the director of the internal revenue service center, with whom the election was filed. For this purpose, Form 3115 shall be attached to a statement clearly identifying the election referred to in subparagraph (1) of this paragraph and the first taxable year to which it applied.

(6) *Revocability of election*—(i) *In general.* An election referred to in subparagraph (1) of this paragraph is binding on the taxpayer or in the case of a joint return both taxpayers) for the taxable year of such election and for all subsequent taxable years (regardless of whether they continue to file a joint return) and may not be revoked except with the consent of the Commissioner. Since revocation would constitute a change in method of accounting, in order to secure the Commissioner's consent to the revocation of such an election and to a change of the taxpayer's method of accounting, all the provisions of paragraph (e)(3) of §1.446–1 must be met including the requirement that Form 3115 must be filed within 180 days after the beginning of the taxable year in which it is desired to make the change. See section 481 and the regulations thereunder (relating to certain adjustments required by such changes).

(ii) *Revocation of elections made prior to May 7, 1976.* If on or before May 7, 1976, an election under section 1251(b)(4) has been made, such election may be revoked without permission of the Commissioner by filing on or before August 5, 1976, with the district director or the director of the internal revenue service center with whom the election was filed a statement of revocation of an election under section 1251(b)(4). If such election to revoke is for a period which falls within one or more taxable years for which an income tax returns shall be filed for any such taxable years for which the computation of taxable income is affected by reason of such revocation.

(e) *Transfer of excess deductions account*—(1) *Certain corporate transactions*—(i) *In general.* Under section 1251(b)(5)(A), in the case of a transfer described in section 1251(d)(3) and paragraph (c)(2) of §1.1251–4 to which section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings), 374(a) (relating to exchanges pursuant to certain railroad reorganizations), or 381 (relating to

carryovers in certain corporate acquisitions) applies, the acquiring corporation shall succeed to and take into account as of the close of the day of distribution or transfer the excess deductions account of the transferor. Determinations under this subdivision shall be made under subdivisions (ii), (iii), and (iv) of this subparagraph regardless of whether section 381 applies. For treatment as farm recapture property of stock or securities received in certain transfers to controlled corporations to which section 1251(d)(3) (but not section 1251(b)(5)(A)) applies, see section 1251(d)(6) and paragraph (f) of § 1.1251–4.

(ii) *Acquiring corporation.* For purposes of subdivision (i) of this subparagraph, determinations as to which corporation is the acquiring corporation shall be made under paragraph (b)(2) of § 1.381(a)–1.

(iii) *Certain operating rules.* For purposes of subdivision (i) of this subparagraph, the operating rules of section 381(b) and § 1.381(b)–1 shall apply. Thus, for example, except in the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the amount of the excess deductions account of the transferor shall be computed, as of the close of the date of distribution or transfer (as determined under paragraph (b) of § 1.381(b)–1), as if the taxable year of the transferor closed on such date (regardless of whether the taxable year actually closed). In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation's excess deductions account shall be treated for purposes of section 1251 just as the transferor corporation's excess deductions account would have been treated if there had been no reorganization.

(iv) *Excess deductions account balance.* For purposes of subdivision (i) of this subparagraph, the amount in the transferor's excess deductions account as of the close of the date of distribution or transfer referred to in subdivision (iii) of this subparagraph shall be the amount in such account determined after making all the applicable additions and subtractions under section 1251(b) (other than subtractions under paragraph (5)(A) of section 1251(b) and this subparagraph) for the taxable year ending (or considered ending) on such date including a subtraction by reason of gain (if any) recognized under section 1251(c)(1) by reason of a disposition which is in part a sale or exchange and in part a gift transaction to which section 1251(d)(1) and paragraph (a)(2) of § 1.1251–4 apply.

(2) *Certain gifts*—(i) *In general.* If farm recapture property is disposed of by gift (including for purposes of this paragraph in a transaction which is in part a sale or exchange and in part a gift or a transaction treated under paragraph (a)(2) of this section as a gift), and if such gift is made during any *1-year period* (described in subdivision (ii) of this subparagraph) for which the *potential gain limitation percentage* (as computed in subdivision (iii) of this subparagraph) exceeds 25 percent, then the provisions of subdivision (iv) of this subparagraph shall apply in respect of such gift.

(ii) *One-year period.* For purposes of this subparagraph, a *1-year period* is a period of 365 days beginning on the date a gift is made by the donor.

(iii) *Potential gain limitation percentage.* Under this subdivision, the *potential gain limitation percentage* for any such 1-year period is a percentage equal to (*a*) the sum of the potential gains (determined as of the first day of such period) on each item of farm recapture property held by such taxpayer on such first day disposed of by gift by the taxpayer during such period, divided by (*b*) the sum of the potential gains (determined as of the first day of such period) on all farm recapture property held by such taxpayer on such first day.

(iv) *Allocation ratio.* With respect to each gift of property (to which the provisions of this subdivision apply) made during a taxable year, each donee shall succeed (at the time the first of such gifts is made during such taxable year) to the same proportion of (*a*) the donor's excess deductions account determined, as of the close of such taxable year of the donor, after making all the applicable additions and subtractions

under section 1251(b) (other than subtractions under section 1251(b)(5) and this paragraph), as (*b*) the potential gain (determined immediately prior to the time the first of such gifts is made during such taxable year) on the property (held by the donor immediately prior to such time) received by such donee bears to (*c*) The aggregate potential gain (determined immediately prior to such time) on all farm recapture property held by the donor immediately prior to such time.

(v) *Definitions and certain special rules.* For purposes of this subparagraph:

(*a*) The term *potential gain* means an amount equal to the excess of the fair market value of property over its adjusted basis, but, in the case of land, limited under paragraph (b)(2)(ii) of §1.1251–1 to the extent of the deductions allowable in respect of such land pursuant to an election (if any) under sections 175 (relating to soil and water conservation expenditures) and 182 (relating to expenditures by farmers for clearing land) for the taxable year of disposition and the four immediately preceding taxable years regardless of whether any such preceding taxable year begins before December 31, 1969. See section 1251(e)(5).

(*b*) Property held on the first day of a one-year period shall include property received by gift during such one-year period and the potential gain with respect to such property, for purposes of making the computations under this subparagraph, shall be the potential gain in the hands of the donor reduced by the amount of gain (in the case of an exchange which is part a sale and part a gift) taken into account by the donor.

(*c*) Property held by a taxpayer on the first day of a one-year period which property becomes farm recapture property in the hands of such taxpayer during such one-year period shall be considered to be farm recapture property on each day of such one-year period.

(vi) *Part-sale-part-gift transaction.* If property is disposed of in a transaction which is in part a sale or exchange and in part a gift, then for purposes of subdivisions (iii)(*a*) and (iv)(*b*) of this subparagraph the potential gain with respect to the property transferred shall be reduced by the amount of gain taken into account by the transferor.

(vii) *Joint return.* For application of the provisions of this subparagraph with respect to a taxable year for which a joint return is filed, see paragraph (f)(4) of this section.

(3) *Examples.* The provisions of subparagraph (2) of this paragraph may be illustrated by the following examples in which it is assumed that all taxpayers are unmarried individuals.

Example 1. The only farm recapture property A owns is a farm, consisting of farm land and certain farm equipment which is farm recapture property. During the period involved, there was no deduction allowable under section 175 or 182 to any person owning an interest in the farm. A, who uses the calendar year as his taxable year, makes a series of gifts of undivided interests in the farm. In these circumstances, computations may be made by reference to percentages of undivided interests in the farm. The potential gain limitation percentages for each applicable 1-year period are computed, in accordance with the additional facts assumed, in the table below:

Date Gift to donee	9/1/70	8/1/71	3/1/72	5/1/73
	C	D	E	F
(1) Percent of undivided interest in entire farm given as gift by A on date indicated	20%	10%	10%	60%
(2) Percent of undivided interest in entire farm held by A immediately before gift	100%	80%	70%	60%
(3) Potential gain:.				
(a) On all property held by A on date of gift	$100,000	$96,000	$140,000	$125,000
(b) Limitation percentage (sum of amounts in line (1) during 1-year period beginning on date of gift divided by line (2))	30%	25%	14.28%	100%

(ii) Under subparagraph (2)(iv) of this paragraph, C, D, and F each succeed to the proportion of A's excess deductions account at each applicable time as computed in accordance with the additional facts assumed, in the table below:

	Taxable year ending—			
	Dec. 31, 1970	Dec. 31, 1971	Dec. 32, 1972	Dec. 31, 1973
Gift to donee to which subparagraph (2)(iv) of this paragraph applies during taxable year	C	D	E	F
(4) Potential gain (determined immediately prior to time first gift to which subparagraph (2)(iv) of this paragraph applies is made):				
(a) On property received by donee to which such subparagraph (2)(iv) applies (line (3)(a) multiplied by line (1) divided by line (2))	$20,000	$12,000		$125,000
(b) Aggregate potential gain on all farm recapture property held by donor (line (3)(a))	$100,000	$96,000		$125,000
(5) Allocation ratio (line (4)(a), divided by line (4)(b))	20%	12.5%		100%
(6) Excess deductions account of A:.				
(a) At end of previous taxable year	0	$160,000	$210,000	$200,000
(b) Net increase (decrease) for taxable year (determined before making any subtractions under section 1251(b)(5) and this paragraph)	$200,000	$80,000	($10,000)	$36,000
(c) At 12/31 (so determined)	$200,000	$240,000	$200,000	$236,000
(d) Less: Portion to which donee succeeds (line (5), multiplied by line (6)(c))	$40,000	$30,000	$0	$236,000
(e) At 12/31 (to line (6)(a) following taxable year)	$160,000	$210,000	$200,000	$0

Since the potential gain limitation percentage for the 1-year period beginning on September 1, 1970, exceeds 25 percent, a portion of A's excess deductions account, under the provisions of subparagraph (2)(iv) of this paragraph, is succeeded to by C and D. Similarly, since such percentage for the 1-year period beginning May 1, 1973, exceeds 25 percent, such provisions apply to the gift made to F. Since, however, such percentage is 25 percent or less for all 1-year periods in which the gift to E falls (i.e., 25 percent and 14.28 percent for the 1-year periods beginning, respectively, on August 1, 1971, and March 1, 1972) such provisions do not apply to the gift to E.

Example: 2. (i) G uses the calendar year as his taxable year and H uses a taxable year ending June 30. As of the close of 1972, G has $100,000 in his excess deductions account, determined before any subtractions under section 1251(b)(5) and this paragraph. G owns only three items of farm recapture property, none of which is land. On May 1, 1972, G makes a gift of farm recapture property No. 1 to his son and on September 1, 1972, G sells to H for $80,000 farm recapture property No. 2 in a transaction which is in part a sale and in part a gift. G owns throughout all relevant periods farm recapture property No. 3. The potential gain limitation percentage for G's one-year period beginning May 1, 1972, is computed in accordance with the additional facts assumed in the table below:

Farm Recapture Property				Total
No. 1	No. 2	No. 3		
(1) Fair market value 5/1/72	$25,000	$100,000	$800,000	
(2) Adjusted basis 5/1/72	$10,000	$60,000	$795,000	
(3) Potential gain (line (1), minus line (2))	$15,000	$40,000	$5,000	$60,000
(4) Sum of potential gains on properties disposed of by gift during period less gain taken into account by transferor on part-sale-part-gift	$15,000	$20,000		$35,000
(5) Potential gain limitation percentage (total line (4), divided by total line (3))				58⅓%

Since the potential gain limitation percentage for the one-year period beginning on May 1, 1972, exceeds 25 percent, the provisions of subparagraph (2)(iv) of this paragraph apply to the gift to the son and that portion of the disposition to H which is a gift.

(ii) The portion of G's excess deductions account determined, as of the close of 1972, before any subtraction under section 1251(b)(5) and this paragraph, allocated to the son and to H as of May 1, 1972, is computed in the table below:

	Property			Total
	No. 1	No. 2	No. 3	
(1) Potential gain under part (i) of this example (since the first day of the one-year period is the same as the time as of which the first gift was made during the taxable year)	$15,000	$40,000	$5,000	$60,000
(2) Potential gain less amount taken into account by transfer on part-sale-part-gift	15,000	20,000		
(3) Allocation percentage (line (2), divided by $60,000)	25%	33⅓%		
(4) Excess deductions account at close of taxable year (determine before making any subtractions under section 1251(b)(5) and this paragraph)				100,000
(5) Portion to which donee succeeds on 5/1/72	25,000	33,333		58,333
(6) G's excess deductions account 12/31/72				$41,667

Accordingly, the amount of G's excess deduction account succeeded to as of May 1, 1972, is $25,000 by the son and $33,333 by H.

(f) *Joint return*—(1) *Joint excess deductions account.* If for a taxable year a taxpayer and his spouse file a joint return under section 6013, then for such taxable year each taxpayer shall (if necessary) establish and maintain a joint excess deductions account. Such joint excess deductions account shall consist of the aggregate of the separately maintained excess deductions account of each spouse. A separately maintained excess deductions account shall be computed under the rules of paragraphs (b) and (c) of this section, except that for each taxable year a joint return is filed:

(i) The $50,000 amount in the nonfarm adjusted gross income limitation in paragraph (b)(2)(i) of this section shall be considered satisfied if the combined nonfarm adjusted gross income of both spouses exceeds $50,000,

(ii) The $25,000 amount in the farm net loss exclusion in paragraph (b)(2)(ii) of this section shall be allocated between the two spouses in proportion to the farm net loss of each spouse having a farm net loss, and

(iii) The separately maintained excess deductions account of each spouse shall be reduced, if necessary, below zero, by the amount of such spouse's farm net income (computed as if a separate return were filed) plus the amount of gain (computed under subparagraph (3) of this paragraph) which is recognized as ordinary income under section 1251(c)(1) in respect of a disposition of farm recapture property owned by the taxpayer.

(2) *Surviving spouse.* For purposes of this paragraph, a joint return does not include a return of a surviving spouse (as defined in section 2 relating to a spouse who died during either of his two taxable years immediate preceding the taxable year) which is treated as a joint return of a husband and wife under section 6013.

(3) *Application of excess deductions account limitation in joint return year.* In the case of a taxable year for which a joint return is filed, the aggregate of the amount of gain recognized as ordinary income under section 1251(c)(1) (after applying paragraph (b) (2)(o) and (3) of §1.125–1, if applicable) shall not exceed the amount in the joint excess deductions account (that is, the aggregate of the separately maintained excess deductions account of each spouse) at the close of the taxable year after subtracting from each such separately maintained account the amount specified in section 1251(b) (3) (A) and paragraph (c) (1) (i) of this section as modified by the rules of this paragraph. For the amount of limitation for a taxable year for which a separate return is filed, see paragraph (b)(4) of this section. For determinations as to which dispositions are taken into account for any taxable year, see paragraph (b)(4) of §1.1251–1.

(4) *Certain gifts*—(i) *In general.* If farm recapture property is transferred as a gift by a spouse to a person other than a spouse during a taxable year for which a joint return is filed, the spouses shall for purposes of applying the provisions of section 1251(b) (5) (B) and paragraph (e)(2) of this section be treated as a single taxpayer. Thus, under paragraph (e)(2) of §1.1251–2, the

potential gain limitation percentage and the proportion for allocating the amount in the joint excess deductions account to one or more donees shall be determined by treating the spouses as a single taxpayer. However, with respect to each gift by a spouse, such spouse's separately maintained excess deductions account shall be reduced (below zero, if necessary) by the amount of the joint excess deductions account balance to which the donee of such gift succeeded under paragraph (e)(2)(iv) of this section.

(ii) *Gift between spouses.* If farm recapture property is transferred by gift by one spouse to another spouse during a taxable year for which a joint return is filed, such gift shall not affect the balance in the joint excess deductions account but its effect on the separately maintained excess deductions account of each spouse shall be determined as if separate returns were filed, but only after applying subdivision (i) of this subparagraph.

(5) *Allocation of joint excess deductions account upon filing separate returns*—(i) *In general.* If for any reason a taxpayer and his spouse cease to file a joint return, then except as provided in this subparagraph the amount of the separately maintained excess deductions account of each spouse as of the close of the last taxable year for which a joint return was filed shall be the amount of such spouse's excess deductions account as of the beginning of the first taxable year for which they cease filing a joint return.

(ii) *Deficit.* If under subparagraph (4)(i) of this paragraph one of the spouses has a deficit in his separately maintained excess deductions account as of the close of the last taxable year for which a joint return was filed, then as of the beginning of the first taxable year for which they cease filing a joint return:

(*a*) The spouse who had such deficit shall have an excess deductions account of zero, and

(*b*) The other spouse shall have an excess deductions account equal to the amount prescribed in subdivision (i) of this subparagraph minus the amount of such deficit.

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

Example 3. Assume the same facts as in example (4) of paragraph (b)(5) of this section, except that H and W file a joint return under section 6013 and that H has a farm net loss of only $40,000. Thus, since the nonfarm adjusted gross income for calendar year 1971 was $60,000 for H and $30,000 for W, their combined nonfarm adjusted gross income exceeds $50,000, thereby satisfying under subparagraph (1)(i) of this paragraph the $50,000 limitation of paragraph (b)(2)(i) of this section. Assume further that for 1971 only W makes a dispostion of farm recapture property (other than land and section 1245 property). As a result of such disposition, W realizes a gain of $14,000. Accordingly, for 1971, the separately maintained excess deductions accounts of H and W, their joint excess deductions account, and the treatment of the gain realized by W on the disposition of the farm recapture property are computed, in accordance with the facts assumed in the table below:

EXCESS DEDUCTIONS ACCOUNTS

		H's		W's		Joint
(1) Balance Jan. 1, 1971	.....	$10,000	.....	$5,000	.....	$15,000
(2) Additions for 1971:						
(a) Farm net loss for 1971	$40,000	.....	$10,000	.....	$50,000	.....
(b) Less amount in paragraph (b)(2)(ii) of this section as allocated under subparagraph (1)(ii) of this paragraph	20,000	.....	5,000	.....	25,000	.....
(c) Total additions for 1971	.....	20,000	.....	5,000	.....	25,000
(3) Subtotal	.....	30,000		10,000	.....	40,000
(4) Subtractions for 1971	.....	0	.....	0	.....	
(5) Excess deductions account limitation on gain recognized as ordinary income under section 1251(e)(1) for 1971	.....	30,000	.....	10,000	.....	40,000
(6) Subtraction for dispositions of farm recapture property:						
(a) Gain to which section 1251(c)(1) applies (computed before applying limitation)	0	.....	14,000	.....	14,000	.....
(b) Limitation (amount in line (5))	30,000	.....	10,000	.....	40,000	.....

EXCESS DEDUCTIONS ACCOUNTS—Continued

		H's		W's		Joint
(c) Gain recognized as ordinary income under section 1251(c)(1), computed for joint account (lower of line 6(a) or line 6(b) subject to provisions as to separately maintained accounts of subparagraph (1)(iii)	.....	.....	.....	14,000	.....	14,000
(7) Balance Dec. 31, 1971	.....	30,000	.....	(4,000)	.....	26,000

If for 1972, H and W were to file separate returns, then the separately maintained excess deductions account balances as of January 1, 1972, would be $26,000 and zero respectively. See subparagraph (5)(ii) of this paragraph.

[T.D. 7418, 41 FR 18816, May 7, 1976; 41 FR 23669, June 11, 1976]

§ 1.1251–3 Definitions relating to section 1251.

(a) *Farm recapture property*—(1) *In general.* (i) The term *farm recapture property* means any property (other than section 1250 property as defined in section 1250(c)) which, in the hands of the taxpayer is or was property:

(*a*) Which is described in section 1231(b)(1) (relating to business property held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), section 1231(b)(3) (relating to livestock), or section 1231(b)(4) (relating to an unharvested crop), and

(*b*) Which, at the time the property qualifies under (*a*) of this subdivision, is used in the trade or business of farming (as defined in paragraph (e) of this section).

(ii) The term *farm recapture property* also includes:

(*a*) Property acquired by gift and property acquired in a transaction to which section 1251(b)(5)(A) applies, if such property was farm recapture property within the meaning of subdivision (i) of this subparagraph in the hands of the transferor, and

(*b*) Property the basis of which in the hands of the taxpayer holding such property is determined by reference to the basis of other property which in the hands of such taxpayer was farm recapture property within the meaning of subdivision (i) of this paragraph. For purposes of (*b*) of this subdivison (ii) property whose basis is determined in accordance with the last sentence of section 1033(c) shall be considered as having as basis determined by reference to the property whose conversion gave rise to the application of such section.

(iii) *Leasehold of farm recapture property.* If property is farm recapture property under this subparagraph, a leasehold of such property is also farm recapture property is also farm recapture property to the same extent as described in, and in accordance with the principles of paragraph (a)(2) of § 1.1245–3.

(iv) If property described in subdivision (ii) of this subparagraph is stock or securities received in certain corporate transactions described in section 1251(d)(6), see paragraph (f) of § 1.1251–4 for determination as to extent such stock or securities is farm recapture property.

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

Example: On December 15, 1971, A, an individual calendar year taxpayer engaged in the trade or business of farming (as defined in paragraph (e) of this section) exchanges in a transaction which qualifies under section 1031(a) (relating to an exchange of property held for productive use or investment) tractor No. 1 which A acquired on March 1, 1971, for tractor No. 2. Under subparagraph (1)(i) of this paragraph, tractor No. 1 is farm recapture property as the tractor was used in the trade or business of farming and was held for a period in excess of 6 months. Under subparagraph (1)(ii) of this paragraph, tractor No. 2 is farm recapture property as the basis of tractor No. 2 in the hands of A is determined with reference to the adjusted basis of tractor No. 1.

(b) *Farm net loss*—(1) *In general.* The term *farm net loss* means the amount by which:

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on