

Internal Revenue Service, Treasury

§ 1.1031(a)-1

COMMON NONTAXABLE EXCHANGES

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[T.D. 8346, 56 FR 19937, May 1, 1991]

§ 1.1031(a)-1 **Property held for productive use in trade or business or for investment.**

(a) *In general*—(1) *Exchanges of property solely for property of a like kind.* Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of—

- (i) Stock in trade or other property held primarily for sale;
- (ii) Stocks, bonds, or notes;
- (iii) Other securities or evidences of indebtedness or interest;
- (iv) Interests in a partnership;
- (v) Certificates of trust or beneficial interests; or
- (vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes

of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

(2) *Exchanges of property not solely for property of a like kind.* A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(b) *Definition of "like kind."* As used in section 1031(a), the words *like kind* have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see § 1.1031 (a)-2.

(c) *Examples of exchanges of property of a "like kind."* No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) *Examples of exchanges not solely in kind.* Gain or loss is recognized if, for instance, a taxpayer exchanges (1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or (2) a real estate mortgage for consolidated farm loan bonds.

(e) *Effective date relating to exchanges of partnership interests.* The provisions of paragraph (a)(1) of this section relating to exchanges of partnership interests apply to transfers of property made by taxpayers on or after April 25, 1991.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967; T.D. 8343, 56 FR 14854, Apr. 12, 1991; T.D. 8346, 56 FR 19937, May 1, 1991]

§ 1.1031(a)-2 Additional rules for exchanges of personal property.

(a) *Introduction.* Section 1.1031(a)-1(b) provides that the nonrecognition rules of section 1031 do not apply to an exchange of one kind or class of property for property of a different kind or class. This section contains additional rules for determining whether personal property has been exchanged for property of a like kind or like class. Personal properties of a like class are considered to be of a "like kind" for purposes of section 1031. In addition, an exchange of properties of a like kind may qualify under section 1031 regardless of whether the properties are also of a

like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Under paragraph (b) of this section, depreciable tangible personal properties are of a like class if they are either within the same General Asset Class (as defined in paragraph (b)(2) of this section) or within the same Product Class (as defined in paragraph (b)(3) of this section). Paragraph (c) of this section provides rules for exchanges of intangible personal property and non-depreciable personal property.

(b) *Depreciable tangible personal property*—(1) *General rule.* Depreciable tangible personal property is exchanged for property of a “like kind” under section 1031 if the property is exchanged for property of a like kind or like class. Depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same General Asset Class or within the same Product Class. A single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property’s General Asset Class or Product Class is determined as of the date of the exchange.

(2) *General Asset Classes.* Except as provided in paragraphs (b)(4) and (b)(5) of this section, property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property that frequently are used in many businesses. The General Asset Classes are as follows:

- (i) Office furniture, fixtures, and equipment (asset class 00.11),
- (ii) Information systems (computers and peripheral equipment) (asset class 00.12),
- (iii) Data handling equipment, except computers (asset class 00.13),
- (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers

or freight, and all helicopters (airframes and engines) (asset class 00.21),

(v) Automobiles, taxis (asset class 00.22),

(vi) Buses (asset class 00.23),

(vii) Light general purpose trucks (asset class 00.241),

(viii) Heavy general purpose trucks (asset class 00.242),

(ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25),

(x) Tractor units for use over-the-road (asset class 00.26),

(xi) Trailers and trailer-mounted containers (asset class 00.27),

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

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

(3) *Product classes.* Except as provided in paragraphs (b)(4) and (5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property’s 6-digit product class is referred to as the property’s NAICS code.

(4) *Modifications of NAICS product classes.* The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the FEDERAL REGISTER and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) *Administrative procedures for revising general asset classes and product classes.* The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See § 601.601(d)(2) of this chapter.) For example, the Commissioner may determine not to follow (in whole or in part) a general asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) *No inference outside of section 1031.* The rules provided in this section concerning the use of general asset classes or product classes are limited to ex-

changes under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) *Examples.* The application of this paragraph (b) may be illustrated by the following examples:

Example 1. Taxpayer A transfers a personal computer (asset class 00.12) to B in exchange for a printer (asset class 00.12). With respect to A, the properties exchanged are within the same General Asset Class and therefore are of a like class.

Example 2. Taxpayer C transfers an airplane (asset class 00.21) to D in exchange for a heavy general purpose truck (asset class 00.242). The properties exchanged are not of a like class because they are within different General Asset Classes. Because each of the properties is within a General Asset Class, the properties may not be classified within a Product Class. The airplane and heavy general purpose truck are also not of a like kind. Therefore, the exchange does not qualify for nonrecognition of gain or loss under section 1031.

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class. The sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) *Transition rule.* Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005.

(c) *Intangible personal property and nondepreciable personal property—(1)*

General rule. An exchange of intangible personal property of nondepreciable personal property qualifies for non-recognition of gain or loss under section 1031 only if the exchanged properties are of a like kind. No like classes are provided for these properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g., a patent or a copyright) and also on the nature or character of the underlying property to which the intangible personal property relates.

(2) *Goodwill and going concern value.* The goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

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

Example 1. Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

Example 2. Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

(d) *Effective date.* Except as otherwise provided in this paragraph (d), this section applies to exchanges occurring on or after April 11, 1991. Paragraphs (b)(3) through (b)(6), *Example 3* and *Example 4* of paragraph (b)(7), and paragraph (b)(8) of this section apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply paragraphs (b)(3) through (b)(6), and *Example 3* and *Example 4* of paragraph (b)(7) of this section to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired.

[T.D. 8343, 56 FR 14854, Apr. 12, 1991, as amended by T.D. 9151, 69 FR 50068, Aug. 13, 2004; T.D. 9202, 70 FR 28819, May 19, 2005]

§ 1.1031(b)-1 Receipt of other property or money in tax-free exchange.

(a) If the taxpayer receives other property (in addition to property permitted to be received without recognition of gain) or money—

(1) In an exchange described in section 1031(a) of property held for investment or productive use in trade or business for property of like kind to be held either for productive use or for investment,

(2) In an exchange described in section 1035(a) of insurance policies or annuity contracts,

(3) In an exchange described in section 1036(a) of common stock for common stock, or preferred stock for preferred stock, in the same corporation and not in connection with a corporate reorganization, or

(4) In an exchange described in section 1037(a) of obligations of the United States, issued under the Second Liberty Bond Act (31 U.S.C. 774 (2)), solely for other obligations issued under such Act, the gain, if any, to the taxpayer will be recognized under section 1031(b) in an amount not in excess of the sum of the money and the fair market value of the other property, but the loss, if any, to the taxpayer from such an exchange will not be recognized under section 1031(c) to any extent.

(b) The application of this section may be illustrated by the following examples:

Example 1. A, who is not a dealer in real estate, in 1954 exchanges real estate held for investment, which he purchased in 1940 for \$5,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of \$6,000, and \$2,000 in cash. The gain from the transaction is \$3,000, but is recognized only to the extent of the cash received of \$2,000.

Example 2. (a) B, who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In 1943, for \$750 each, B purchased four \$1,000 series E U.S. savings bonds bearing an issue date of March 1, 1943.

(b) On October 1, 1963, the redemption value of each such bond was \$1,396, and the total redemption value of the four bonds was \$5,584. On that date B submitted the four \$1,000 series E bonds to the United States in a transaction in which one of such \$1,000 bonds was reissued by issuing four \$100 series E U.S. savings bonds bearing an issue date of March 1, 1943, and by considering six \$100 series E bonds bearing an issue date of March 1, 1943, to have been issued. The redemption value of each such \$100 series E bond was

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\$139.60 on October 1, 1963. Then, as part of the transaction, the six \$100 series E bonds so considered to have been issued and the three \$1,000 series E bonds were exchanged, in an exchange qualifying under section 1037(a), for five \$1,000 series H U.S. savings bonds plus \$25.60 in cash.

(c) The gain realized on the exchange qualifying under section 1037(a) is \$2,325.60, determined as follows:

Amount realized:	
Par value of five series H bonds	\$5,000.00
Cash received	25.60
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Total realized	5,025.60
Less: Adjusted basis of series E bonds surrendered in the exchange:	
Three \$1,000 series E bonds	\$2,250.00
Six \$100 series E bonds at \$75 each	450.00
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	2,700.00
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Gain realized	2,325.60

(d) Pursuant to section 1031(b), only \$25.60 (the money received) of the total gain of \$2,325.60 realized on the exchange is recognized at the time of exchange and must be included in B's gross income for 1963. The \$2,300 balance of the gain (\$2,325.60 less \$25.60) must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454-1.

(e) The gain on the four \$100 series E bonds, determined by using \$75 as a basis for each such bond, must be included in B's gross income for the taxable year in which such bonds are redeemed or disposed of, or reach final maturity, whichever is earlier.

Example 3. (a) The facts are the same as in example (2), except that, as part of the transaction, the \$1,000 series E bond is reissued by considering ten \$100 series E bonds bearing an issue date of March 1, 1943, to have been issued. Six of the \$100 series E bonds so considered to have been issued are surrendered to the United States as part of the exchange qualifying under section 1037(a) and the other four are immediately redeemed.

(b) Pursuant to section 1031(b), only \$25.60 (the money received) of the total gain of \$2,325.60 realized on the exchange qualifying under section 1037(a) is recognized at the time of the exchange and must be included in B's gross income for 1963. The \$2,300 balance of the gain (\$2,325.60 less \$25.60) realized on such exchange must be included in B's gross income for the taxable year in which the series H bonds are redeemed or disposed of, or reach final maturity, whichever is earlier, as provided in paragraph (c) of § 1.454-1.

(c) The redemption on October 1, 1963, of the four \$100 series E bonds considered to have been issued at such time results in gain of \$258.40, which is then recognized and must be included in B's gross income for 1963. This

gain of \$258.40 is the difference between the \$558.40 redemption value of such bonds on the date of the exchange and the \$300 (4×\$75) paid for such series E bonds in 1943.

Example 4. On November 1, 1963, C purchased for \$91 a marketable U.S. bond which was originally issued at its par value of \$100 under the Second Liberty Bond Act. On February 1, 1964, in an exchange qualifying under section 1037(a), C surrendered the bond to the United States for another marketable U.S. bond, which then had a fair market value of \$92, and \$1.85 in cash, \$0.85 of which was interest. The \$0.85 interest received is includible in gross income for the taxable year of the exchange, but the \$2 gain (\$93 less \$91) realized on the exchange is recognized for such year under section 1031(b) to the extent of \$1 (the money received). Under section 1031(d), C's basis in the bond received in exchange is \$91 (his basis of \$91 in the bond surrendered, reduced by the \$1 money received and increased by the \$1 gain recognized).

(c) Consideration received in the form of an assumption of liabilities (or a transfer subject to a liability) is to be treated as *other property or money* for the purposes of section 1031(b). Where, on an exchange described in section 1031(b), each party to the exchange either assumes a liability of the other party or acquires property subject to a liability, then, in determining the amount of *other property or money* for purposes of section 1031(b), consideration given in the form of an assumption of liabilities (or a receipt of property subject to a liability) shall be offset against consideration received in the form of an assumption of liabilities (or a transfer subject to a liability). See § 1.1031(d)-2, examples (1) and (2).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967]

§ 1.1031(b)-2 Safe harbor for qualified intermediaries.

(a) In the case of simultaneous transfers of like-kind properties involving a qualified intermediary (as defined in § 1.1031(k)-1(g)(4)(iii)), the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the transfer and receipt of property by the taxpayer is treated as an exchange.

(b) In the case of simultaneous exchanges of like-kind properties involving a qualified intermediary (as defined

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in § 1.1031(k)-1(g)(4)(iii)), the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and § 15a.453-1(b)(3)(i) of this chapter.

(c) Paragraph (a) of this section applies to transfers of property made by taxpayers on or after June 10, 1991.

(d) Paragraph (b) of this section applies to transfers of property made by taxpayers on or after April 20, 1994. A taxpayer may choose to apply paragraph (b) of this section to transfers of property made on or after June 10, 1991.

[T.D. 8346, 56 FR 19937, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994]

§ 1.1031(c)-1 Nonrecognition of loss.

Section 1031(c) provides that a loss shall not be recognized from an exchange of property described in section 1031(a), 1035(a), 1036(a), or 1037(a) where there is received in the exchange other property or money in addition to property permitted to be received without recognition of gain or loss. See example (4) of paragraph (a)(3) of § 1.1037-1 for an illustration of the application of this section in the case of an exchange of U.S. obligations described in section 1037(a).

[T.D. 6935, 32 FR 15822, Nov. 17, 1967]

§ 1.1031(d)-1 Property acquired upon a tax-free exchange.

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, sec-

tion 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

Example: A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of \$2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of \$2,400 and \$200 in cash. A realizes a gain of \$100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	\$2,500
Less: Amount of money received	200
	2,300
Difference	2,300
Plus: Amount of gain recognized	100
	2,400
Basis of truck acquired by A	2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example: A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for \$10,000 in exchange for other real estate (to

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be held for investment) which has a fair market value of \$9,000, an automobile which has a fair market value of \$2,000, and \$1,500 in cash. A realizes a gain of \$2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers (\$10,000) decreased by the amount of money received (\$1,500) and increased in the amount of gain that was recognized (\$2,500), which results in a basis for the property received of \$11,000. This basis of \$11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, \$2,000, and the basis of the real estate received being the remainder, \$9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

Example: A exchanges real estate held for investment plus stock for real estate to be held for investment. The real estate transferred has an adjusted basis of \$10,000 and a fair market value of \$11,000. The stock transferred has an adjusted basis of \$4,000 and a fair market value of \$2,000. The real estate acquired has a fair market value of \$13,000. A is deemed to have received a \$2,000 portion of the acquired real estate in exchange for the stock, since \$2,000 is the fair market value of the stock at the time of the exchange. A \$2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	\$10,000
Adjusted basis of stock transferred	4,000
	14,000
Less: Loss recognized on transfer of stock	2,000
	12,000
Basis of real estate acquired upon the exchange	12,000

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15823, Nov. 17, 1967]

§ 1.1031(d)-1T Coordination of section 1060 with section 1031 (temporary).

If the properties exchanged under section 1031 are part of a group of assets which constitute a trade or business under section 1060, the like-kind property and other property or money which are treated as transferred in exchange for the like-kind property shall be excluded from the allocation rules of section 1060. However, section 1060 shall apply to property which is not like-kind property or other property or money which is treated as transferred in exchange for the like-kind property. For application of the section 1060 allocation rules to property which is not part of the like-kind exchange, see § 1.1060-1(b), (c), and (d) *Example 1 in § 1.338-6(b)*, to which reference is made by § 1.1060-1(c)(2).

[T.D. 8215, 53 FR 27044, July 18, 1988, as amended by T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.1031(d)-2 Treatment of assumption of liabilities.

For the purposes of section 1031(d), the amount of any liabilities of the

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taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

Example 1. B, an individual, owns an apartment house which has an adjusted basis in his hands of \$500,000, but which is subject to a mortgage of \$150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor \$50,000 in cash and another apartment house with a fair market value on that date of \$600,000. The transfer to C is made subject to the \$150,000 mortgage. B realizes a gain of \$300,000 on the exchange, computed as follows:

Value of property received	\$600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	300,000

Under section 1031(b), \$200,000 of the \$300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is \$500,000, computed as follows:

Adjusted basis of property transferred	500,000
Less: Amount of money received:	
Cash	50,000
Amount of liabilities subject to which property was transferred	150,000
	200,000
Difference	300,000
Plus: Amount of gain recognized upon the exchange	200,000
Basis of property acquired upon the exchange	500,000

Example 2. (a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of \$100,000, a fair market value of \$220,000, but is subject to a mortgage of \$80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of \$175,000, a fair market value of \$250,000, but is subject to a mortgage of \$150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore \$40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of \$120,000 on the exchange, computed as follows:

Value of property received	\$250,000
Cash	40,000
Liabilities subject to which old property was transferred	80,000
Total consideration received	370,000
Less:	
Adjusted basis of property transferred	\$100,000
Liabilities to which new property is subject	150,000
	250,000
Gain realized	120,000

For purposes of section 1031(b), the amount of *other property or money* received by D is \$40,000. (Consideration received by D in the form of a transfer subject to a liability of \$80,000 is offset by consideration given in the form of a receipt of property subject to a \$150,000 liability. Thus, only the consideration received in the form of cash, \$40,000, is treated as *other property or money* for purposes of section 1031(b).) Accordingly, under section 1031(b), \$40,000 of the \$120,000 gain is recognized. The basis of the apartment house acquired by D is \$170,000, computed as follows:

Adjusted basis of property transferred	\$100,000
Liabilities to which new property is subject	150,000
Total	250,000
Less:	
Amount of money received:	
Cash	\$40,000
Amount of liabilities subject to which property was transferred	80,000
	120,000
Difference	130,000
Plus: Amount of gain recognized upon the exchange	40,000
Basis of property acquired upon the exchange	170,000

(c) E realizes a gain of \$75,000 on the exchange, computed as follows:

Value of property received	\$220,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	370,000
Less:	
Adjusted basis of property transferred ..	\$175,000
Cash	40,000

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Liabilities to which new property is subject	80,000	
		295,000
Gain realized		75,000

For purposes of section 1031(b), the amount of *other property or money* received by E is \$30,000. (Consideration received by E in the form of a transfer subject to a liability of \$150,000 is offset by consideration given in the form of a receipt of property subject to an \$80,000 liability and by the \$40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), \$30,000 of the \$75,000 gain is recognized. The basis of the apartment house acquired by E is \$175,000, computed as follows:

Adjusted basis of property transferred	\$175,000	
Cash	40,000	
Liabilities to which new property is subject	80,000	
Total		295,000
Less:		
Amount of money received:		
Amount of liabilities subject to which property was transferred	\$150,000	
		150,000
Difference		145,000
Plus: Amount of gain recognized upon the exchange		30,000
Basis of property acquired upon the exchange		175,000

§ 1.1031(e)-1 Exchange of livestock of different sexes.

Section 1031(e) provides that livestock of different sexes are not property of like kind. Section 1031(e) and this section are applicable to taxable years to which the Internal Revenue Code of 1954 applies.

[T.D. 7141, 36 FR 18792, Sept. 22, 1971]

§ 1.1031(j)-1 Exchanges of multiple properties.

(a) *Introduction*—(1) *Overview*. As a general rule, the application of section 1031 requires a property-by-property comparison for computing the gain recognized and basis of property received in a like-kind exchange. This section provides an exception to this general rule in the case of an exchange of multiple properties. An exchange is an exchange of multiple properties if, under paragraph (b)(2) of this section, more than one exchange group is created. In addition, an exchange is an exchange of multiple properties if only one exchange group is created but there is more than one property being transferred or received within that exchange group. Paragraph (b) of this section provides rules for computing the amount of gain recognized in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031. Paragraph (c) of this section provides rules for computing the basis of properties received in an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031.

(2) *General approach*. (i) In general, the amount of gain recognized in an exchange of multiple properties is computed by first separating the properties transferred and the properties received by the taxpayer in the exchange into exchange groups in the manner described in paragraph (b)(2) of this section. The separation of the properties transferred and the properties received in the exchange into exchange groups involves matching up properties of a like kind of like class to the extent possible. Next, all liabilities assumed by the taxpayer as part of the transaction are offset by all liabilities of which the taxpayer is relieved as part of the transaction, with the excess liabilities assumed or relieved allocated in accordance with paragraph (b)(2)(ii) of this section. Then, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to determine the amount of gain recognized in the exchange. See §§ 1.1031(b)-1 and 1.1031(c)-1. Finally, the rules of section 1031 and the regulations thereunder are applied separately to each exchange group to

determine the basis of the properties received in the exchange. See §§1.1031(d)-1 and 1.1031(d)-2.

(ii) For purposes of this section, the exchanges are assumed to be made at arms' length, so that the aggregate fair market value of the property received in the exchange equals the aggregate fair market value of the property transferred. Thus, the amount realized with respect to the properties transferred in each exchange group is assumed to equal their aggregate fair market value.

(b) *Computation of gain recognized*—(1) *In general.* In computing the amount of gain recognized in an exchange of multiple properties, the fair market value must be determined for each property transferred and for each property received by the taxpayer in the exchange. In addition, the adjusted basis must be determined for each property transferred by the taxpayer in the exchange.

(2) *Exchange groups and residual group.* The properties transferred and the properties received by the taxpayer in the exchange are separated into exchange groups and a residual group to the extent provided in this paragraph (b)(2).

(i) *Exchange groups.* Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or like class. If a property could be included in more than one exchange group, the taxpayer may include the property in any of those exchange groups. Property eligible for inclusion within an exchange group does not include money or property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action). For example, an exchange group may consist of all exchanged properties that are within the same General Asset Class or within the same Product Class (as defined in §1.1031(a)-2(b)). Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

(ii) *Treatment of liabilities.* (A) All liabilities assumed by the taxpayer as part of the exchange are offset against

all liabilities of which the taxpayer is relieved as part of the exchange, regardless of whether the liabilities are recourse or nonrecourse and regardless of whether the liabilities are secured by or otherwise relate to specific property transferred or received as part of the exchange. See §§1.1031 (b)-1(c) and 1.1031(d)-2. For purposes of this section, liabilities assumed by the taxpayer as part of the exchange consist of liabilities of the other party to the exchange assumed by the taxpayer and liabilities subject to which the other party's property is transferred in the exchange. Similarly, liabilities of which the taxpayer is relieved as part of the exchange consist of liabilities of the taxpayer assumed by the other party to the exchange and liabilities subject to which the taxpayer's property is transferred.

(B) If there are excess liabilities assumed by the taxpayer as part of the exchange (i.e., the amount of liabilities assumed by the taxpayer exceeds the amount of liabilities of which the taxpayer is relieved), the excess is allocated among the exchange groups (but not to the residual group) in proportion to the aggregate fair market value of the properties received by the taxpayer in the exchange groups. The amount of excess liabilities assumed by the taxpayer that are allocated to each exchange group may not exceed the aggregate fair market value of the properties received in the exchange group.

(C) If there are excess liabilities of which the taxpayer is relieved as part of the exchange (i.e., the amount of liabilities of which the taxpayer is relieved exceeds the amount of liabilities assumed by the taxpayer), the excess is treated as a Class I asset for purposes of making allocations to the residual group under paragraph (b)(2)(iii) of this section.

(D) Paragraphs (b)(2)(ii) (A), (B), and (C) of this section are applied in the same manner even if section 1031 and this section apply to only a portion of a larger transaction (such as a transaction described in section 1060(c) and §1.1060-1T(b)). In that event, the amount of excess liabilities assumed by the taxpayer or the amount of excess

liabilities of which the taxpayer is relieved is determined based on all liabilities assumed by the taxpayer and all liabilities of which the taxpayer is relieved as part of the larger transaction.

(iii) *Residual group.* If the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups (taking liabilities into account in the manner described in paragraph (b)(2)(ii) of this section), a residual group is created. The residual group consists of an amount of money or other property having an aggregate fair market value equal to that difference. The residual group consists of either money or other property transferred in the exchange or money or other property received in the exchange, but not both. For this purpose, other property includes property described in section 1031(a)(2) (i.e., stock in trade or other property held primarily for sale, stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action), property transferred that is not of a like kind or like class with any property received, and property received that is not of a like kind or like class with any property transferred. The money and properties that are allocated to the residual group are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, and then from Class IV assets. The terms Class I assets, Class II assets, Class III assets, and Class IV assets have the same meanings as in § 1.338-6(b), to which reference is made by § 1.1060-1(c)(2). Within each Class, taxpayers may choose which properties are allocated to the residual group.

(iv) *Exchange group surplus and deficiency.* For each of the exchange groups described in this section, an “exchange group surplus” or “exchange group deficiency,” if any, must be determined. An exchange group surplus is the excess of the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allo-

cated to that exchange group), in an exchange group over the aggregate fair market value of the properties transferred in that exchange group. An exchange group deficiency is the excess of the aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess liabilities assumed by the taxpayer that are allocated to that exchange group) in that exchange group.

(3) *Amount of gain recognized.* (i) For purposes of this section, the amount of gain or loss realized with respect to each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties’ aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. Losses realized with respect to an exchange group are not recognized. See section 1031 (a) and (c). The total amount of gain recognized under section 1031 in the exchange is the sum of the amount of gain recognized with respect to each exchange group. With respect to the residual group, the gain or loss realized (as determined under this section) is recognized as provided in section 1001 or other applicable provision of the Code.

(ii) The amount of gain or loss realized and recognized with respect to properties transferred by the taxpayer that are not within any exchange group or the residual group is determined under section 1001 and other applicable provisions of the Code, with proper adjustments made for all liabilities not allocated to the exchange groups or the residual group.

(c) *Computation of basis of properties received.* In an exchange of multiple properties qualifying for nonrecognition of gain or loss under section 1031 and this section, the aggregate basis of properties received in each of the exchange groups is the aggregate adjusted basis of the properties transferred by the taxpayer within that exchange group, increased by the amount of gain recognized by the taxpayer with

respect to that exchange group, increased by the amount of the exchange group surplus or decreased by the amount of the exchange group deficiency, and increased by the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value. The basis of each property received within the residual group (other than money) is equal to its fair market value.

(d) *Examples.* The application of this section may be illustrated by the following examples:

Example 1. (i) K exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by K for productive use in its business, with W for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by K for productive use in its business. K's adjusted basis and the fair market value of the exchanged properties are as follows:

	Adjusted basis	Fair market value
Computer A	\$375	\$1,000
Automobile A	1,500	4,000
Printer B		2,050
Automobile B		2,950

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to K, has an exchange group surplus of \$1050 because the fair market value of printer B (\$2050) exceeds the fair market value of computer A (\$1000) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to K, has an exchange group deficiency of \$1050 because the fair market value of automobile A (\$4000) exceeds the fair market value of automobile B (\$2950) by that amount.

(iii) K recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A (\$1000) over its adjusted basis (\$375), or \$625. The amount of gain recognized is the lesser of the gain realized (\$625) and the exchange group deficiency (\$0), or \$0.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A (\$4000) over its adjusted basis (\$1500), or \$2500. The amount of gain recognized is the lesser of the gain realized (\$2500) and the exchange group deficiency (\$1050), or \$1050.

(iv) The total amount of gain recognized by K in the exchange is the sum of the gains recognized with respect to both exchange groups (\$0 + \$1050), or \$1050.

(v) The bases of the property received by K in the exchange, printer B and automobile B, are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within the exchange group (\$375), increased by the amount of gain recognized with respect to that exchange group (\$0), increased by the amount of the exchange group surplus (\$1050), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$1425. Because printer B was the only property received within the first exchange group, the entire basis of \$1425 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group (\$1500), increased by the amount of gain recognized with respect to that exchange group (\$1050), decreased by the amount of the exchange group deficiency (\$1050), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$1500. Because automobile B was the only property received within the second exchange group, the entire basis of \$1500 is allocated to automobile B.

Example 2. (i) F exchanges computer A (asset class 00.12) and automobile A (asset class 00.22), both of which were held by F for productive use in its business, with G for printer B (asset class 00.12) and automobile B (asset class 00.22), both of which will be held by F for productive use in its business, and corporate stock and \$500 cash. The adjusted basis and fair market value of the properties are as follows:

	Adjusted basis	Fair market value
Computer A	\$375	\$1,000
Automobile A	3,500	4,000
Printer B		800
Automobile B		2,950
Corporate stock		750
Cash		500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A and printer B (both are within the same General Asset Class) and, as to F,

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has an exchange group deficiency of \$200 because the fair market value of computer A (\$1000) exceeds the fair market value of printer B (\$800) by that amount.

(B) The second exchange group consists of automobile A and automobile B (both are within the same General Asset Class) and, as to F, has an exchange group deficiency of \$1050 because the fair market value of automobile A (\$4000) exceeds the fair market value of automobile B (\$2950) by that amount.

(C) Because the aggregate fair market value of the properties transferred by F in the exchange groups (\$5,000) exceeds the aggregate fair market value of the properties received by F in the exchange groups (\$3750) by \$1250, there is a residual group in that amount consisting of the \$500 cash and the \$750 worth of corporate stock.

(iii) F recognizes gain on the exchange as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A (\$1000) over its adjusted basis (\$375), or \$625. The amount of gain recognized is the lesser of the gain realized (\$625) and the exchange group deficiency (\$200), or \$200.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A (\$4000) over its adjusted basis (\$3500), or \$500. The amount of gain recognized is the lesser of the gain realized (\$500) and the exchange group deficiency (\$1050), or \$500.

(C) No property transferred by F was allocated to the residual group. Therefore, F does not recognize gain or loss with respect to the residual group.

(iv) The total amount of gain recognized by F in the exchange is the sum of the gains recognized with respect to both exchange groups (\$200 + \$500), or \$700.

(v) The bases of the properties received by F in the exchange (printer B, automobile B, and the corporate stock) are determined in the following manner:

(A) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group (\$375), increased by the amount of gain recognized with respect to that exchange group (\$200), decreased by the amount of the exchange group deficiency (\$200), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$375. Because printer B was the only property received within the first exchange group, the entire basis of \$375 is allocated to printer B.

(B) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group (\$3500), increased by the amount of gain recognized with respect to that exchange group (\$500), decreased by the amount of the exchange group deficiency (\$1050), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$2950. Because automobile B was the only property received within the second exchange group, the entire basis of \$2950 is allocated to automobile B.

(C) The basis of the property received within the residual group (the corporate stock) is equal to its fair market value or \$750. Cash of \$500 is also received within the residual group.

Example 3. (i) J and H enter into an exchange of the following properties. All of the property (except for the inventory) transferred by J was held for productive use in J's business. All of the property received by J will be held by J for productive use in its business.

J Transfers:			H Transfers:	
Property	Adjusted basis	Fair market value	Property	Fair market value
Computer A	\$1,500	\$5,000	Computer Z	\$4,500
Computer B	500	3,000	Printer Y	2,500
Printer C	2,000	1,500	Real Estate X	1,000
Real Estate D	1,200	2,000	Real Estate W	4,000
Real Estate E	0	1,800	Grader V	2,000
Scraper F	3,300	2,500	Truck T	1,700
Inventory	1,000	1,700	Cash	1,800
Total	9,500	17,500	.....	17,500

(ii) Under paragraph (b)(2) of this section, the properties exchanged are separated into exchange groups as follows:

(A) The first exchange group consists of computer A, computer B, printer C, computer Z, and printer Y (all are within the same General Asset Class) and, as to J, has

an exchange group deficiency of \$2500 ((\$5000 + \$3000 + \$1500) - (\$4500 + \$2500)).

(B) The second exchange group consists of real estate D, E, X and W (all are of a like kind) and, as to J, has an exchange group surplus of \$1200 ((\$1000 + \$4000) - (\$2000 + \$1800)).

(C) The third exchange group consists of scraper F and grader V (both are within the same Product Class (NAICS code 333120)) and, as to J, has an exchange group deficiency of \$500 (\$2500 - \$2000).

(D) Because the aggregate fair market value of the properties transferred by J in the exchange groups (\$15,800) exceeds the aggregate fair market value of the properties received by J in the exchange groups (\$14,000) by \$1800, there is a residual group in that amount consisting of the \$1800 cash (a Class I asset).

(E) The transaction also includes a taxable exchange of inventory (which is property described in section 1031 (a)(2)) for truck T (which is not of a like kind or like class to any property transferred in the exchange).

(iii) J recognizes gain on the transaction as follows:

(A) With respect to the first exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group (\$9500) over the aggregate adjusted basis (\$4000), or \$5500. The amount of gain recognized is the lesser of the gain realized (\$5500) and the exchange group deficiency (\$2500), or \$2500.

(B) With respect to the second exchange group, the amount of gain realized is the excess of the aggregate fair market value of the properties transferred in the exchange group (\$3800) over the aggregate adjusted basis (\$1200), or \$2600. The amount of gain recognized is the lesser of the gain realized (\$2600) and the exchange group deficiency (\$0), or \$0.

(C) With respect to the third exchange group, a loss is realized in the amount of \$800 because the fair market value of the property transferred in the exchange group (\$2500) is less than its adjusted basis (\$3300). Although a loss of \$800 was realized, under section 1031 (a) and (c) losses are not recognized.

(D) No property transferred by J was allocated to the residual group. Therefore, J does not recognize gain or loss with respect to the residual group.

(E) With respect to the taxable exchange of inventory for truck T, gain of \$700 is realized and recognized by J (amount realized of \$1700 (the fair market value of truck T) less the adjusted basis of the inventory (\$1000)).

(iv) The total amount of gain recognized by J in the transaction is the sum of the gains recognized under section 1031 with respect to each exchange group (\$2500 + \$0 + \$0) and any gain recognized outside of section 1031 (\$700), or \$3200.

(v) The bases of the property received by J in the exchange are determined in the following manner:

(A) The aggregate basis of the properties received in the first exchange group is the adjusted basis of the properties transferred

within that exchange group (\$4000), increased by the amount of gain recognized with respect to that exchange group (\$2500), decreased by the amount of the exchange group deficiency (\$2500), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$4000. This \$4000 of basis is allocated proportionately among the assets received within the first exchange group in accordance with their fair market values: Computer Z's basis is \$2571 ($\$4000 \times \$4500/\7000); printer Y's basis is \$1429 ($\$4000 \times \$2500/\7000).

(B) The aggregate basis of the properties received in the second exchange group is the adjusted basis of the properties transferred within that exchange group (\$1200), increased by the amount of gain recognized with respect to that exchange group (\$0), increased by the amount of the exchange group surplus (\$1200), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$2400. This \$2400 of basis is allocated proportionately among the assets received within the second exchange group in accordance with their fair market values: Real estate X's basis is \$480 ($\$2400 \times \$1000/\5000); real estate W's basis is \$1920 ($\$2400 \times \$4000/\5000).

(c) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group (\$3300), increased by the amount of gain recognized with respect to that exchange group (\$0), decreased by the amount of the exchange group deficiency (\$500), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$2800. Because grader V was the only property received within the third exchange group, the entire basis of \$2800 is allocated to grader V.

(D) Cash of \$1800 is received within the residual group.

(E) The basis of the property received in the taxable exchange (truck T) is equal to its cost of \$1700.

Example 4. (i) B exchanges computer A (asset class 00.12), automobile A (asset class 00.22) and truck A (asset class 00.241), with C for computer R (asset class 00.12), automobile R (asset class 00.22), truck R (asset class 00.241) and \$400 cash. All properties transferred by either B or C were held for productive use in the respective transferor's business. Similarly, all properties to be received by either B or C will be held for productive use in the respective recipient's business. Automobile A, automobile R and truck R are each secured by a nonrecourse liability and are transferred subject to such liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

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	Adjusted basis	Fair market value	Liability
B transfers:			
Computer A	\$800	\$1,500	\$0
Automobile A	900	2,500	500
Truck A	700	2,000	0
C transfers:			
Computer R	1,100	1,600	0
Automobile R	2,100	3,100	750
Truck R	600	1,400	250
Cash		400	

(ii) The tax treatment to B is as follows:

(A)(1) The first exchange group consists of computers A and R (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles A and R (both are within the same General Asset Class).

(3) The third exchange group consists of trucks A and R (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(i) of this section, all liabilities assumed by B (\$1000) are offset by all liabilities of which B is relieved (\$500), resulting in excess liabilities assumed of \$500. The excess liabilities assumed of \$500 is allocated among the exchange groups in proportion to the fair market value of the properties received by B in the exchange groups as follows:

(1) \$131 of excess liabilities assumed (\$500 × \$1600/\$6100) is allocated to the first exchange group. The first exchange group has an exchange group deficiency of \$31 because the fair market value of computer A (\$1500) exceeds the fair market value of computer R less the excess liabilities assumed allocated to the exchange group (\$1600-\$131) by that amount.

(2) \$254 of excess liabilities assumed (\$500 × \$3100/\$6100) is allocated to the second exchange group. The second exchange group has an exchange group surplus of \$346 because the fair market value of automobile R less the excess liabilities assumed allocated to the exchange group (\$3100-\$254) exceeds the fair market value of automobile A (\$2500) by that amount.

(3) \$115 of excess liabilities assumed (\$500 × \$1400/\$6100) is allocated to the third exchange group. The third exchange group has an exchange group deficiency of \$715 because the fair market value of truck A (\$2000) exceeds the fair market value of truck R less the excess liabilities assumed allocated to the exchange group (\$1400-\$115) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred in all of the exchange groups, \$6000, and the aggregate fair market value of the properties received in all of the exchange groups (taking excess liabilities assumed into account), \$5600, is \$400. Therefore there is a residual group in that amount consisting of \$400 cash received.

(C) B recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer A (\$1500) over its adjusted basis (\$800), or \$700. The amount of gain recognized is the lesser of the gain realized (\$700) and the exchange group deficiency (\$31), or \$31.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile A (\$2500) over its adjusted basis (\$900), or \$1600. The amount of gain recognized is the lesser of the gain realized (\$1600) and the exchange group deficiency (\$0), or \$0.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck A (\$2000) over its adjusted basis (\$700), or \$1300. The amount of gain recognized is the lesser of gain realized (\$1300) and the exchange group deficiency (\$715), or \$715.

(4) No property transferred by B was allocated to the residual group. Therefore, B does not recognize gain or loss with respect to the residual group.

(D) The total amount of gain recognized by B in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group (\$31 + \$0 + \$715), or \$746.

(E) the bases of the property received by B in the exchange (computer R, automobile R, and truck R) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group (\$800), increased by the amount of gain recognized with respect to that exchange group (\$31), decreased by the amount of the exchange group deficiency (\$31), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$131), or \$931. Because computer R was the only property received within the first exchange group, the entire basis of \$931 is allocated to computer R.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group (\$900), increased by the amount of gain recognized with respect to that exchange group (\$0), increased by the amount of the exchange group surplus (\$346), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$254), or \$1500. Because automobile R was the only property received within the second exchange group, the entire basis of \$1500 is allocated to automobile R.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group (\$700), increased by the amount of gain recognized with respect to that exchange group (\$715), decreased by the

amount of the exchange group deficiency (\$715), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$115), or \$815. Because truck R was the only property received within the third exchange group, the entire basis of \$815 is allocated to truck R.

(F) Cash of \$400 is also received by B.

(iii) The tax treatment to C is as follows:

(A) (1) The first exchange group consists of computers R and A (both are within the same General Asset Class).

(2) The second exchange group consists of automobiles R and A (both are within the same General Asset Class).

(3) The third exchange group consists of trucks R and A (both are in the same General Asset Class).

(B) Under paragraph (b)(2)(ii) of this section, all liabilities of which C is relieved (\$1000) are offset by all liabilities assumed by C (\$500), resulting in excess liabilities relieved of \$500. This excess liabilities relieved is treated as cash received by C.

(1) The first exchange group has an exchange group deficiency of \$100 because the fair market value of computer R (\$1600) exceeds the fair market value of computer A (\$1500) by that amount.

(2) The second exchange group has an exchange group deficiency of \$600 because the fair market value of automobile R (\$3100) exceeds the fair market value of automobile A (\$2500) by that amount.

(3) The third exchange group has an exchange group surplus of \$600 because the fair market value of truck A (\$2000) exceeds the fair market value of truck R (\$1400) by that amount.

(4) The difference between the aggregate fair market value of the properties transferred by C in all of the exchange groups, \$6100, and the aggregate fair market value of the properties received by C in all of the exchange groups, \$6000, is \$100. Therefore, there is a residual group in that amount, consisting of excess liabilities relieved of \$100, which is treated as cash received by C.

(5) The \$400 cash paid by C and \$400 of the excess liabilities relieved which is treated as cash received by C are not within the exchange groups of the residual group.

(C) C recognizes gain on the exchange as follows:

(1) With respect to the first exchange group, the amount of gain realized is the excess of the fair market value of computer R (\$1600) over its adjusted basis (\$1100), or \$500. The amount of gain recognized is the lesser of the gain realized (\$500) and the exchange group deficiency (\$100), or \$100.

(2) With respect to the second exchange group, the amount of gain realized is the excess of the fair market value of automobile R (\$3100) over its adjusted basis (\$2100), or \$1000. The amount of gain recognized is the lesser

of the gain realized (\$1000) and the exchange group deficiency (\$600), or \$600.

(3) With respect to the third exchange group, the amount of gain realized is the excess of the fair market value of truck R (\$1400) over its adjusted basis (\$600), or \$800. The amount of gain recognized is the lesser of gain realized (\$800) and the exchange group deficiency (\$0), or \$0.

(4) No property transferred by C was allocated to the residual group. Therefore, C does not recognize any gain with respect to the residual group.

(D) The total amount of gain recognized by C in the exchange is the sum of the gains recognized under section 1031 with respect to each exchange group (\$100+\$600+\$0), or \$700.

(E) The bases of the properties received by C in the exchange (computer A, automobile A, and truck A) are determined in the following manner:

(1) The basis of the property received in the first exchange group is the adjusted basis of the property transferred within that exchange group (\$1100), increased by the amount of gain recognized with respect to that exchange group (\$100), decreased by the amount of the exchange group deficiency (\$100), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$1100. Because computer A was the only property received within the first exchange group, the entire basis of \$1100 is allocated to computer A.

(2) The basis of the property received in the second exchange group is the adjusted basis of the property transferred within that exchange group (\$2100), increased by the amount of gain recognized with respect to that exchange group (\$600), decreased by the amount of the exchange group deficiency (\$600), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$2100. Because automobile A was the only property received within the second exchange group, the entire basis of \$2100 is allocated to automobile A.

(3) The basis of the property received in the third exchange group is the adjusted basis of the property transferred within that exchange group (\$600), increased by the amount of gain recognized with respect to that exchange group (\$0), increased by the amount of the exchange group surplus (\$600), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$0), or \$1200. Because truck A was the only property received within the third exchange group, the entire basis of \$1200 is allocated to truck A.

Example 5. (i) U exchanges real estate A, real estate B, and grader A (NAICS code 333120) with V for real estate R and railroad car R (General Asset Class 00.25). All properties transferred by either U or V were held for productive use in the respective transferor's business. Similarly, all properties to

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be received by either U or V will be held for productive use in the respective recipient's business. Real estate R is secured by a recourse liability and is transferred subject to that liability. The adjusted basis, fair market value, and liability secured by each property, if any, are as follows:

	Adjusted basis	Fair market value	Liability
U Transfers:			
Real Estate A	\$2000	\$5000	.....
Real Estate B	8000	13,500	.....
Grader A	500	2000	.....
V Transfers:			
Real Estate R	\$20,000	\$26,500	\$7000
Railroad car R	1200	1000	

(ii) The tax treatment to U is as follows:

(A) The exchange group consists of real estate A, real estate B, and real estate R.

(B) Under paragraph (b)(2)(ii) of this section, all liabilities assumed by U (\$7000) are excess liabilities assumed. The excess liabilities assumed of \$7000 is allocated to the exchange group.

(1) The exchange group has an exchange group surplus of \$1000 because the fair market value of real estate R less the excess liabilities assumed allocated to the exchange group (\$26,500-\$7000) exceeds the aggregate fair market value of real estate A and B (\$18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties received in the exchange group (taking excess liabilities assumed into account), \$19,500, and the aggregate fair market value of the properties transferred in the exchange group, \$18,500, is \$1000. Therefore, there is a residual group in that amount consisting of \$1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of the 50 percent portion of grader A not allocated to the residual group (which is not of a like kind or like class to any property received by U in the exchange) for railroad car R (which is not of a like kind or like class to any property transferred by U in the exchange).

(C) U recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the aggregate fair market value of real estate A and B (\$18,500) over the aggregate adjusted basis (\$10,000), or \$8500. The amount of the gain recognized is the lesser of the gain realized (\$8500) and the exchange group deficiency (\$0), or \$0.

(2) With respect to the residual group, the amount of gain realized and recognized is the excess of the fair market value of the 50 percent portion of grader A that is allocated to the residual group (\$1000) over its adjusted basis (\$250), or \$750.

(3) With respect to the taxable exchange of the 50 percent portion of grader A not allocated to the residual group for railroad car R, gain of \$750 is realized and recognized by U (amount realized of \$1000 (the fair market value of railroad car R) less the adjusted basis of the 50 percent portion of grader A not allocated to the residual group (\$250)).

(D) The total amount of gain recognized by U in the transaction is the sum of the gain recognized under section 1031 with respect to the exchange group (\$0), any gain recognized with respect to the residual group (\$750), and any gain recognized with respect to property transferred that is not in the exchange group or the residual group (\$750), or \$1500.

(E) The bases of the property received by U in the exchange (real estate R and railroad car R) are determined in the following manner:

(1) The basis of the property received in the exchange group is the aggregate adjusted basis of the property transferred within that exchange group (\$10,000), increased by the amount of gain recognized with respect to that exchange group (\$0), increased by the amount of the exchange group surplus (\$1000), and increased by the amount of excess liabilities assumed allocated to that exchange group (\$7000), or \$18,000. Because real estate R is the only property received within the exchange group, the entire basis of \$18,000 is allocated to real estate R.

(2) The basis of railroad car R is equal to its cost of \$1000.

(iii) The tax treatment to V is as follows:

(A) The exchange group consists of real estate R, real estate A, and real estate B.

(B) Under paragraph (b)(2)(ii) of this section, the liabilities of which V is relieved (\$7000) results in excess liabilities relieved of \$7000 and is treated as cash received by V.

(1) The exchange group has an exchange group deficiency of \$8000 because the fair market value of real estate R (\$26,500) exceeds the aggregate fair market value of real estate A and B (\$18,500) by that amount.

(2) The difference between the aggregate fair market value of the properties transferred by V in the exchange group, \$26,500, and the aggregate fair market value of the properties received by V in the exchange group, \$18,500, is \$8000. Therefore, there is a residual group in that amount, consisting of the excess liabilities relieved of \$7000, which is treated as cash received by V, and \$1000 (or 50 percent of the fair market value) of grader A.

(3) The transaction also includes a taxable exchange of railroad car R (which is not of a like kind or like class to any property received by V in the exchange) for the 50 percent portion of grader A (which is not of a like kind or like class to any property transferred by V in the exchange) not allocated to the residual group.

(C) V recognizes gain on the exchange as follows:

(1) With respect to the exchange group, the amount of the gain realized is the excess of the fair market value of real estate R (\$26,500) over its adjusted basis (\$20,000), or \$6500. The amount of the gain recognized is the lesser of the gain realized (\$6500) and the exchange group deficiency (\$8000), or \$6500.

(2) No property transferred by V was allocated to the residual group. Therefore, V does not recognize gain or loss with respect to the residual group.

(3) With respect to the taxable exchange of railroad car R for the 50 percent portion of grader A not allocated to the exchange group or the residual group, a loss is realized and recognized in the amount of \$200 (the excess of the \$1200 adjusted basis of railroad car R over the amount realized of \$1000 (fair market value of the 50 percent portion of grader A)).

(D) The basis of the property received by V in the exchange (real estate A, real estate B, and grader A) are determined in the following manner:

(1) The basis of the property received in the exchange group is the adjusted basis of the property transferred within that exchange group (\$20,000), increased by the amount of gain recognized with respect to that exchange group (\$6500), and decreased by the amount of the exchange group deficiency (\$8000), or \$18,500. This \$18,500 of basis is allocated proportionately among the assets received within the exchange group in accordance with their fair market values: real estate A's basis is \$5000 ($\$18,500 \times \$5000 / \$18,500$); real estate B's basis is \$13,500 ($\$18,500 \times \$13,500 / \$18,500$).

(2) The basis of grader A is \$2000.

(e) *Effective date.* Section 1.1031 (j)-1 is effective for exchanges occurring on or after April 11, 1991.

[T.D. 8343, 56 FR 14855, Apr. 12, 1991, as amended by T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001; T.D. 9202, 70 FR 28820, May 19, 2005]

§ 1.1031(k)-1 Treatment of deferred exchanges.

(a) *Overview.* This section provides rules for the application of section 1031 and the regulations thereunder in the case of a "deferred exchange." For purposes of section 1031 and this section, a deferred exchange is defined as an exchange in which, pursuant to an agreement, the taxpayer transfers property held for productive use in a trade or business or for investment (the "relinquished property") and subsequently receives property to be held either for

productive use in a trade or business or for investment (the "replacement property"). In the case of a deferred exchange, if the requirements set forth in paragraphs (b), (c), and (d) of this section (relating to identification and receipt of replacement property) are not satisfied, the replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property. In order to constitute a deferred exchange, the transaction must be an exchange (i.e., a transfer of property for property, as distinguished from a transfer of property for money). For example, a sale of property followed by a purchase of property of a like kind does not qualify for nonrecognition of gain or loss under section 1031 regardless of whether the identification and receipt requirements of section 1031(a)(3) and paragraphs (b), (c), and (d) of this section are satisfied. The transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See § 1.1031(a)-1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or property which does not meet the requirements of section 1031(a) in the full amount of the consideration for the relinquished property, the transaction will constitute a sale, and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. For purposes of this section, property which does not meet the requirements of section 1031(a) (whether by being described in section 1031(a)(2) or otherwise) is referred to as "other property." For rules regarding actual and constructive receipt, and safe harbors therefrom, see paragraphs (f) and (g), respectively, of this section.

For rules regarding the determination of gain or loss recognized and the basis of property received in a deferred exchange, see paragraph (j) of this section.

(b) *Identification and receipt requirements*—(1) *In general.* In the case of a deferred exchange, any replacement property received by the taxpayer will be treated as property which is not of a like kind to the relinquished property if—

(i) The replacement property is not “identified” before the end of the “identification period,” or

(ii) The identified replacement property is not received before the end of the “exchange period.”

(2) *Identification period and exchange period.* (i) The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter.

(ii) The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer’s return of the tax imposed by chapter 1 of subtitle A of the Code for the taxable year in which the transfer of the relinquished property occurs.

(iii) If, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred.

(iv) For purposes of this paragraph (b)(2), property is transferred when the property is disposed of within the meaning of section 1001(a).

(3) *Example.* This paragraph (b) may be illustrated by the following example.

Example: (i) M is a corporation that files its Federal income tax return on a calendar year basis. M and C enter into an agreement for an exchange of property that requires M to transfer property X to C. Under the agreement, M is to identify like-kind replacement property which C is required to purchase and to transfer to M. M transfers property X to C on November 16, 1992.

(ii) The identification period ends at midnight on December 31, 1992, the day which is

45 days after the date of transfer of property X. The exchange period ends at midnight on March 15, 1993, the due date for M’s Federal income tax return for the taxable year in which M transferred property X. However, if M is allowed the automatic six-month extension for filing its tax return, the exchange period ends at midnight on May 15, 1993, the day which is 180 days after the date of transfer of property X.

(c) *Identification of replacement property before the end of the identification period*—(1) *In general.* For purposes of paragraph (b)(1)(i) of this section (relating to the identification requirement), replacement property is identified before the end of the identification period only if the requirements of this paragraph (c) are satisfied with respect to the replacement property. However, any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

(2) *Manner of identifying replacement property.* Replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either—

(i) The person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person as defined in paragraph (k) of this section); or

(ii) Any other person involved in the exchange other than the taxpayer or a disqualified person (as defined in paragraph (k) of this section).

Examples of persons involved in the exchange include any of the parties to the exchange, an intermediary, an escrow agent, and a title company. An identification of replacement property made in a written agreement for the exchange of properties signed by all parties thereto before the end of the identification period will be treated as satisfying the requirements of this paragraph (c)(2).

(3) *Description of replacement property.* Replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described if it is described by a

legal description, street address, or distinguishable name (e.g., the Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model, and year.

(4) *Alternative and multiple properties.*

(i) The taxpayer may identify more than one replacement property. Regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is—

(A) Three properties without regard to the fair market values of the properties (the “3-property rule”), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the “200-percent rule”).

(ii) If, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by paragraph (c)(4)(i) of this section, the taxpayer is treated as if no replacement property had been identified. The preceding sentence will not apply, however, and an identification satisfying the requirements of paragraph (c)(4)(i) of this section will be considered made, with respect to—

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the “95-percent rule”).

For this purpose, the fair market value of each identified replacement property

is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period.

(iii) For purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications of replacement property that have been revoked in the manner provided in paragraph (c)(6) of this section, are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of \$100,000 to C and B receives like-kind property Y with a fair market value of \$50,000 before the end of the identification period, under paragraph (c)(1) of this section, property Y is treated as identified by reason of being received before the end of the identification period. Thus, under paragraph (c)(4)(i) of this section, B may identify either two additional replacement properties of any fair market value or any number of additional replacement properties as long as the aggregate fair market value of the additional replacement properties does not exceed \$150,000.

(5) *Incidental property disregarded.* (i) Solely for purposes of applying this paragraph (c), property that is incidental to a larger item of property is not treated as property that is separate from the larger item of property. Property is incidental to a larger item of property if—

(A) In standard commercial transactions, the property is typically transferred together with the larger item of property, and

(B) The aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.

(ii) This paragraph (c)(5) may be illustrated by the following examples.

Example 1. For purposes of paragraph (c) of this section, a spare tire and tool kit will not be treated as separate property from a truck with a fair market value of \$10,000, if the aggregate fair market value of the spare tire and tool kit does not exceed \$1,500. For purposes of the 3-property rule, the truck, spare tire, and tool kit are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the truck, spare tire,

and tool kit are all considered to be unambiguously described if the make, model, and year of the truck are specified, even if no reference is made to the spare tire and tool kit.

Example 2. For purposes of paragraph (c) of this section, furniture, laundry machines, and other miscellaneous items of personal property will not be treated as separate property from an apartment building with a fair market value of \$1,000,000, if the aggregate fair market value of the furniture, laundry machines, and other personal property does not exceed \$150,000. For purposes of the 3-property rule, the apartment building, furniture, laundry machines, and other personal property are treated as 1 property. Moreover, for purposes of paragraph (c)(3) of this section (relating to the description of replacement property), the apartment building, furniture, laundry machines, and other personal property are all considered to be unambiguously described if the legal description, street address, or distinguishable name of the apartment building is specified, even if no reference is made to the furniture, laundry machines, and other personal property.

(6) *Revocation of identification.* An identification of replacement property may be revoked at any time before the end of the identification period. An identification of replacement property is revoked only if the revocation is made in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to the person to whom the identification of the replacement property was sent. An identification of replacement property that is made in a written agreement for the exchange of properties is treated as revoked only if the revocation is made in a written amendment to the agreement or in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to all of the parties to the agreement.

(7) *Examples.* This paragraph (c) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of \$100,000. On or before July 1, 1991 (the end of the iden-

tification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. No replacement property is identified in the agreement. When subsequently identified, the replacement property is described by legal description and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold the replacement property received for investment.

Example 1. (i) On July 2, 1991, B identifies real property E as replacement property by designating real property E as replacement property in a written document signed by B and personally delivered to C.

(ii) Because the identification was made after the end of the identification period, pursuant to paragraph (b)(1)(i) of this section (relating to the identification requirement), real property E is treated as property which is not of a like kind to real property X.

Example 2. (i) C is a corporation of which 20 percent of the outstanding stock is owned by B. On July 1, 1991, B identifies real property F as replacement property by designating real property F as replacement property in a written document signed by B and mailed to C.

(ii) Because C is the person obligated to transfer the replacement property to B, real property F is identified before the end of the identification period. The fact that C is a "disqualified person" as defined in paragraph (k) of this section does not change this result.

(iii) Real property F would also have been treated as identified before the end of the identification period if, instead of sending the identification to C, B had designated real property F as replacement property in a written agreement for the exchange of properties signed by all parties thereto on or before July 1, 1991.

Example 3. (i) On June 3, 1991, B identifies the replacement property as "unimproved land located in Hood County with a fair market value not to exceed \$100,000." The designation is made in a written document signed by B and personally delivered to C. On

July 8, 1991, B and C agree that real property G is the property described in the June 3, 1991 document.

(ii) Because real property G was not unambiguously described before the end of the identification period, no replacement property is identified before the end of the identification period.

Example 4. (i) On June 28, 1991, B identifies real properties H, J, and K as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by August 1, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties H, J, and K are \$75,000, \$100,000, and \$125,000, respectively.

(ii) Because B did not identify more than three properties as replacement properties, the requirements of the 3-property rule are satisfied, and real properties H, J, and K are all identified before the end of the identification period.

Example 5. (i) On May 17, 1991, B identifies real properties L, M, N, and P as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. The written document provides that by July 2, 1991, B will orally inform C which of the identified properties C is to transfer to B. As of July 1, 1991, the fair market values of real properties L, M, N, and P are \$30,000, \$40,000, \$50,000, and \$60,000, respectively.

(ii) Although B identified more than three properties as replacement properties, the aggregate fair market value of the identified properties as of the end of the identification period (\$180,000) did not exceed 200 percent of the aggregate fair market value of real property X ($200\% \times \$100,000 = \$200,000$). Therefore, the requirements of the 200-percent rule are satisfied, and real properties L, M, N, and P are all identified before the end of the identification period.

Example 6. (i) On June 21, 1991, B identifies real properties Q, R, and S as replacement properties by designating these properties as replacement properties in a written document signed by B and mailed to C. On June 24, 1991, B identifies real properties T and U as replacement properties in a written document signed by B and mailed to C. On June 28, 1991, B revokes the identification of real properties Q and R in a written document signed by B and personally delivered to C.

(ii) B has revoked the identification of real properties Q and R in the manner provided by paragraph (c)(6) of this section. Identifications of replacement property that have been revoked in the manner provided by paragraph (c)(6) of this section are not taken into account for purposes of applying the 3-property rule. Thus, as of June 28, 1991, B has

identified only replacement properties S, T, and U for purposes of the 3-property rule. Because B did not identify more than three properties as replacement properties for purposes of the 3-property rule, the requirements of that rule are satisfied, and real properties S, T, and U are all identified before the end of the identification period.

Example 7. (i) On May 20, 1991, B identifies real properties V and W as replacement properties by designating these properties as replacement properties in a written document signed by B and personally delivered to C. On June 4, 1991, B identifies real properties Y and Z as replacement properties in the same manner. On June 5, 1991, B telephones C and orally revokes the identification of real properties V and W. As of July 1, 1991, the fair market values of real properties V, W, Y, and Z are \$50,000, \$70,000, \$90,000, and \$100,000, respectively. On July 31, 1991, C purchases real property Y and Z and transfers them to B.

(ii) Pursuant to paragraph (c)(6) of this section (relating to revocation of identification), the oral revocation of the identification of real properties V and W is invalid. Thus, the identification of real properties V and W is taken into account for purposes of determining whether the requirements of paragraph (c)(4) of this section (relating to the identification of alternative and multiple properties) are satisfied. Because B identified more than three properties and the aggregate fair market value of the identified properties as of the end of the identification period (\$310,000) exceeds 200 percent of the fair market value of real property X ($200\% \times \$100,000 = \$200,000$), the requirements of paragraph (c)(4) of this section are not satisfied, and B is treated as if B did not identify any replacement property.

(d) *Receipt of identified replacement property—(1) In general.* For purposes of paragraph (b)(1)(ii) of this section (relating to the receipt requirement), the identified replacement property is received before the end of the exchange period only if the requirements of this paragraph (d) are satisfied with respect to the replacement property. In the case of a deferred exchange, the identified replacement property is received before the end of the exchange period if—

(i) The taxpayer receives the replacement property before the end of the exchange period, and

(ii) The replacement property received is substantially the same property as identified.

If the taxpayer has identified more than one replacement property, section

1031(a)(3)(B) and this paragraph (d) are applied separately to each replacement property.

(2) *Examples.* This paragraph (d) may be illustrated by the following examples. The following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of \$100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified in a manner that satisfies paragraph (c) of this section (relating to identification of replacement property) and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) In the agreement, B identifies real properties J, K, and L as replacement properties. The agreement provides that by July 26, 1991, B will orally inform C which of the properties C is to transfer to B.

(ii) As of July 1, 1991, the fair market values of real properties J, K, and L are \$75,000, \$100,000, and \$125,000, respectively. On July 26, 1991, B instructs C to acquire real property K. On October 31, 1991, C purchases real property K for \$100,000 and transfers the property to B.

(iii) Because real property K was identified before the end of the identification period and was received before the end of the exchange period, the identification and receipt requirements of section 1031(a)(3) and this section are satisfied with respect to real property K.

Example 2. (i) In the agreement, B identifies real property P as replacement property. Real property P consists of two acres of un-

improved land. On October 15, 1991, the owner of real property P erects a fence on the property. On November 1, 1991, C purchases real property P and transfers it to B.

(ii) The erection of the fence on real property P subsequent to its identification did not alter the basic nature or character of real property P as unimproved land. B is considered to have received substantially the same property as identified.

Example 3. (i) In the agreement, B identifies real property Q as replacement property. Real property Q consists of a barn on two acres of land and has a fair market value of \$250,000 (\$187,500 for the barn and underlying land and \$87,500 for the remaining land). As of July 26, 1991, real property Q remains unchanged and has a fair market value of \$250,000. On that date, at B's direction, C purchases the barn and underlying land for \$187,500 and transfers it to B, and B pays \$87,500 to C.

(ii) The barn and underlying land differ in basic nature or character from real property Q as a whole. B is not considered to have received substantially the same property as identified.

Example 4. (i) In the agreement, B identifies real property R as replacement property. Real property R consists of two acres of unimproved land and has a fair market value of \$250,000. As of October 3, 1991, real property R remains unimproved and has a fair market value of \$250,000. On that date, at B's direction, C purchases 1½ acres of real property R for \$187,500 and transfers it to B, and B pays \$87,500 to C.

(ii) The portion of real property R that B received does not differ from the basic nature or character of real property R as a whole. Moreover, the fair market value of the portion of real property R that B received (\$187,500) is 75 percent of the fair market value of real property R as of the date of receipt. Accordingly, B is considered to have received substantially the same property as identified.

(e) *Special rules for identification and receipt of replacement property to be produced—(1) In general.* A transfer of relinquished property in a deferred exchange will not fail to qualify for non-recognition of gain or loss under section 1031 merely because the replacement property is not in existence or is being produced at the time the property is identified as replacement property. For purposes of this paragraph (e), the terms “produced” and “production” have the same meanings as provided in section 263A(g)(1) and the regulations thereunder.

(2) *Identification of replacement property to be produced.* (i) In the case of replacement property that is to be produced, the replacement property must be identified as provided in paragraph (c) of this section (relating to identification of replacement property). For example, if the identified replacement property consists of improved real property where the improvements are to be constructed, the description of the replacement property satisfies the requirements of paragraph (c)(3) of this section (relating to description of replacement property) if a legal description is provided for the underlying land and as much detail is provided regarding construction of the improvements as is practicable at the time the identification is made.

(ii) For purposes of paragraphs (c)(4)(i)(B) and (c)(5) of this section (relating to the 200-percent rule and incidental property), the fair market value of replacement property that is to be produced is its estimated fair market value as of the date it is expected to be received by the taxpayer.

(3) *Receipt of replacement property to be produced.* (i) For purposes of paragraph (d)(1)(ii) of this section (relating to receipt of the identified replacement property), in determining whether the replacement property received by the taxpayer is substantially the same property as identified where the identified replacement property is property to be produced, variations due to usual or typical production changes are not taken into account. However, if substantial changes are made in the property to be produced, the replacement property received will not be considered to be substantially the same property as identified.

(ii) If the identified replacement property is personal property to be produced, the replacement property received will not be considered to be substantially the same property as identified unless production of the replacement property received is completed on or before the date the property is received by the taxpayer.

(iii) If the identified replacement property is real property to be produced and the production of the property is not completed on or before the date the taxpayer receives the prop-

erty, the property received will be considered to be substantially the same property as identified only if, had production been completed on or before the date the taxpayer receives the replacement property, the property received would have been considered to be substantially the same property as identified. Even so, the property received is considered to be substantially the same property as identified only to the extent the property received constitutes real property under local law.

(4) *Additional rules.* The transfer of relinquished property is not within the provisions of section 1031(a) if the relinquished property is transferred in exchange for services (including production services). Thus, any additional production occurring with respect to the replacement property after the property is received by the taxpayer will not be treated as the receipt of property of a like kind.

(5) *Example.* This paragraph (e) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B transfers improved real property X and personal property Y to C on May 17, 1991. On or before November 13, 1991 (the end of the exchange period), C is required to transfer to B real property M, on which C is constructing improvements, and personal property N, which C is producing. C is obligated to complete the improvements and production regardless of when properties M and N are transferred to B. Properties M and N are identified in a manner that satisfies paragraphs (c) (relating to identification of replacement property) and (e)(2) of this section. In addition, properties M and N are of a like kind, respectively, to real property X and personal property Y (determined without regard to section 1031(a)(3) and this section). On November 13, 1991, when construction of the improvements to property M is 20 percent completed and the production of property N is 90 percent completed, C transfers to B property M and property N. If construction of the improvements had been completed, property M would have been considered to be substantially the same property as identified. Under local law, property M constitutes real property to the extent of the underlying land and the 20 percent of the construction that is completed.

(ii) Because property N is personal property to be produced and production of property N is not completed before the date the property is received by B, property N is not

considered to be substantially the same property as identified and is treated as property which is not of a like kind to property Y.

(iii) Property M is considered to be substantially the same property as identified to the extent of the underlying land and the 20 percent of the construction that is completed when property M is received by B. However, any additional construction performed by C with respect to property M after November 13, 1991, is not treated as the receipt of property of a like kind.

(f) *Receipt of money or other property—*

(1) *In general.* A transfer of relinquished property in a deferred exchange is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). See §1.1031(a)-1(a)(2). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

(2) *Actual and constructive receipt.* Except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of section 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the

time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

(3) *Example.* This paragraph (f) may be illustrated by the following example.

Example: (i) B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to the agreement, on May 17, 1991, B transfers real property X to C. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of \$100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. At any time after May 17, 1991, and before C has purchased the replacement property, B has the right, upon notice, to demand that C pay \$100,000 in lieu of acquiring and transferring the replacement property. Pursuant to the agreement, B identifies replacement property, and C purchases the replacement property and transfers it to B.

(ii) Under the agreement, B has the unrestricted right to demand the payment of \$100,000 as of May 17, 1991. B is therefore in constructive receipt of \$100,000 on that date. Because B is in constructive receipt of money in the full amount of the consideration for the relinquished property before B actually receives the like-kind replacement property, the transaction constitutes a sale, and the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031. B is treated as if B received the \$100,000 in consideration for the sale of real property X and then purchased the like-kind replacement property.

(iii) If B's right to demand payment of the \$100,000 were subject to a substantial limitation or restriction (e.g., the agreement provided that B had no right to demand payment before November 14, 1991 (the end of the exchange period)), then, for purposes of this section, B would not be in actual or constructive receipt of the money unless (or until) the limitation or restriction lapsed, expired, or was waived.

(g) *Safe harbors*—(1) *In general.* Paragraphs (g)(2) through (g)(5) of this section set forth four safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of section 1031 and this section. More than one safe harbor can be used in the same deferred exchange, but the terms and conditions of each must be separately satisfied. For purposes of the safe harbor rules, the term "taxpayer" does not include a person or entity utilized in a safe harbor (e.g., a qualified intermediary). See paragraph (g)(8), *Example 3(v)*, of this section.

(2) *Security or guarantee arrangements.*

(i) In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured or guaranteed by one or more of the following—

(A) A mortgage, deed of trust, or other security interest in property (other than cash or a cash equivalent),

(B) A standby letter of credit which satisfies all of the requirements of § 15A.453-1 (b)(3)(iii) and which may not be drawn upon in the absence of a default of the transferee's obligation to transfer like-kind replacement property to the taxpayer, or

(C) A guarantee of a third party.

(ii) Paragraph (g)(2)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive money or other property pursuant to the security or guarantee arrangement.

(3) *Qualified escrow accounts and qualified trusts.* (i) In the case of a deferred exchange, the determination of

whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust.

(ii) A qualified escrow account is an escrow account wherein—

(A) The escrow holder is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) The escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account as provided in paragraph (g)(6) of this section.

(iii) A qualified trust is a trust wherein—

(A) The trustee is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section, except that for this purpose the relationship between the taxpayer and the trustee created by the qualified trust will not be considered a relationship under section 267(b)), and

(B) The trust agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held by the trustee as provided in paragraph (g)(6) of this section.

(iv) Paragraph (g)(3)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the qualified escrow account or qualified trust. Rights conferred upon the taxpayer under state law to terminate or dismiss the escrow holder of a qualified escrow account or the trustee of a qualified trust are disregarded for this purpose.

(v) A taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust, without affecting the application of paragraph (g)(3)(i) of this section.

(4) *Qualified intermediaries.* (i) In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a). In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer.

(ii) Paragraph (g)(4)(i) of this section applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

(iii) A qualified intermediary is a person who—

(A) Is not the taxpayer or a disqualified person (as defined in paragraph (k) of this section), and

(B) Enters into a written agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

(iv) Regardless of whether an intermediary acquires and transfers property under general tax principals, solely for purposes of paragraph (g)(4)(iii)(B) of this section—

(A) An intermediary is treated as acquiring and transferring property if the intermediary acquires and transfers legal title to that property,

(B) An intermediary is treated as acquiring and transferring the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agree-

ment, the relinquished property is transferred to that person, and

(C) An intermediary is treated as acquiring and transferring replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement property for the transfer of that property and, pursuant to that agreement, the replacement property is transferred to the taxpayer.

(v) Solely for purposes of paragraphs (g)(4)(iii) and (g)(4)(iv) of this section, an intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the relevant transfer of property. For example, if a taxpayer enters into an agreement for the transfer of relinquished property and thereafter assigns its rights in that agreement to an intermediary and all parties to that agreement are notified in writing of the assignment on or before the date of the transfer of the relinquished property, the intermediary is treated as entering into that agreement. If the relinquished property is transferred pursuant to that agreement, the intermediary is treated as having acquired and transferred the relinquished property.

(vi) Paragraph (g)(4)(i) of this section ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Rights conferred upon the taxpayer under state law to terminate or dismiss the qualified intermediary are disregarded for this purpose.

(vii) A taxpayer may receive money or other property directly from a party to the transaction other than the qualified intermediary without affecting the application of paragraph (g)(4)(i) of this section.

(5) *Interest and growth factors.* In the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer

actually receives the like-kind replacement property will be made without regard to the fact that the taxpayer is or may be entitled to receive any interest or growth factor with respect to the deferred exchange. The preceding sentence applies only if the agreement pursuant to which the taxpayer is or may be entitled to the interest or growth factor expressly limits the taxpayer's rights to receive the interest or growth factor as provided in paragraph (g)(6) of this section. For additional rules concerning interest or growth factors, see paragraph (h) of this section.

(6) *Additional restrictions on safe harbors under paragraphs (g)(3) through (g)(5).* (i) An agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraph (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.

(ii) The agreement may provide that if the taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period.

(iii) The agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after—

(A) The receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement, or

(B) The occurrence after the end of the identification period of a material and substantial contingency that—

(1) Relates to the deferred exchange,

(2) Is provided for in writing, and

(3) Is beyond the control of the taxpayer and of any disqualified person (as defined in paragraph (k) of this section), other than the person obligated to transfer the replacement property to the taxpayer.

(7) *Items disregarded in applying safe harbors under paragraphs (g)(3) through (g)(5).* In determining whether a safe harbor under paragraphs (g)(3) through (g)(5) of this section ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section, the taxpayer's receipt of or right to receive any of the following items will be disregarded—

(i) Items that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents), and

(ii) Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

(8) *Examples.* This paragraph (g) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of \$100,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received by B. The replacement property is identified as provided in paragraph (c) of this section (relating to identification of replacement property)

and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C. On the same day, C pays \$10,000 to B and deposits \$90,000 in escrow as security for C's obligation to perform under the agreement. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) if B fails to identify replacement property on or before July 1, 1991, B may demand the funds in escrow at any time after July 1, 1991; and

(B) if B identifies and receives replacement property, then B may demand the balance of the remaining funds in escrow at any time after B has received the replacement property.

The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as defined in paragraph (k) of this section. Pursuant to the terms of the agreement, B identifies replacement property, and C purchases the replacement property using the funds in escrow and transfers the replacement property to B.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. In addition, B did not have the immediate ability or unrestricted right to receive money or other property in escrow before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the \$90,000 held in escrow before B received the like-kind replacement property. The transfer of real property X by B and B's acquisition of the replacement property qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 2. (i) On May 17, 1991, B transfers real property X to C, and C deposits \$100,000 in escrow as security for C's obligation to perform under the agreement. Also on May 17, B identifies real property J as replacement property. The escrow agreement provides that no funds may be paid out without prior written approval of both B and C. The escrow agreement also provides that B has no rights to receive, pledge, borrow, or oth-

erwise obtain the benefits of the money in escrow before November 14, 1991, except that:

(A) B may demand the funds in escrow at any time after the later of July 1, 1991, and the occurrence of any of the following events—

(1) real property J is destroyed, seized, re-acquisitioned, or condemned, or

(2) a determination is made that the regulatory approval necessary for the transfer of real property J cannot be obtained in time for real property J to be transferred to B before the end of the exchange period;

(B) B may demand the funds in escrow at any time after August 14, 1991, if real property J has not been rezoned from residential to commercial use by that date; and

(C) B may demand the funds in escrow at the time B receives real property J or any time thereafter.

Otherwise, B is entitled to all funds in escrow after November 13, 1991. The funds in escrow may be used to purchase the replacement property. The escrow holder is not a disqualified person as described in paragraph (k) of this section. Real property J is not rezoned from residential to commercial use on or before August 14, 1991.

(ii) C's obligation to transfer the replacement property to B was secured by cash held in a qualified escrow account because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in escrow as provided in paragraph (g)(6) of this section. From May 17, 1991, until August 15, 1991, B did not have the immediate ability or unrestricted right to receive money or other property before B actually received the like-kind replacement property. Therefore, for purposes of section 1031 and this section, B is determined not to be in actual or constructive receipt of the \$100,000 in escrow from May 17, 1991, until August 15, 1991. However, on August 15, 1991, B had the unrestricted right, upon notice, to draw upon the \$100,000 held in escrow. Thus, the safe harbor ceased to apply and B was in constructive receipt of the funds held in escrow. Because B constructively received the full amount of the consideration (\$100,000) before B actually received the like-kind replacement property, the transaction is treated as a sale and not as a deferred exchange. The result does not change even if B chose not to demand the funds in escrow and continued to attempt to have real property J rezoned and to receive the property on or before November 13, 1991.

(iii) If real property J had been rezoned on or before August 14, 1991, and C had purchased real property J and transferred it to B on or before November 13, 1991, the transaction would have qualified for nonrecognition of gain or loss under section 1031(a).

Example 3. (i) On May 1, 1991, D offers to purchase real property X for \$100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The exchange agreement between B and C provides that B is to execute and deliver a deed conveying real property X to C who, in turn, is to execute and deliver a deed conveying real property X to D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 3, 1991, C enters into an agreement with D to transfer real property X to D for \$100,000. On May 17, 1991, B executes and delivers to C a deed conveying real property X to C. On the same date, C executes and delivers to D a deed conveying real property X to D, and D deposits \$100,000 in escrow. The escrow holder is not a disqualified person as defined in paragraph (k) of this section and the escrow agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section. However, the escrow agreement provides that the money in escrow may be used to purchase replacement property. On June 3, 1991, B identifies real property K as replacement property. On August 9, 1991, E executes and delivers to C a deed conveying real property K to C and \$80,000 is released from the escrow and paid to E. On the same date, C executes and delivers to B a deed conveying real property K to B, and the escrow holder pays B \$20,000, the balance of the \$100,000 sale price of real property X remaining after the purchase of real property K for \$80,000.

(ii) B and C entered into an exchange agreement that satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Regardless of whether C may have acquired and transferred real property X under general tax principles, C is treated as having acquired and transferred real property X because C acquired and transferred legal title to real property X. Similarly, C is treated as having acquired and transferred real property K because C acquired and transferred legal title to real property K. Thus, C was a qualified intermediary. This result is reached for purposes of this section regardless of whether C was B's agent under state law.

(iii) Because the escrow holder was not a disqualified person and the escrow agreement expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, the escrow account was a qualified escrow

account. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the funds in escrow before B received real property K.

(iv) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of any money held by C as provided in paragraph (g)(6) of this section. Because C was a qualified intermediary, for purposes of section 1031 and this section B is determined not to be in actual or constructive receipt of any funds held by C before B received real property K. In addition, B's transfer of real property X and acquisition of real property K qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

(v) If the escrow agreement had expressly limited C's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property in escrow as provided in paragraph (g)(6) of this section, but had not expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of that money or other property, the escrow account would not have been a qualified escrow account. Consequently, paragraph (g)(3)(i) of this section would not have been applicable in determining whether B was in actual or constructive receipt of that money or other property before B received real property K.

Example 4. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for \$100,000 on May 17, 1991. However, D is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. In the exchange agreement between B and C, B assigns to C all of B's rights in the agreement with D. The exchange agreement expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. On May 17, 1991, B notifies D in writing of the assignment. On the same date, B executes and delivers to D a deed conveying real property X to D. D pays \$10,000 to B and \$90,000 to C. On June 1, 1991, B identifies real property L as replacement property. On July 5, 1991, B enters into an agreement to purchase real property L from E for \$90,000, assigns its rights in that agreement to C, and notifies E in writing of the assignment. On August 9, 1991, C pays \$90,000 to E, and E executes and delivers to B a deed conveying real property L to B.

(ii) The exchange agreement entered into by B and C satisfied the requirements of paragraph (g)(4)(iii)(B) of this section. Because B's rights in its agreements with D and

E were assigned to C, and D and E were notified in writing of the assignment on or before the transfer of real properties X and L, respectively, C is treated as entering into those agreements. Because C is treated as entering into an agreement with D for the transfer of real property X and, pursuant to that agreement, real property X was transferred to D, C is treated as acquiring and transferring real property X. Similarly, because C is treated as entering into an agreement with E for the transfer of real property K and, pursuant to that agreement, real property K was transferred to B, C is treated as acquiring and transferring real property K. This result is reached for purposes of this section regardless of whether C was B's agent under state law and regardless of whether C is considered, under general tax principles, to have acquired title or beneficial ownership of the properties. Thus, C was a qualified intermediary.

(iii) The exchange agreement between B and C expressly limited B's rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C as provided in paragraph (g)(6) of this section. Thus, B did not have the immediate ability or unrestricted right to receive money or other property held by C before B received real property L. For purposes of section 1031 and this section, therefore, B is determined not to be in actual or constructive receipt of the \$90,000 held by C before B received real property L. In addition, the transfer of real property X by B and B's acquisition of real property L qualify as an exchange under section 1031. See paragraph (j) of this section for determining the amount of gain or loss recognized.

Example 5. (i) On May 1, 1991, B enters into an agreement to sell real property X to D for \$100,000. However, D is unwilling to participate in a like-kind exchange. B thus enters into an agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is not a disqualified person as described in paragraph (k) of this section. The agreement between B and C expressly limits B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by C as provided in paragraph (g)(6) of this section. C neither enters into an agreement with D to transfer real property X to D nor is assigned B's rights in B's agreement to sell real property X to D. On May 17, 1991, B transfers real property X to D and instructs D to transfer the \$100,000 to C. On June 1, 1991, B identifies real property M as replacement property. On August 9, 1991, C purchases real property L from E for \$100,000, and E executes and delivers to C a deed conveying real property M to C. On the same date, C executes and delivers to B a deed conveying real property M to B.

(ii) Because B transferred real property X directly to D under B's agreement with D, C

did not acquire real property X from B and transfer real property X to D. Moreover, because C did not acquire legal title to real property X, did not enter into an agreement with D to transfer real property X to D, and was not assigned B's rights in B's agreement to sell real property X to D, C is not treated as acquiring and transferring real property X. Thus, C was not a qualified intermediary and paragraph (g)(4)(i) of this section does not apply.

(iii) B did not exchange real property X for real property M. Rather, B sold real property X to D and purchased, through C, real property M. Therefore, the transfer of real property X does not qualify for nonrecognition of gain or loss under section 1031.

(h) *Interest and growth factors*—(1) *In general.* For purposes of this section, the taxpayer is treated as being entitled to receive interest or a growth factor with respect to a deferred exchange if the amount of money or property the taxpayer is entitled to receive depends upon the length of time elapsed between transfer of the relinquished property and receipt of the replacement property.

(2) *Treatment as interest.* If, as part of a deferred exchange, the taxpayer receives interest or a growth factor, the interest or growth factor will be treated as interest, regardless of whether it is paid to the taxpayer in cash or in property (including property of a like kind). The taxpayer must include the interest or growth factor in income according to the taxpayer's method of accounting. For rules under section 468B(g) relating to the current taxation of qualified escrow accounts, qualified trusts, and other escrow accounts, trusts, and funds used during deferred exchanges of like-kind property, see § 1.468B-6.

(i) [Reserved]

(j) *Determination of gain or loss recognized and the basis of property received in a deferred exchange*—(1) *In general.* Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See §§ 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, 1.1031(d)-2, and 1.1031(j)-1.

(2) *Coordination with section 453*—(i) *Qualified escrow accounts and qualified trusts.* Subject to the limitations of

paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property in which the obligation of the taxpayer's transferee to transfer replacement property to the taxpayer is or may be secured by cash or a cash equivalent, the determination of whether the taxpayer has received a payment for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter will be made without regard to the fact that the obligation is or may be so secured if the cash or cash equivalent is held in a qualified escrow account or a qualified trust. This paragraph (j)(2)(i) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(3)(iv) of this section; or

(B) The end of the exchange period.

(ii) *Qualified intermediaries.* Subject to the limitations of paragraphs (j)(2) (iv) and (v) of this section, in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the determination of whether the taxpayer has received a payment for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter is made as if the qualified intermediary is not the agent of the taxpayer. For purposes of this paragraph (j)(2)(ii), a person who otherwise satisfies the definition of a qualified intermediary is treated as a qualified intermediary even though that person ultimately fails to acquire identified replacement property and transfer it to the taxpayer. This paragraph (j)(2)(ii) ceases to apply at the earlier of—

(A) The time described in paragraph (g)(4)(vi) of this section; or

(B) The end of the exchange period.

(iii) *Transferee indebtedness.* In the case of a transaction described in paragraph (j)(2)(ii) of this section, the receipt by the taxpayer of an evidence of indebtedness of the transferee of the qualified intermediary is treated as the receipt of an evidence of indebtedness of the person acquiring property from the taxpayer for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter.

(iv) *Bona fide intent requirement.* The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply unless the taxpayer has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period. A

taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period.

(v) *Disqualified property.* The provisions of paragraphs (j)(2) (i) and (ii) of this section do not apply if the relinquished property is disqualified property. For purposes of this paragraph (j)(2), *disqualified property* means property that is not held for productive use in a trade or business or for investment or is property described in section 1031(a)(2).

(vi) *Examples.* This paragraph (j)(2) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B is a calendar year taxpayer who agrees to enter into a deferred exchange. Pursuant to the agreement, B is to transfer real property X. Real property X, which has been held by B for investment, is unencumbered and has a fair market value of \$100,000 at the time of transfer. B's adjusted basis in real property X at that time is \$60,000. B identifies a single like-kind replacement property before the end of the identification period, and B receives the replacement property before the end of the exchange period. The transaction qualifies as a like-kind exchange under section 1031.

Example 1. (i) On September 22, 1994, B transfers real property X to C and C agrees to acquire like-kind property and deliver it to B. On that date B has a bona fide intent to enter into a deferred exchange. C's obligation, which is not payable on demand or readily tradable, is secured by \$100,000 in cash. The \$100,000 is deposited by C in an escrow account that is a qualified escrow account under paragraph (g)(3) of this section. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash deposited in the escrow account until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of \$80,000 and delivers the replacement property to B. The \$20,000 in cash remaining in the qualified escrow account is distributed to B at that time.

(ii) Under section 1031(b), B recognizes gain to the extent of the \$20,000 in cash that B receives in the exchange. Under paragraph (j)(2)(i) of this section, the qualified escrow account is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of C's obligation on September 22, 1994, does not constitute a payment. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the \$20,000 in cash from the qualified escrow account. Subject to the other requirements of sections 453 and 453A, B may report the \$20,000 gain in 1995 under the installment method. See section 453(f)(6) for special rules for determining total contract price and gross profit in the case of an exchange described in section 1031(b).

Example 2. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for \$100,000 in cash. On that date B has a bona fide intent to enter into a deferred exchange. C is a qualified intermediary under paragraph (g)(4) of this section. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. On March 11, 1995, C acquires replacement property having a fair market value of \$80,000 and delivers it, along with the remaining \$20,000 from the transfer of real property X to B.

(ii) Under section 1031(b), B recognizes gain to the extent of the \$20,000 cash B receives in the exchange. Under paragraph (j)(2)(i) of this section, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment on March 11, 1995, on receipt of the \$20,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the \$20,000 gain in 1995 under the installment method.

Example 3. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On December 1, 1994, pursuant to the agreement, B transfers real property X to C who transfers it to D for \$100,000 in cash. On that date

B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. Although B has a bona fide intent to enter into a deferred exchange at the beginning of the exchange period, B does not identify or acquire any replacement property. In 1995, at the end of the identification period, C delivers the entire \$100,000 from the sale of real property X to B.

(ii) Under section 1001, B realizes gain to the extent of the amount realized (\$100,000) over the adjusted basis in real property X (\$60,000), or \$40,000. Because B has a bona fide intent at the beginning of the exchange period to enter into a deferred exchange, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary even though C does not acquire and transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on December 1, 1994, on C's receipt of payment from D for the relinquished property. Instead, B is treated as receiving payment at the end of the identification period in 1995 on receipt of the \$100,000 in cash from C. Subject to the other requirements of sections 453 and 453A, B may report the \$40,000 gain in 1995 under the installment method.

Example 4. (i) D offers to purchase real property X but is unwilling to participate in a like-kind exchange. B thus enters into an exchange agreement with C whereby B retains C to facilitate an exchange with respect to real property X. C is a qualified intermediary under paragraph (g)(4) of this section. On September 22, 1994, pursuant to the agreement, B transfers real property X to C who then transfers it to D for \$80,000 in cash and D's 10-year installment obligation for \$20,000. On that date B has a bona fide intent to enter into a deferred exchange. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by C until the earlier of the date the replacement property is delivered to B or the end of the exchange period. D's obligation bears adequate stated interest and is not payable on demand or readily tradable. On March 11, 1995, C acquires replacement property having a fair market

value of \$80,000 and delivers it, along with the \$20,000 installment obligation, to B.

(ii) Under section 1031(b), \$20,000 of B's gain (i.e., the amount of the installment obligation B receives in the exchange) does not qualify for nonrecognition under section 1031(a). Under paragraphs (j)(2)(ii) and (iii) of this section, B's receipt of D's obligation is treated as the receipt of an obligation of the person acquiring the property for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B's receipt of the obligation is not treated as a payment. Subject to the other requirements of sections 453 and 453A, B may report the \$20,000 gain under the installment method on receiving payments from D on the obligation.

Example 5. (i) B is a corporation that has held real property X to expand its manufacturing operations. However, at a meeting in November 1994, B's directors decide that real property X is not suitable for the planned expansion, and authorize a like-kind exchange of this property for property that would be suitable for the planned expansion. B enters into an exchange agreement with C whereby B retains C as a qualified intermediary to facilitate an exchange with respect to real property X. On November 28, 1994, pursuant to the agreement, B transfers real property X to C, who then transfers it to D for \$100,000 in cash. The exchange agreement does not include any limitations or conditions that make it unreasonable to believe that like-kind replacement property will be acquired before the end of the exchange period. The exchange agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash held by C until the earliest of the end of the identification period, if B has not identified replacement property, the date the replacement property is delivered to B, or the end of the exchange period. In early January 1995, B's directors meet and decide that it is not feasible to proceed with the planned expansion due to a business downturn reflected in B's preliminary financial reports for the last quarter of 1994. Thus, B's directors instruct C to stop seeking replacement property. C delivers the \$100,000 cash to B on January 12, 1995, at the end of the identification period. Both the decision to exchange real property X for other property and the decision to cease seeking replacement property because of B's business downturn are recorded in the minutes of the directors' meetings. There are no other facts or circumstances that would indicate whether, on November 28, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized (\$100,000) over the adjusted basis of real property X (\$60,000), or \$40,000. The directors' authoriza-

tion of a like-kind exchange, the terms of the exchange agreement with C, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred like-kind exchange. Thus, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(ii) of this section inapplicable, even though B fails to acquire replacement property. Further, under paragraph (j)(2)(ii) of this section, C is a qualified intermediary, even though C does not transfer replacement property to B. Thus, any agency relationship between B and C is disregarded for purposes of section 453 and §15a.453-1(b)(3)(i) of this chapter in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment until January 12, 1995, on receipt of the \$100,000 cash from C. Subject to the other requirements of sections 453 and 453A, B may report the \$40,000 gain in 1995 under the installment method.

Example 6. (i) B has held real property X for use in its trade or business, but decides to transfer that property because it is no longer suitable for B's planned expansion of its commercial enterprise. B and D agree to enter into a deferred exchange. Pursuant to their agreement, B transfers real property X to D on September 22, 1994, and D deposits \$100,000 cash in a qualified escrow account as security for D's obligation under the agreement to transfer replacement property to B before the end of the exchange period. D's obligation is not payable on demand or readily tradable. The agreement provides that B is not required to accept any property that is not zoned for commercial use. Before the end of the identification period, B identifies real properties J, K, and L, all zoned for residential use, as replacement properties. Any one of these properties, rezoned for commercial use, would be suitable for B's planned expansion. In recent years, the zoning board with jurisdiction over properties J, K, and L has rezoned similar properties for commercial use. The escrow agreement provides that B has no rights to receive, pledge, borrow, or otherwise obtain the benefits of the money in the escrow account until the earlier of the time that the zoning board determines, after the end of the identification period, that it will not rezone the properties for commercial use or the end of the exchange period. On January 5, 1995, the zoning board decides that none of the properties will be rezoned for commercial use. Pursuant to the exchange agreement, B receives the \$100,000 cash from the escrow on January 5, 1995. There are no other facts or circumstances that would indicate whether, on September 22, 1994, B had a bona fide intent to enter into a deferred like-kind exchange.

(ii) Under section 1001, B realizes gain to the extent of the amount realized (\$100,000) over the adjusted basis of real property X

(\$60,000), or \$40,000. The terms of the exchange agreement with D, the identification of properties J, K, and L, the efforts to have those properties rezoned for commercial purposes, and the absence of other relevant facts, indicate that B had a bona fide intent at the beginning of the exchange period to enter into a deferred exchange. Moreover, the limitations imposed in the exchange agreement on acceptable replacement property do not make it unreasonable to believe that like-kind replacement property would be acquired before the end of the exchange period. Therefore, paragraph (j)(2)(iv) of this section does not make paragraph (j)(2)(i) of this section inapplicable even though B fails to acquire replacement property. Thus, for purposes of section 453 and § 15a.453-1(b)(3)(i) of this chapter, the qualified escrow account is disregarded in determining whether B is in receipt of payment. Accordingly, B is not treated as having received payment on September 22, 1994, on D's deposit of the \$100,000 cash into the qualified escrow account. Instead, B is treated as receiving payment on January 5, 1995. Subject to the other requirements of sections 453 and 453A, B may report the \$40,000 gain in 1995 under the installment method.

(vii) *Effective date.* This paragraph (j)(2) is effective for transfers of property occurring on or after April 20, 1994. Taxpayers may apply this paragraph (j)(2) to transfers of property occurring before April 20, 1994, but on or after June 10, 1991, if those transfers otherwise meet the requirements of § 1.1031(k)-1. In addition, taxpayers may apply this paragraph (j)(2) to transfers of property occurring before June 10, 1991, but on or after May 16, 1990, if those transfers otherwise meet the requirements of § 1.1031(k)-1 or follow the guidance of IA-237-84 published in 1990-1, C.B. See § 601.601(d)(2)(ii)(b) of this chapter.

(3) *Examples.* This paragraph (j) may be illustrated by the following examples. Unless otherwise provided in an example, the following facts are assumed: B, a calendar year taxpayer, and C agree to enter into a deferred exchange. Pursuant to their agreement, B is to transfer real property X to C on May 17, 1991. Real property X, which has been held by B for investment, is unencumbered and has a fair market value on May 17, 1991, of \$100,000. B's adjusted basis in real property X is \$40,000. On or before July 1, 1991 (the end of the identification period), B is to identify replacement property that

is of a like kind to real property X. On or before November 13, 1991 (the end of the exchange period), C is required to purchase the property identified by B and to transfer that property to B. To the extent the fair market value of the replacement property transferred to B is greater or less than the fair market value of real property X, either B or C, as applicable, will make up the difference by paying cash to the other party after the date the replacement property is received. The replacement property is identified as provided in paragraph (c) of this section and is of a like kind to real property X (determined without regard to section 1031(a)(3) and this section). B intends to hold any replacement property received for investment.

Example 1. (i) On May 17, 1991, B transfers real property X to C and identifies real property R as replacement property. On June 3, 1991, C transfers \$10,000 to B. On September 4, 1991, C purchases real property R for \$90,000 and transfers real property R to B.

(ii) The \$10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of \$10,000. Under section 1031(d), B's basis in real property R is \$40,000 (i.e., B's basis in real property X (\$40,000), decreased in the amount of money received (\$10,000), and increased in the amount of gain recognized (\$10,000) in the deferred exchange).

Example 2. (i) On May 17, 1991, B transfers real property X to C and identifies real property S as replacement property, and C transfers \$10,000 to B. On September 4, 1991, C purchases real property S for \$100,000 and transfers real property S to B. On the same day, B transfers \$10,000 to C.

(ii) The \$10,000 received by B is "money or other property" for purposes of section 1031 and the regulations thereunder. Under section 1031(b), B recognizes gain in the amount of \$10,000. Under section 1031(d), B's basis in real property S is \$50,000 (i.e., B's basis in real property X (\$40,000), decreased in the amount of money received (\$10,000), increased in the amount of gain recognized (\$10,000), and increased in the amount of the additional consideration paid by B (\$10,000) in the deferred exchange).

Example 3. (i) Under the exchange agreement, B has the right at all times to demand \$100,000 in cash in lieu of replacement property. On May 17, 1991, B transfers real property X to C and identifies real property T as replacement property. On September 4, 1991, C purchases real property T for \$100,000 and transfers real property T to B.

(ii) Because B has the right on May 17, 1991, to demand \$100,000 in cash in lieu of replacement property, B is in constructive receipt of the \$100,000 on that date. Thus, the transaction is a sale and not an exchange, and the \$60,000 gain realized by B in the transaction (i.e., \$100,000 amount realized less \$40,000 adjusted basis) is recognized. Under section 1031(d), B's basis in real property T is \$100,000.

Example 4. (i) Under the exchange agreement, B has the right at all times to demand up to \$30,000 in cash and the balance in replacement property instead of receiving replacement property in the amount of \$100,000. On May 17, 1991, B transfers real property X to C and identifies real property U as replacement property. On September 4, 1991, C purchases real property U for \$100,000 and transfers real property U to B.

(ii) The transaction qualifies as a deferred exchange under section 1031 and this section. However, because B had the right on May 17, 1991, to demand up to \$30,000 in cash, B is in constructive receipt of \$30,000 on that date. Under section 1031(b), B recognizes gain in the amount of \$30,000. Under section 1031(d), B's basis in real property U is \$70,000 (i.e., B's basis in real property X (\$40,000), decreased in the amount of money that B received (\$30,000), increased in the amount of gain recognized (\$30,000), and increased in the amount of additional consideration paid by B (\$30,000) in the deferred exchange).

Example 5. (i) Assume real property X is encumbered by a mortgage of \$30,000. On May 17, 1991, B transfers real property X to C and identifies real property V as replacement property, and C assumes the \$30,000 mortgage on real property X. Real property V is encumbered by a \$20,000 mortgage. On July 5, 1991, C purchases real property V for \$90,000 by paying \$70,000 and assuming the mortgage and transfers real property V to B with B assuming the mortgage.

(ii) The consideration received by B in the form of the liability assumed by C (\$30,000) is offset by the consideration given by B in the form of the liability assumed by B (\$20,000). The excess of the liability assumed by C over the liability assumed by B, \$10,000, is treated as "money or other property." See § 1.1031(b)-1(c). Thus, B recognizes gain under section 1031(b) in the amount of \$10,000. Under section 1031(d), B's basis in real property V is \$40,000 (i.e., B's basis in real property X (\$40,000), decreased in the amount of money that B is treated as receiving in the form of the liability assumed by C (\$30,000), increased in the amount of money that B is treated as paying in the form of the liability assumed by B (\$20,000), and increased in the amount of the gain recognized (\$10,000) in the deferred exchange).

(k) *Definition of disqualified person.* (1) For purposes of this section, a disquali-

fied person is a person described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

(2) The person is the agent of the taxpayer at the time of the transaction. For this purpose, a person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the 2-year period ending on the date of the transfer of the first of the relinquished properties is treated as an agent of the taxpayer at the time of the transaction. Solely for purposes of this paragraph (k)(2), performance of the following services will not be taken into account—

(i) Services for the taxpayer with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031; and

(ii) Routine financial, title insurance, escrow, or trust services for the taxpayer by a financial institution, title insurance company, or escrow company.

(3) The person and the taxpayer bear a relationship described in either section 267(b) or section 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(4)(i) Except as provided in paragraph (k)(4)(ii) of this section, the person and a person described in paragraph (k)(2) of this section bear a relationship described in either section 267(b) or 707(b) (determined by substituting in each section "10 percent" for "50 percent" each place it appears).

(ii) In the case of a transfer of relinquished property made by a taxpayer on or after January 17, 2001, paragraph (k)(4)(i) of this section does not apply to a bank (as defined in section 581) or a bank affiliate if, but for this paragraph (k)(4)(ii), the bank or bank affiliate would be a disqualified person under paragraph (k)(4)(i) of this section solely because it is a member of the same controlled group (as determined under section 267(f)(1), substituting "10 percent" for "50 percent" where it appears) as a person that has provided investment banking or brokerage services to the taxpayer within the 2-year period described in paragraph (k)(2) of this section. For purposes of this paragraph (k)(4)(ii), a bank affiliate is a

corporation whose principal activity is rendering services to facilitate exchanges of property intended to qualify for nonrecognition of gain under section 1031 and all of whose stock is owned by either a bank or a bank holding company (within the meaning of section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a))).

(5) This paragraph (k) may be illustrated by the following examples. Unless otherwise provided, the following facts are assumed: On May 1, 1991, B enters into an exchange agreement (as defined in paragraph (g)(4)(iii)(B) of this section) with C whereby B retains C to facilitate an exchange with respect to real property X. On May 17, 1991, pursuant to the agreement, B executes and delivers to C a deed conveying real property X to C. C has no relationship to B described in paragraph (k)(2), (k)(3), or (k)(4) of this section.

Example 1. (i) C is B's accountant and has rendered accounting services to B within the 2-year period ending on May 17, 1991, other than with respect to exchanges of property intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) C is a disqualified person because C has acted as B's accountant within the 2-year period ending on May 17, 1991.

(iii) If C had not acted as B's accountant within the 2-year period ending on May 17, 1991, or if C had acted as B's accountant within that period only with respect to exchanges intended to qualify for nonrecognition of gain or loss under section 1031, C would not have been a disqualified person.

Example 2. (i) C, which is engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges, is a wholly owned subsidiary of an escrow company that has performed routine escrow services for B in the past. C has previously been retained by B to act as an intermediary in prior section 1031 exchanges.

(ii) C is not a disqualified person notwithstanding the intermediary services previously provided by C to B (see paragraph (k)(2)(i) of this section) and notwithstanding the combination of C's relationship to the escrow company and the escrow services previously provided by the escrow company to B (see paragraph (k)(2)(ii) of this section).

Example 3. (i) C is a corporation that is only engaged in the trade or business of acting as an intermediary to facilitate deferred exchanges. Each of 10 law firms owns 10 percent of the outstanding stock of C. One of the 10 law firms that owns 10 percent of C is M. J is the managing partner of M and is the

president of C. J, in his capacity as a partner in M, has also rendered legal advice to B within the 2-year period ending on May 17, 1991, on matters other than exchanges intended to qualify for nonrecognition of gain or loss under section 1031.

(ii) J and M are disqualified persons. C, however, is not a disqualified person because neither J nor M own, directly or indirectly, more than 10 percent of the stock of C. Similarly, J's participation in the management of C does not make C a disqualified person.

(1) [Reserved]

(m) *Definition of fair market value.* For purposes of this section, the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property.

(n) *No inference with respect to actual or constructive receipt rules outside of section 1031.* The rules provided in this section relating to actual or constructive receipt are intended to be rules for determining whether there is actual or constructive receipt in the case of a deferred exchange. No inference is intended regarding the application of these rules for purposes of determining whether actual or constructive receipt exists for any other purpose.

(o) *Effective date.* This section applies to transfers of property made by a taxpayer on or after June 10, 1991. However, a transfer of property made by a taxpayer on or after May 16, 1990, but before June 10, 1991, will be treated as complying with section 1031 (a)(3) and this section if the deferred exchange satisfies either the provision of this section or the provisions of the notice of proposed rulemaking published in the FEDERAL REGISTER on May 16, 1990 (55 FR 20278).

[T.D. 8346, 56 FR 19938, May 1, 1991, as amended by T.D. 8535, 59 FR 18749, Apr. 20, 1994; T.D. 8982, 67 FR 4909, Feb. 1, 2002; T.D. 9413, 73 FR 39622, July 10, 2008]

§ 1.1032-1 Disposition by a corporation of its own capital stock.

(a) The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. For example, the

receipt by a corporation of the subscription price of shares of its stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be equal to, in excess of, or less than, the par or stated value of such stock. Also, the exchange or sale by a corporation of its own shares for money or other property does not result in taxable gain or deductible loss, even though the corporation deals in such shares as it might in the shares of another corporation. A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered, for purposes of section 1032(a), as a disposition by the corporation of such shares for money or other property.

(b) Section 1032(a) does not apply to the acquisition by a corporation of shares of its own stock except where the corporation acquires such shares in exchange for shares of its own stock (including treasury stock). See paragraph (e) of §1.311-1, relating to treatment of acquisitions of a corporation's own stock. Section 1032(a) also does not relate to the tax treatment of the recipient of a corporation's stock.

(c) Where a corporation acquires shares of its own stock in exchange for shares of its own stock (including treasury stock) the transaction may qualify not only under section 1032(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights).

(d) For basis of property acquired by a corporation in connection with a transaction to which section 351 applies or in connection with a reorganization, see section 362. For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012.

§ 1.1032-2 Disposition by a corporation of stock of a controlling corporation in certain triangular reorganizations.

(a) *Scope.* This section provides rules for certain triangular reorganizations described in §1.358-6(b) when the acquiring corporation (S) acquires property or stock of another corporation

(T) in exchange for stock of the corporation (P) in control of S.

(b) *General nonrecognition of gain or loss.* For purposes of §1.1032-1(a), in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358-6(b)), P stock provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization is treated as a disposition by P of shares of its own stock for T's assets or stock, as applicable. For rules governing the use of P stock in a reverse triangular merger, see section 361.

(c) *Treatment of S.* S must recognize gain or loss on its exchange of P stock as consideration in a forward triangular merger, a triangular C reorganization, or a triangular B reorganization (as described in §1.358-6(b)), if S did not receive the P stock from P pursuant to the plan of reorganization. See §1.358-6(d) for the effect on P's basis in its S or T stock, as applicable. For rules governing S's use of P stock in a reverse triangular merger, see section 361.

(d) *Examples.* The rules of this section are illustrated by the following examples. For purposes of these examples, P, S, and T are domestic corporations, P and S do not file consolidated returns, P owns all of the only class of S stock, the P stock exchanged in the transaction satisfies the requirements of the applicable reorganization provisions, and the facts set forth the only corporate activity.

Example 1. Forward triangular merger solely for P stock. (a) *Facts.* T has assets with an aggregate basis of \$60 and fair market value of \$100 and no liabilities. Pursuant to a plan, P forms S by transferring \$100 of P stock to S and T merges into S. In the merger, the T shareholders receive, in exchange for their T stock, the P stock that P transferred to S. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *No gain or loss recognized on the use of P stock.* Under paragraph (b) of this section, the P stock provided by P pursuant to the plan of reorganization is treated for purposes of §1.1032-1(a) as disposed of by P for the T assets acquired by S in the merger. Consequently, neither P nor S has taxable gain or deductible loss on the exchange.

Example 2. Forward triangular merger solely for P stock provided in part by S. (a) *Facts.* T has assets with an aggregate basis of \$60 and

fair market value of \$100 and no liabilities. *S* is an operating company with substantial assets that has been in existence for several years. *S* also owns *P* stock with a \$20 adjusted basis and \$30 fair market value. *S* acquired the *P* stock in an unrelated transaction several years before the reorganization. Pursuant to a plan, *P* transfers additional *P* stock worth \$70 to *S* and *T* merges into *S*. In the merger, the *T* shareholders receive \$100 of *P* stock (\$70 of *P* stock provided by *P* to *S* as part of the plan and \$30 of *P* stock held by *S* previously). The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.

(b) *Gain or loss recognized by S on the use of its P stock.* Under paragraph (b) of this section, the \$70 of *P* stock provided by *P* pursuant to the plan of reorganization is treated as disposed of by *P* for the *T* assets acquired by *S* in the merger. Consequently, neither *P* nor *S* has taxable gain or deductible loss on the exchange of those shares. Under paragraph (c) of this section, however, *S* recognizes \$10 of gain on the exchange of its *P* stock in the reorganization because *S* did not receive the *P* stock from *P* pursuant to the plan of reorganization. See § 1.358-6(d) for the effect on *P*'s basis in its *S* stock.

(e) *Stock options.* The rules of this section shall apply to an option to buy or sell *P* stock issued by *P* in the same manner as the rules of this section apply to *P* stock.

(f) *Effective dates.* This section applies to triangular reorganizations occurring on or after December 23, 1994, except for paragraph (e) of this section, which applies to transfers of stock options occurring on or after May 16, 2000.

[T.D. 8648, 60 FR 66081, Dec. 21, 1995, as amended by T.D. 8883, 65 FR 31076, May 16, 2000]

§ 1.1032-3 Disposition of stock or stock options in certain transactions not qualifying under any other non-recognition provision.

(a) *Scope.* This section provides rules for certain transactions in which a corporation or a partnership (the acquiring entity) acquires money or other property (as defined in § 1.1032-1) in exchange, in whole or in part, for stock of a corporation (the issuing corporation).

(b) *Nonrecognition of gain or loss—(1) General rule.* In a transaction to which this section applies, no gain or loss is recognized on the disposition of the issuing corporation's stock by the acquiring entity. The transaction is treated as if, immediately before the

acquiring entity disposes of the stock of the issuing corporation, the acquiring entity purchased the issuing corporation's stock from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation (or, if necessary, through intermediate corporations or partnerships). For rules that may apply in determining the issuing corporation's adjustment to basis in the acquiring entity (or, if necessary, in determining the adjustment to basis in intermediate entities), see sections 358, 722, and the regulations thereunder.

(2) *Special rule for actual payment for stock of the issuing corporation.* If the issuing corporation receives money or other property in payment for its stock, the amount of cash deemed contributed under paragraph (b)(1) of this section is the difference between the fair market value of the issuing corporation stock and the amount of money or the fair market value of other property that the issuing corporation receives as payment.

(c) *Applicability.* The rules of this section apply only if, pursuant to a plan to acquire money or other property—

(1) The acquiring entity acquires stock of the issuing corporation directly or indirectly from the issuing corporation in a transaction in which, but for this section, the basis of the stock of the issuing corporation in the hands of the acquiring entity would be determined, in whole or in part, with respect to the issuing corporation's basis in the issuing corporation's stock under section 362(a) or 723 (provided that, in the case of an indirect acquisition by the acquiring entity, the transfers of issuing corporation stock through intermediate entities occur immediately after one another);

(2) The acquiring entity immediately transfers the stock of the issuing corporation to acquire money or other property (from a person other than an entity from which the stock was directly or indirectly acquired);

(3) The party receiving stock of the issuing corporation in the exchange specified in paragraph (c)(2) of this section from the acquiring entity does not receive a substituted basis in the stock

of the issuing corporation within the meaning of section 7701(a)(42); and

(4) The issuing corporation stock is not exchanged for stock of the issuing corporation.

(d) *Stock options.* The rules of this section shall apply to an option issued by a corporation to buy or sell its own stock in the same manner as the rules of this section apply to the stock of an issuing corporation.

(e) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) *X*, a corporation, owns all of the stock of *Y* corporation. *Y* reaches an agreement with *C*, an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of \$100. To effectuate *Y*'s agreement with *C*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *C* to acquire the truck.

(ii) In this *Example 1*, no gain or loss is recognized on the disposition of the *X* stock by *Y*. Immediately before *Y*'s disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 2. (i) Assume the same facts as *Example 1*, except that, rather than *X* stock, *X* transfers an option with a fair market value of \$100 to purchase *X* stock.

(ii) In this *Example 2*, no gain or loss is recognized on the disposition of the *X* stock option by *Y*. Immediately before *Y*'s disposition of the *X* stock option, *Y* is treated as purchasing the *X* stock option from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 3. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *Y* is a partner in partnership *Z*. *Z* reaches an agreement with *C*, an individual, to acquire a truck from *C* in exchange for 10 shares of *X* stock with a fair market value of \$100. To effectuate *Z*'s agreement with *C*, *X* transfers to *Y* the *X* stock in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a). *Y* immediately transfers the *X* stock to *Z* in a transaction in which, but for this section, the basis of the *X* stock in the hands of *Z* would be determined under section 723. *Z* immediately transfers the *X* stock to *C* to acquire the truck.

(ii) In this *Example 3*, no gain or loss is recognized on the disposition of the *X* stock by

Z. Immediately before *Z*'s disposition of the *X* stock, *Z* is treated as purchasing the *X* stock from *X* for \$100 of cash indirectly contributed to *Z* by *X* through an intermediate corporation, *Y*. Under section 722, *Y*'s basis in its *Z* partnership interest is increased by \$100, and, under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 4. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *B*, an individual, is an employee of *Y*. Pursuant to an agreement between *X* and *Y* to compensate *B* for services provided to *Y*, *X* transfers to *B* 10 shares of *X* stock with a fair market value of \$100. Under § 1.83-6(d), but for this section, the transfer of *X* stock by *X* to *B* would be treated as a contribution of the *X* stock by *X* to the capital of *Y*, and immediately thereafter, a transfer of the *X* stock by *Y* to *B*. But for this section, the basis of the *X* stock in the hands of *Y* would be determined with respect to *X*'s basis in the *X* stock under section 362(a).

(ii) In this *Example 4*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100 of cash contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$100.

Example 5. (i) *X*, a corporation, owns all of the outstanding stock of *Y* corporation. *B*, an individual, is an employee of *Y*. To compensate *B* for services provided to *Y*, *B* is offered the opportunity to purchase 10 shares of *X* stock with a fair market value of \$100 at a reduced price of \$80. *B* transfers \$80 and *Y* transfers \$10 to *X* as partial payment for the *X* stock.

(ii) In this *Example 5*, no gain or loss is recognized on the deemed disposition of the *X* stock by *Y*. Immediately before *Y*'s deemed disposition of the *X* stock, *Y* is treated as purchasing the *X* stock from *X* for \$100, \$80 of which *Y* is deemed to have received from *B*, \$10 of which originated with *Y*, and \$10 of which is deemed to have been contributed to *Y* by *X*. Under section 358, *X*'s basis in its *Y* stock is increased by \$10.

Example 6. (i) *X*, a corporation, owns stock of *Y*. To compensate *Y*'s employee, *B*, for services provided to *Y*, *X* issues 10 shares of *X* stock to *B*, subject to a substantial risk of forfeiture. *B* does not have an election under section 83(b) in effect with respect to the *X* stock. *X* retains the only reversionary interest in the *X* stock in the event that *B* forfeits the right to the stock. Several years after *X*'s transfer of the *X* shares, the stock vests. At the time the stock vests, the 10 shares of *X* stock have a fair market value of \$100. Under § 1.83-6(d), but for this section, the transfer of the *X* stock by *X* to *B* would be treated, at the time the stock vests, as a

contribution of the X stock by X to the capital of Y, and immediately thereafter, a disposition of the X stock by Y to B. The basis of the X stock in the hands of Y, but for this section, would be determined with respect to X's basis in the X stock under section 362(a).

(ii) In this *Example 6*, no gain or loss is recognized on the deemed disposition of X stock by Y when the stock vests. Immediately before Y's deemed disposition of the X stock, Y is treated as purchasing X's stock from X for \$100 of cash contributed to Y by X. Under section 358, X's basis in its Y stock is increased by \$100.

Example 7. (i) Assume the same facts as in *Example 6*, except that Y (rather than X) retains a reversionary interest in the X stock in the event that B forfeits the right to the stock. Several years after X's transfer of the X shares, the stock vests.

(ii) In this *Example 7*, this section does not apply to Y's deemed disposition of the X shares because Y is not deemed to have transferred the X stock to B immediately after receiving the stock from X. For the tax consequences to Y on the deemed disposition of the X stock, see § 1.83-6(b).

Example 8. (i) X, a corporation, owns all of the outstanding stock of Y corporation. In Year 1, X issues to Y's employee, B, a non-statutory stock option to purchase 10 shares of X stock as compensation for services provided to Y. The option is exercisable against X and does not have a readily ascertainable fair market value (determined under § 1.83-7(b)) at the time the option is granted. In Year 2, B exercises the option by paying X the strike price of \$80 for the X stock, which then has a fair market value of \$100.

(ii) In this *Example 8*, because, under section 83(e)(3), section 83(a) does not apply to the grant of the option, paragraph (d) of this section also does not apply to the grant of the option. Section 83 and § 1.1032-3 apply in Year 2 when the option is exercised; thus, no gain or loss is recognized on the deemed disposition of X stock by Y in Year 2. Immediately before Y's deemed disposition of the X stock in Year 2, Y is treated as purchasing the X stock from X for \$100, \$80 of which Y is deemed to have received from B and the remaining \$20 of which is deemed to have been contributed to Y by X. Under section 358, X's basis in its Y stock is increased by \$20.

Example 9. (i) A, an individual, owns a majority of the stock of X. X owns stock of Y constituting control of Y within the meaning of section 368(c). A transfers 10 shares of its X stock to B, a key employee of Y. The fair market value of the 10 shares on the date of transfer was \$100.

(ii) In this *Example 9*, A is treated as making a nondeductible contribution of the 10 shares of X to the capital of X, and no gain or loss is recognized by A as a result of this transfer. See *Commissioner v. Fink*, 483 U.S. 89

(1987). A must allocate his basis in the transferred shares to his remaining shares of X stock. No gain or loss is recognized on the deemed disposition of the X stock by Y. Immediately before Y's disposition of the X stock, Y is treated as purchasing the X stock from X for \$100 of cash contributed to Y by X. Under section 358, X's basis in its Y stock is increased by \$100.

Example 10. (i) In Year 1, X, a corporation, forms a trust which will be used to satisfy deferred compensation obligations owed by Y, X's wholly owned subsidiary, to Y's employees. X funds the trust with X stock, which would revert to X upon termination of the trust, subject to the employees' rights to be paid the deferred compensation due to them. The creditors of X can reach all the trust assets upon the insolvency of X. Similarly, Y's creditors can reach all the trust assets upon the insolvency of Y. In Year 5, the trust transfers X stock to the employees of Y in satisfaction of the deferred compensation obligation.

(ii) In this *Example 10*, X is considered to be the grantor of the trust, and, under section 677, X is also the owner of the trust. Any income earned by the trust would be reflected on X's income tax return. Y is not considered a grantor or owner of the trust corpus at the time X transfers X stock to the trust. In Year 5, when employees of Y receive X stock in satisfaction of the deferred compensation obligation, no gain or loss is recognized on the deemed disposition of the X stock by Y. Immediately before Y's deemed disposition of the X stock, Y is treated as purchasing the X stock from X for fair market value using cash contributed to Y by X. Under section 358, X's basis in its Y stock increases by the amount of cash deemed contributed.

(f) *Effective date.* This section applies to transfers of stock or stock options of the issuing corporation occurring on or after May 16, 2000.

[T.D. 8883, 65 FR 31076, May 16, 2000; 65 FR 37482, June 15, 2000]

§ 1.1033(a)-1 Involuntary conversions; nonrecognition of gain.

(a) *In general.* Section 1033 applies to cases where property is compulsorily or involuntarily converted. An *involuntary conversion* may be the result of the destruction of property in whole or in part, the theft of property, the seizure of property, the requisition or condemnation of property, or the threat or imminence of requisition or condemnation of property. An *involuntary conversion* may be a conversion into similar property or into money or into dissimilar property. Section 1033 provides

that, under certain specified circumstances, any gain which is realized from an involuntary conversion shall not be recognized. In cases where property is converted into other property similar or related in service or use to the converted property, no gain shall be recognized regardless of when the disposition of the converted property occurred and regardless of whether or not the taxpayer elects to have the gain not recognized. In other types of involuntary conversion cases, however, the proceeds arising from the disposition of the converted property must (within the time limits specified) be reinvested in similar property in order to avoid recognition of any gain realized. Section 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

(b) *Special rules.* For rules relating to the application of section 1033 to involuntary conversions of a principal residence with respect to which an election has been made under section 121 (relating to gain from sale or exchange of residence of individual who has attained age 65), see paragraph (g) of §1.121-5. For rules applicable to involuntary conversions of a principal residence occurring before January 1, 1951, see §1.1033(a)-3. For rules applicable to involuntary conversions of a principal residence occurring after December 31, 1950, and before January 1, 1954, see paragraph (h)(1) of §1.1034-1. For rules applicable to involuntary conversions of a personal residence occurring after December 31, 1953, see §1.1033(a)-3. For special rules relating to the election to have section 1034 apply to certain involuntary conversions of a principal residence occurring after December 31, 1957, see paragraph (h)(2) of §1.1034-1. For special rules relating to certain involuntary conversions of real property held either for productive use in trade or business or for investment and occurring after December 31, 1957, see §1.1033(g)-1. See also special rules applicable to involuntary conversions of property sold pursuant to reclamation laws, livestock destroyed by disease, and livestock sold on account of drought provided in §§1.1033(c)-1, 1.1033(d)-1, and 1.1033(e)-1, respectively. For rules relating to basis of property

acquired through involuntary conversions, see §1.1033(b)-1. For determination of the period for which the taxpayer has held property acquired as a result of certain involuntary conversions, see section 1223 and regulations issued thereunder. For treatment of gains from involuntary conversions as capital gains in certain cases, see section 1231(a.) and regulations issued thereunder. For portion of war loss recoveries treated as gain on involuntary conversion, see section 1332(b)(3) and regulations issued thereunder.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6856, 30 FR 13318, Oct. 20, 1965; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(a)-2 Involuntary conversion into similar property, into money or into dissimilar property.

(a) *In general.* The term *disposition of the converted property* means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) *Conversion into similar property.* If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted only into property similar or related in service or use to the property so converted, no gain shall be recognized. Such non-recognition of gain is mandatory.

(c) *Conversion into money or into dissimilar property.* (1) If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized upon such conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or the cost of stock of a corporation owning such other property

which is purchased by the taxpayer in the acquisition of control of such corporation, if the taxpayer purchased such other property, or such stock, for the purpose of replacing the property so converted and during the period specified in subparagraph (3) of this paragraph. For the purposes of section 1033, the term *control* means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(2) All of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. An election to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph shall be made by including such gain in gross income for such year or years only to such extent. If, at the time of filing such a return, the period within which the converted property must be replaced has expired, or if such an election is not desired, the gain should be included in gross income for such year or years in the regular manner. A failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent provided in subparagraph (1) of this paragraph even though the details in connection with the conversion are not reported in such return. If, after having made an election under section 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such recomputation should be in the form of an *amended return*. If a decision is made to make an election under section 1033(a)(2) after the filing of the return and the payment of the tax for the year or years in which any of the gain

on an involuntary conversion is realized and before the expiration of the period within which the converted property must be replaced, a claim for credit or refund for such year or years should be filed. If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years.

(3) The period referred to in subparagraphs (1) and (2) of this paragraph is the period of time commencing with the date of the disposition of the converted property, or the date of the beginning of the threat or imminence of requisition or condemnation of the converted property, whichever is earlier, and ending 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. Such application shall be made prior to the expiration of 2 years (or, in the case of a disposition occurring before December 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain from the conversion is realized, unless the taxpayer can show to the satisfaction of the district director—

(i) Reasonable cause for not having filed the application within the required period of time, and

(ii) The filing of such application was made within a reasonable time after the expiration of the required period of time. The application shall contain all of the details in connection with the involuntary conversion. Such application shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the involuntary conversion is realized. No extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time.

See section 1033(g)(4) and § 1.1033(g)-1 for the circumstances under which, in

the case of the conversion of real property held either for productive use in trade or business or for investment, the 2-year period referred to in this paragraph (c)(3) shall be extended to 3 years.

(4) Property or stock purchased before the disposition of the converted property shall be considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property or stock shall be considered to have been purchased only if, but for the provisions of section 1033(b), the unadjusted basis of such property or stock would be its cost to the taxpayer within the meaning of section 1012. If the taxpayer's unadjusted basis of the replacement property would be determined, in the absence of section 1033(b), under any of the exceptions referred to in section 1012, the unadjusted basis of the property would not be its cost within the meaning of section 1012. For example, if property similar or related in service or use to the converted property is acquired by gift and its basis is determined under section 1015, such property will not qualify as a replacement for the converted property.

(5) If a taxpayer makes an election under section 1033(a)(2), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain all of the details in connection with such replacement. Such notification should be made in the return for the taxable year or years in which the replacement occurs, or the intention not to replace is formed, or the period for replacement expires, if this return is filed with such district

director. If this return is not filed with such district director, then such notification shall be made to such district director at the time of filing this return. If the taxpayer so desires, he may, in either event, also notify such district director before the filing of such return.

(6) If a taxpayer makes an election under section 1033(a)(2) and the replacement property or stock was purchased before the beginning of the last taxable year in which any part of the gain upon the conversion is realized, any deficiency, for any taxable year ending before such last taxable year, which is attributable to such election may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment.

(7) If the taxpayer makes an election under section 1033(a)(2), the gain upon the conversion shall be recognized to the extent that the amount realized upon such conversion exceeds the cost of the replacement property or stock, regardless of whether such amount is realized in one or more taxable years.

(8) The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

(9) There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase or a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

(10) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy special assessments levied against the remaining portion of the plot or parcel of

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real estate affected for benefits accruing in connection with the condemnation, the amount so retained shall be deducted from the gross award in determining the amount of the net award.

(11) If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property, and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. If, in a condemnation proceeding, the Government makes an award to a mortgagee to satisfy a mortgage on the condemned property, the amount of such award shall be considered as a part of the *amount realized* upon the conversion regardless of whether or not the taxpayer was personally liable for the mortgage debt. Thus, if a taxpayer has acquired property worth \$100,000 subject to a \$50,000 mortgage (regardless of whether or not he was personally liable for the mortgage debt) and, in a condemnation proceeding, the Government awards the taxpayer \$60,000 and awards the mortgagee \$50,000 in satisfaction of the mortgage, the entire \$110,000 is considered to be the *amount realized* by the taxpayer.

(12) An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6679, 28 FR 10515, Oct. 1, 1963; T.D. 7075, 35 FR 17996, Nov. 24, 1970; T.D. 7625, 44 FR 31013, May 30, 1979; T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1033(a)-3 Involuntary conversion of principal residence.

Section 1033 shall apply in the case of property used by the taxpayer as his principal residence if the destruction, theft, seizure, requisition, or condemnation of such residence, or the sale or exchange of such residence

under threat or imminence thereof, occurs before January 1, 1951, or after December 31, 1953. However, section 1033 shall not apply to the seizure, requisition, or condemnation (but not destruction), or the sale or exchange under threat or imminence thereof, of such residence property if the seizure, requisition, condemnation, sale, or exchange occurs after December 31, 1957, and if the taxpayer properly elects under section 1034(i) to treat the transaction as a sale (see paragraph (h)(2)(ii) of § 1.1034-1). See section 121 and paragraphs (d) and (g) of § 1.121-5 for special rules relating to the involuntary conversion of a principal residence of individuals who have attained age 65.

[T.D. 6856, 30 FR 13319, Oct. 20, 1965. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(b)-1 Basis of property acquired as a result of an involuntary conversion.

(a) The provisions of the first sentence of section 1033(b) may be illustrated by the following example:

Example: A's vessel which has an adjusted basis of \$100,000 is destroyed in 1950 and A receives in 1951 insurance in the amount of \$200,000. If A invests \$150,000 in a new vessel, taxable gain to the extent of \$50,000 would be recognized. The basis of the new vessel is \$100,000; that is, the adjusted basis of the old vessel (\$100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel (\$50,000) plus the amount of gain recognized upon the conversion (\$50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

(b) The provisions of the last sentence of section 1033(b) may be illustrated by the following example:

Example: A taxpayer realizes \$22,000 from the involuntary conversion of his barn in 1955; the adjusted basis of the barn to him was \$10,000, and he spent in the same year \$20,000 for a new barn which resulted in the nonrecognition of \$10,000 of the \$12,000 gain on the conversion. The basis of the new barn to the taxpayer would be \$10,000—the cost of the new barn (\$20,000) less the amount of the gain not recognized on the conversion (\$10,000). The basis of the new barn would not be a substituted basis in the hands of the taxpayer within the meaning of section

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1016(b)(2). If the replacement of the converted barn had been made by the purchase of two smaller barns which, together, were similar or related in service or use to the converted barn and which cost \$8,000 and \$12,000, respectively, then the basis of the two barns would be \$4,000 and \$6,000, respectively, the total basis of the purchased property (\$10,000) allocated in proportion to their respective costs (8,000/20,000 of \$10,000 or \$4,000; and 12,000/20,000 of \$10,000, or \$6,000).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(c)-1 Disposition of excess property within irrigation project deemed to be involuntary conversion.

(a) The sale, exchange, or other disposition occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of excess lands lying within an irrigation project or division in order to conform to acreage limitations of the Federal reclamation laws effective with respect to such project or division shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. The term *excess lands* means irrigable lands within an irrigation project or division held by one owner in excess of the amount of irrigable land held by such owner entitled to receive water under the Federal reclamation laws applicable to such owner in such project or division. Such excess lands may be either (1) lands receiving no water from the project or division, or (2) lands receiving water only because the owner thereof has executed a valid recordable contract agreeing to sell such lands under terms and conditions satisfactory to the Secretary of the Interior.

(b) If a disposition in order to conform to the acreage limitation provisions of Federal reclamation laws includes property other than excess lands (as, for example, where the excess lands alone do not constitute a marketable parcel) the provisions of section 1033(d) shall apply only to the part of the disposition that relates to excess lands.

(c) The provisions of §1.1033(a)-2 shall be applicable in the case of dispositions treated as involuntary conversions under this section. The details in connection with such a disposition required to be reported under paragraph

(c)(2) of §1.1033(a)-2 shall include the authority whereby the lands disposed of are considered *excess lands*, as defined in this section, and a statement that such disposition is not part of a plan contemplating the disposition of all or any nonexcess land within the irrigation project or division.

(d) The term *involuntary conversion*, where it appears in subtitle A of the Code or the regulations thereunder, includes dispositions of excess property within irrigation projects described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(d)-1 Destruction or disposition of livestock because of disease.

(a) The destruction occurring in a taxable year to which the Internal Revenue Code of 1954 applies, of livestock by, or on account of, disease, or the sale or exchange, in such a year, of livestock because of disease, shall be treated as an involuntary conversion to which the provisions of section 1033 and the regulations thereunder shall be applicable. Livestock which are killed either because they are diseased or because of exposure to disease shall be considered destroyed on account of disease. Livestock which are sold or exchanged because they are diseased or have been exposed to disease, and would not otherwise have been sold or exchanged at that particular time shall be considered sold or exchanged because of disease.

(b) The provisions of §1.1033(a)-2 shall be applicable in the case of a disposition treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of §1.1033(a)-2 shall include a recital of the evidence that the livestock were destroyed by or on account of disease, or sold or exchanged because of disease.

(c) The term *involuntary conversion*, where it appears in subtitle A of the

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Code or the regulations thereunder, includes disposition of livestock described in this section. (See, e.g., section 1231 and the regulations thereunder.)

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(e)-1 Sale or exchange of livestock solely on account of drought.

(a) The sale or exchange of livestock (other than poultry) held for draft, breeding, or dairy purposes in excess of the number the taxpayer would sell or exchange during the taxable year if he followed his usual business practices shall be treated as an involuntary conversion to which section 1033 and the regulations thereunder are applicable if the sale or exchange of such livestock by the taxpayer is solely on account of drought. Section 1033(e) and this section shall apply only to sales and exchanges occurring after December 31, 1955.

(b) To qualify under section 1033(e) and this section, the sale or exchange of the livestock need not take place in a drought area. While it is not necessary that the livestock be held in a drought area, the sale or exchange of the livestock must be solely on account of drought conditions the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(c) The total sales or exchanges of livestock held for draft, breeding, or dairy purposes occurring in any taxable year which may qualify as an involuntary conversion under section 1033(e) and this section is limited to the excess of the total number of such livestock sold or exchanged during the taxable year over the number that the taxpayer would have sold or exchanged if he had followed his usual business practices, that is, the number he would have been expected to sell or exchange under ordinary circumstances if there had been no drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually one-half of his herd of dairy cows, only the number sold or exchanged solely on account of drought conditions which is in excess of one-half of his herd, may

qualify as an involuntary conversion under section 1033(e) and this section.

(d) The replacement requirements of section 1033 will be satisfied only if the livestock sold or exchanged is replaced within the prescribed period with livestock which is similar or related in service or use to the livestock sold or exchanged because of drought, that is, the new livestock must be functionally the same as the livestock involuntarily converted. This means that the new livestock must be held for the same useful purpose as the old was held. Thus, although dairy cows could be replaced by dairy cows, a taxpayer could not replace draft animals with breeding or dairy animals.

(e) The provisions of § 1.1033(a)-2 shall be applicable in the case of a sale or exchange treated as an involuntary conversion under this section. The details in connection with such a disposition required to be reported under paragraph (c)(2) of § 1.1033(a)-2 shall include:

(1) Evidence of the existence of the drought conditions which forced the sale or exchange of the livestock;

(2) A computation of the amount of gain realized on the sale or exchange;

(3) The number and kind of livestock sold or exchanged; and

(4) The number of livestock of each kind that would have been sold or exchanged under the usual business practice in the absence of the drought.

(f) The term *involuntary conversion*, where it appears in subtitle A of the Code or the regulations thereunder, includes the sale or exchange of livestock described in this section.

(g) The provisions of section 1033(e) and this section apply to taxable years ending after December 31, 1955, but only in the case of sales or exchange of livestock after December 31, 1955.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated by T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1033(g)-1 Condemnation of real property held for productive use in trade or business or for investment.

(a) *Special rule in general.* This section provides special rules for applying section 1033 with respect to certain dispositions, occurring after December 31, 1957, of real property held either for productive use in trade or business or

for investment (not including stock in trade or other property held primarily for sale). For this purpose, disposition means the seizure, requisition, or condemnation (but not destruction) of the converted property, or the sale or exchange of such property under threat or imminence of seizure, requisition, or condemnation. In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of §1.1031(a)-1.

(b) *Election to treat outdoor advertising displays as real property*—(1) *In general.* Under section 1033(g)(3) of the Code, a taxpayer may elect to treat property which constitutes an outdoor advertising display as real property for purposes of chapter 1 of the Code. The election is available for taxable years beginning after December 31, 1970. In the case of an election made on or before July 21, 1981, the election is available whether or not the period for filing a claim for credit or refund under section 6511 has expired. No election may be made with respect to any property for which (i) the investment credit under section 38 has been claimed, or (ii) an election to expense certain depreciable business assets under section 179(a) is in effect. The election once made applies to all outdoor advertising displays of the taxpayer which may be made the subject of an election under this paragraph, including all outdoor advertising displays acquired or constructed by the taxpayer in a taxable year after the taxable year for which the election is made. The election applies with respect to dispositions during the taxable year for which made and all subsequent taxable years (unless an effective revocation is made pursuant to paragraph (b)(2) (ii) or (iii)).

(2) *Election*—(i) *Time and manner of making election*—(A) *In general.* Unless otherwise provided in the return or in the instructions for a return for a taxable year, any election made under section 1033(g)(3) shall be made by attach-

ing a statement to the return (or amended return if filed on or before July 21, 1981) for the first taxable year to which the election is to apply. Any election made under this paragraph must be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for such taxable year or July 21, 1981, whichever occurs last. If a taxpayer makes an election (or revokes an election under subdivision (ii) or (iii) of this subparagraph (b) (2)) for a taxable year for which he or she has previously filed a return, the return for that taxable year and all other taxable years affected by the election (or revocation) must be amended to reflect any tax consequences of the election (or revocation). However, no return for a taxable year for which the period for filing a claim for credit or refund under section 6511 has expired may be amended to make any changes other than those resulting from the election (or revocation). In order for the election (or revocation) to be effective, the taxpayer must remit with the amended return any additional tax due resulting from the election (or revocation), notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any other law which would prevent assessment or collection of such tax.

(B) *Statement required when making election.* The statement required when making the election must clearly indicate that the election to treat outdoor advertising displays as real property is being made.

(ii) *Revocation of election by Commissioner's consent.* Except as otherwise provided in paragraph (b)(2)(iii) of this section, an election under section 1033(g)(3) shall be irrevocable unless consent to revoke is obtained from the Commissioner. In order to secure the Commissioner's consent to revoke an election, the taxpayer must file a request for revocation of election with the Commissioner of Internal Revenue, Washington, DC 20224. The request for revocation shall include—

(A) The taxpayer's name, address, and taxpayer identification number,

(B) The date on which and taxable year for which the election was made and the Internal Revenue Service office with which it was filed,

(C) Identification of all outdoor advertising displays of the taxpayer to which the revocation would apply (including the location, date of purchase, and adjusted basis in such property),

(D) The effective date desired for the revocation, and

(E) The reasons for requesting the revocation.

The Commissioner may require such other information as may be necessary in order to determine whether the requested revocation will be permitted. The Commissioner may prescribe administrative procedures (subject to such limitations, terms and conditions as he deems necessary) to obtain his consent to permit the taxpayer to revoke the election. The taxpayer may submit a request for revocation for any taxable year for which the period of limitations for filing a claim for credit or refund or overpayment of tax has not expired.

(iii) *Revocation where election was made on or before December 11, 1979.* In the case of an election made on or before December 11, 1979, the taxpayer may revoke such election provided such revocation is made not later than March 23, 1981. The request for revocation shall be made in conformity with the requirements of paragraph (b)(2)(ii), except that, in lieu of the information required by paragraph (b)(2)(ii)(E), the taxpayer shall state that the revocation is being made pursuant to this paragraph. In addition, the taxpayer must forward, with the statement of revocation, copies of his or her tax returns, including both the original return and any amended returns, for the taxable year in which the original election was made and for all subsequent years and must remit any additional tax due as a result of the revocation.

(3) *Definition of outdoor advertising display.* The term *outdoor advertising display* means a rigidly assembled sign, display, or device that constitutes, or is used to display, a commercial or other advertisement to the public and is permanently affixed to the ground or permanently attached to a building or other inherently permanent structure. The term includes highway billboards affixed to the ground with wood or

metal poles, pipes, or beams, with or without concrete footings.

(4) *Character of replacement property.* For purposes of section 1033(g), an interest in real property purchased as replacement property for a compulsorily or involuntarily converted outdoor advertising display (with respect to which an election under this section is in effect) shall be considered property of a like kind as the property converted even though a taxpayer's interest in the replacement property is different from the interest held in the property converted. Thus, for example, a fee simple interest in real estate acquired to replace a converted billboard and a 5-year leasehold interest in the real property on which the billboard was located qualifies as property of a like kind under this section.

(c) *Special rule for period within which property must be replaced.* In the case of a disposition described in paragraph (a) of this section, section 1033(a)(2)(B) and § 1.1033(a)-2(c)(3) (relating to the period within which the property must be replaced) shall be applied by substituting 3 years for 2 years. This paragraph shall apply to any disposition described in section 1033(f)(1) and paragraph (a) of this section occurring after December 31, 1974, unless a condemnation proceeding with respect to the property was begun before October 4, 1976. Thus, regardless of when the property is disposed of, the taxpayer will not be eligible for the 3-year replacement period if a condemnation proceeding was begun before October 4, 1976. However, if the property is disposed of after December 31, 1974, and the condemnation proceeding was begun (if at all) after October 4, 1976, then the taxpayer is eligible for the 3-year replacement period. For the purposes of this paragraph, whether a condemnation proceeding is considered as having begun is determined under the applicable State or Federal procedural law.

(d) *Limitation on application of special rule.* This section shall not apply to the purchase of stock in the acquisition of

control of a corporation described in section 1033(a)(2)(A).

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979; 44 FR 38458, July 2, 1979. Further redesignated and amended by T.D. 7758, 46 FR 6925, Jan. 22, 1981; T.D. 7758, 46 FR 23235, Apr. 24, 1981; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 1.1033(h)-1 Effective date.

Except as provided otherwise in § 1.1033(e)-1 and § 1.1033(g)-1, the provisions of section 1033 and the regulations thereunder are effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(Secs. 1033 (90 Stat. 1920, 26 U.S.C. 1033), and 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960. Redesignated and amended by T.D. 7625, 44 FR 31013, May 30, 1979. Further redesignated and amended by T.D. 7758, 46 FR 6925, Jan. 22, 1981]

§ 1.1034-1 Sale or exchange of residence.

(a) *Nonrecognition of gain; general statement.* Section 1034 provides rules for the nonrecognition of gain in certain cases where a taxpayer sells one residence after December 31, 1953, and buys or builds, and uses as his principal residence, another residence within specified time limits before or after such sale. In general, if the taxpayer invests in a new residence an amount at least as large as the adjusted sales price of his old residence, no gain is recognized on the sale of the old residence (see paragraph (b) of this section for definitions of *adjusted sales price*, *new residence*, and *old residence*). On the other hand, if the new residence costs the taxpayer less than the adjusted sales price of the old residence, gain is recognized to the extent of the difference. Thus, if an amount equal to or greater than the adjusted sales price of an old residence is invested in a new residence, according to the rules stated in section 1034, none of the gain (if any) realized from the sale shall be recognized. If an amount less than such adjusted sales price is so invested, gain shall be recognized, but only to the extent provided in section 1034. If there is

no investment in a new residence, section 1034 is inapplicable and all of the gain shall be recognized. Whenever, as a result of the application of section 1034, any or all of the gain realized on the sale of an old residence is not recognized, a corresponding reduction must be made in the basis of the new residence. The provisions of section 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable. Section 1034 applies only to gains; losses are recognized or not recognized without regard to the provisions of this section. Section 1034 affects only the amount of gain recognized, and not the amount of gain realized (see also section 1001 and the regulations issued thereunder). Any gain realized upon disposition of other property in exchange for the new residence is not affected by section 1034. For special rules relating to the sale or exchange of a principal residence by a taxpayer who has attained age 65, see section 121 and paragraph (g) of § 1.121-5. For special rules relating to a case where real property with respect to the sale of which gain is not recognized under this section is reacquired by the seller in partial or full satisfaction of the indebtedness arising from such sale and resold by him within 1 year after the date of such reacquisition, see § 1.1038-2.

(b) *Definitions.* The following definitions of frequently used terms are applicable for purposes of section 1034 (other definitions and detailed explanations appear in subsequent paragraphs of this regulation):

(1) *Old residence* means property used by the taxpayer as his principal residence which is the subject of a sale by him after December 31, 1953 (section 1034(a); for detailed explanation see paragraph (c)(3) of this section).

(2) *New residence* means property used by the taxpayer as his principal residence which is the subject of a purchase by him (section 1034(a); for detailed explanation and limitations see paragraphs (c)(3) and (d)(1) of this section).

(3) *Adjusted sales price* means the amount realized reduced by the fixing-up expenses (section 1034(b)(1); for special rule applicable in some cases to

husband and wife, see paragraph (f) of this section).

(4) *Amount realized* is to be computed by subtracting,

(i) The amount of the items which, in determining the gain from the sale of the old residence, are properly an offset against the consideration received upon the sale (such as commissions and expenses of advertising the property for sale, of preparing the deed, and of other legal services in connection with the sale); from

(ii) The amount of the consideration so received, determined (in accordance with section 1001(b) and regulations issued thereunder) by adding to the sum of any money so received, the fair market value of the property (other than money) so received. If, as part of the consideration for the sale, the purchaser either assumes a liability of the taxpayer or acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the *amount realized*.

(5) *Gain realized* is the excess (if any) of the amount realized over the adjusted basis of the old residence (see also section 1001(a) and regulations issued thereunder).

(6) *Fixing-up expenses* means the aggregate of the expenses for work performed (in any taxable year, whether beginning before, on, or after January 1, 1954) on the old residence in order to assist in its sale, provided that such expenses (i) are incurred for work performed during the 90-day period ending on the day on which the contract to sell the old residence is entered into; and (ii) are paid on or before the 30th day after the date of the sale of the old residence; and (iii) are neither (a) allowable as deductions in computing taxable income under section 63(a), nor (b) taken into account in computing the amount realized from the sale of the old residence (section 1034(b) (2) and (3)). *Fixing-up expenses* does not include expenditures which are properly chargeable to capital account and which would, therefore, constitute adjustments to the basis of the old residence (see section 1016 and regulations issued thereunder).

(7) *Cost of purchasing the new residence* means the total of all amounts which are attributable to the acquisition, construction, reconstruction, and improvements constituting capital expenditures, made during the period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of sale of the old residence and ending either (i) 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date in the case of a new residence purchased but not constructed by the taxpayer, or (ii) two years (18 months in the case of a sale of an old residence prior to January 1, 1975) after such date in the case of a new residence the construction of which was commenced by the taxpayer before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date (section 1034(a), (c)(2) and (c)(5); for detailed explanation, see paragraph (c)(4) of this section; for special rule applicable in some cases to husband and wife, see paragraph (f) of this section; see also paragraph (b)(9) of this section for definition of *purchase*).

(8) *Sale* (of a residence) means a sale or an exchange (of a residence) for other property which occurs after December 31, 1953, an involuntary conversion (of a residence) which occurs after December 31, 1950, and before January 1, 1954, or certain involuntary conversions where the disposition of the property occurs after December 31, 1957, in respect of which a proper election is made under section 1034(i)(2) (see sections 1034(c)(1), 1034(i)(1)(A), and 1034(i)(2); for detailed explanation concerning involuntary conversions, see paragraph (h) of this section).

(9) *Purchase* (of a residence) means a purchase or an acquisition (of a residence) on the exchange of property or the partial or total construction or reconstruction (of a residence) by the taxpayer (section 1034(c) (1) and (2)). However, the mere improvement of a residence, not amounting to reconstruction, does not constitute *purchase* of a residence.

(c) *Rules for application of section 1034—(1) General rule; limitations on applicability.* Gain realized from the sale

(after December 31, 1953) of an old residence will be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence, provided that the taxpayer either (i) within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of such sale and ending 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date purchases property and uses it as his principal residence, or (ii) within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of such sale and ending two years (18 months in the case of a sale of an old residence prior to January 1, 1975) after such date uses as his principal residence a new residence the construction of which was commenced by him at any time before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the date of the sale of the old residence (section 1034 (a) and (c)(5); for detailed explanation of use as *principal residence* see subparagraph (3) of this paragraph). The rule stated in the preceding sentence applies to a new residence purchased by the taxpayer before the date of sale of the old residence provided the new residence is still owned by him on such date (section 1034(c)(3)). Whether the construction of a new residence was commenced by the taxpayer before the expiration of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the date of the sale of the old residence will depend upon the facts and circumstances of each case. Section 1034 is not applicable to the sale of a residence if within the previous 18 months (previous year in the case of a sale of an old residence prior to January 1, 1975) the taxpayer made another sale of residential property on which gain was realized but not recognized (section 1034(d)). For further details concerning limitations on the application of section 1034, see paragraph (d) of this section.

(2) *Computation and examples.* In applying the general rule stated in subparagraph (1) of this paragraph, the taxpayer should first subtract the com-

missions and other selling expenses from the selling price of his old residence, to determine the amount realized. A comparison of the amount realized with the cost or other basis of the old residence will then indicate whether there is any gain realized on the sale. Unless the amount realized is greater than the cost or other basis, no gain is realized and section 1034 does not apply. If the amount realized exceeds the cost or other basis, the amount of such excess constitutes the gain realized. The amount realized should then be reduced by the fixing-up expenses (if any), to determine the adjusted sales price. A comparison of the adjusted sales price of the old residence with the cost of purchasing the new residence will indicate how much (if any) of the realized gain is to be recognized. If the cost of purchasing the new residence is the same as, or greater than, the adjusted sales price of the old residence, then none of the realized gain is to be recognized. On the other hand, if the cost of purchasing the new residence is smaller than the adjusted sales price of the old residence, the gain realized, all of the gain realized is to be recognized to the extent of the difference. It should be noted that any amount of gain realized but not recognized is to be applied as a downward adjustment to the basis of the new residence (for details see paragraph (e) of this section.) The application of the general rule stated above may be illustrated by the following examples:

Example 1. A taxpayer decides to sell his residence, which has a basis of \$17,500. To make it more attractive to buyers, he paints the outside at a cost of \$300 in April, 1954. He pays for the painting when the work is finished. In May, 1954, he sells the house for \$20,000. Brokers' commissions and other selling expenses are \$1,000. In October, 1954, the taxpayer buys a new residence for \$18,000. The amount realized, the gain realized, the adjusted sales price, and the gain to be recognized are computed as follows:

Selling price	\$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700

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Cost of purchasing new residence	18,000
Gain recognized	700
Gain realized but not recognized	800
Adjusted basis of new residence (see paragraph (e) of this section)	17,200

Example 2. The facts are the same as in example (1), except that the selling price of the old residence is \$18,500. The computations are as follows:

Selling price	\$18,500
Less: Commissions and other selling expenses	1,000
Amount realized	17,500
Less: Basis	17,500
Gain realized	0

NOTE: Since no gain is realized, section 1034 is inapplicable; it is, therefore, unnecessary to compute the adjusted sales price of the old residence and compare it with the cost of purchasing the new residence. No adjustment to the basis of the new residence is to be made.

Example 3. The facts are the same as in example (1), except that the cost of purchasing the new residence is \$17,000. The computations are as follows:

Selling price	\$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	300
Adjusted sales price	18,700
Cost of purchasing the new residence	17,000
Gain recognized	1,500

NOTE: Since the adjusted sales price of the old residence exceeds the cost of purchasing the new residence by \$1,700, which is more than the gain realized, all of the gain realized is recognized. No adjustment to the basis of the new residence is to be made.

Gain realized but not recognized \$0

Example 4. The facts are the same as in example (1), except that the fixing-up expenses are \$1,100. The computations are as follows:

Selling price	\$20,000
Less: Commissions and other selling expenses	1,000
Amount realized	19,000
Less: Basis	17,500
Gain realized	1,500
Amount realized	19,000
Less: Fixing-up expenses	1,100
Adjusted sales price	17,900
Cost of purchasing the new residence	18,000
Gain recognized	0

NOTE: Since the cost of purchasing the new residence exceeds the adjusted sales price, none of the gain realized is recognized.

Gain realized but not recognized	\$1,500
Adjusted basis of new residence (see paragraph (e) of this section)	16,500

(3) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)), if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence (section 1034(f)). Property used by the taxpayer as his principal residence does not include personal property such as a piece of furniture, a radio, etc., which, in accordance with the applicable local law, is not a fixture.

(ii) Where part of a property is used by the taxpayer as his principal residence and part is used for other purposes, an allocation must be made to determine the application of this section. If the old residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is not to be recognized under this section and only an amount allocable to the selling price of such portion need be invested in the new residence in order to have the gain

allocable to such portion not recognized under this section. If the new residence is used only partially for residential purposes only so much of its cost as is allocable to the residential portion may be counted as the cost of purchasing the new residence.

(4) *Cost of purchasing new residence.* (i) The taxpayer's cost of purchasing the new residence includes not only cash but also any indebtedness to which the property purchased is subject at the time of purchase whether or not assumed by the taxpayer (including purchase-money mortgages, etc.) and the face amount of any liabilities of the taxpayer which are part of the consideration for the purchase. Commissions and other purchasing expenses paid or incurred by the taxpayer on the purchase of the new residence are to be included in determining such cost. In the case of an acquisition of a residence upon an exchange which is considered as a *purchase* under this section, the fair market value of the new residence on the date of the exchange shall be considered as the taxpayer's cost of purchasing the new residence. Where any part of the new residence is acquired by the taxpayer other than by *purchase*, the value of such part is not to be included in determining the taxpayer's cost of the new residence (see paragraph (b)(9) of this section for definition of *purchase*). For example, if the taxpayer acquires a residence by gift or inheritance, and spends \$20,000 in reconstructing such residence, only such \$20,000 may be treated as his cost of purchasing the new residence.

(ii) The taxpayer's cost of purchasing the new residence includes only so much of such cost as is attributable to acquisition, construction, reconstruction, or improvements made within the period of three years or 42 months (two years or 30 months in the case of a sale of an old residence prior to January 1, 1975), as the case may be, in which the purchase and use of the new residence must be made in order to have gain on the sale of the old residence not recognized under this section. Thus, if the construction of the new residence is begun three years before the date of sale of the old residence and completed on the date of sale of the old residence, only that portion of the cost which is

attributable to the last 18 months (last year in the case of a sale of an old residence prior to January 1, 1975) of such construction constitutes the taxpayer's cost of purchasing the new residence, for purposes of section 1034. Furthermore, the taxpayer's cost of purchasing the new residence includes only such amounts as are properly chargeable to capital account rather than to current expense. As to what constitutes capital expenditures, see section 263.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example: M began the construction of a new residence on January 15, 1974, and completed it on October 14, 1974. The cost of \$45,000 was incurred ratably over the 9-month period of construction. On December 14, 1975, M sold his old residence and realized a gain. In determining the extent to which the realized gain is not to be recognized under section 1034, M's cost of constructing the new residence shall include only the \$20,000 which was attributable to the June 15—October 14, 1974, period (4 months at \$5,000). The \$25,000 balance of the cost of constructing the new residence was not attributable to the period beginning 18 months before the date of the sale of the old residence and ending two years after such date and, under section 1034, is not properly a part of M's cost of constructing the new residence.

(d) *Limitations on application of section 1034.* (1) If a residence is purchased by the taxpayer prior to the date of the sale of the old residence, the purchased residence shall, in no event, be treated as a new residence if such purchased residence is sold or otherwise disposed of by him prior to the date of the sale of the old residence (section 1034(c)(3)). And, if the taxpayer, during the period within which the purchase and use of the new residence must be made in order to have any gain on the sale of the old residence not recognized under this section, purchases more than one property which is used by him as his principal residence during the 18 months (or two years in the case of the construction of the new residence) succeeding the date of the sale of the old residence, only the last of such properties shall be considered a new residence (section 1034(c)(4)). In the case of a sale of an old residence prior to January 1, 1975, the period of 18 months (or two years) referred to in the preceding

sentence shall be one year (or 18 months). If within 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of the sale of the old residence, the taxpayer sold other property used by him as his principal residence at a gain, and any part of such gain was not recognized under this section or section 112(n) of the Internal Revenue Code of 1939, this section shall not apply with respect to the sale of the old residence (section 1034(d)).

(2) The following example will illustrate the rules of subparagraph (1) of this paragraph:

Example: A taxpayer sells his old residence on January 15, 1954, and purchases another residence on February 15, 1954. On March 15, 1954, he sells the residence which he bought on February 15, 1954, and purchases another residence on April 15, 1954. The gain on the sale of the old residence on January 15, 1954, will not be recognized except to the extent to which the taxpayer's adjusted sales price of the old residence exceeds the cost of purchasing the residence which he purchased on April 15, 1954. Gain on the sale of the residence which was bought on February 15, 1954, and sold on March 15, 1954, will be recognized.

(e) *Basis of new residence.* (1) Where the purchase of a new residence results, under this section, in the nonrecognition of any part of the gain realized upon the sale of an old residence, then, in determining the adjusted basis of the new residence as of any time following the sale of the old residence, the adjustments to basis shall include a reduction by an amount equal to the amount of the gain which was not recognized upon the sale of the old residence (section 1034(e); for special rule applicable in some cases to husband and wife, see paragraph (f) of this section). Such a reduction is not to be made for the purpose of determining the adjusted basis of the new residence as of any time preceding the sale of the old residence. For the purpose of this determination, the amount of the gain not recognized under this section upon the sale of the old residence includes only so much of the gain as is not recognized because of the taxpayer's cost, up to the date of the determination of the adjusted basis, of purchasing the new residence.

(2) The following example will illustrate the rule of subparagraph (1) of this paragraph:

Example: On January 1, 1954, the taxpayer buys a new residence for \$10,000. On March 1, 1954, he sells for an adjusted sales price of \$15,000 his old residence, which has an adjusted basis to him of \$5,000 (no fixing-up expenses are involved, so that \$15,000 is the amount realized as well as the adjusted sales price). Between April 1 and April 15 a wing is constructed on the new house at a cost of \$5,000. Between May 1 and May 15 a garage is constructed at a cost of \$2,000. The adjusted basis of the new residence is \$10,000 during January and February, \$5,000 during March, \$5,000 following the completion of the construction in April, and \$7,000 following the completion of the construction in May. Since the old residence was not sold until March 1, no adjustment to the basis of the new residence is made during January and February. Computations for March, April, and May are as follows:

Amount realized on sale of old residence	\$15,000
Less: Adjusted basis of old residence	5,000
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Gain realized on sale of old residence ..	10,000
<i>March 1, 1954</i>	
Adjusted sales price of old residence ...	15,000
Less: Cost of purchasing new residence	10,000
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Gain recognized	5,000
Gain realized but not recognized	5,000
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Cost of purchasing new residence	10,000
Less: Gain realized but not recognized	5,000
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Adjusted basis of new residence	5,000
<i>April 15, 1954</i>	
Gain realized on sale of old residence ..	10,000
Adjusted sales price of old residence ...	15,000
Less: Cost of purchasing new residence	15,000
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Gain recognized	0
Gain realized but not recognized	10,000
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Cost of purchasing new residence	15,000
Less: Gain realized but not recognized	10,000
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Adjusted basis of new residence	5,000
<i>May 15, 1954</i>	
Gain realized on sale of old residence ..	10,000
Adjusted sales price of old residence ...	15,000
Less: Cost of purchasing new residence	17,000
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Gain recognized	0
Gain realized but not recognized	10,000
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Cost of purchasing new residence	17,000
Less: Gain realized but not recognized	10,000
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Adjusted basis of new residence	7,000

(f) *Husband and wife.* (1) If the taxpayer and his spouse file the consent referred to in this paragraph, then the *taxpayer's adjusted sales price of the old residence* shall mean the taxpayer's, or the taxpayer's and his spouse's, adjusted sales price of the old residence, and the *taxpayer's cost of purchasing the new residence* shall mean the cost to the taxpayer, or to his spouse, or to both of them, of purchasing the new residence, whether such new residence is held by the taxpayer, or his spouse, or both (section 1034(g)). Such consent may be filed only if the old residence and the new residence are each used by the taxpayer and his same spouse as their principal residence. If the taxpayer and his spouse do not file such a consent, the recognition of gain upon sale of the old residence shall be determined under this section without regard to the foregoing.

(2) The consent referred to in subparagraph (1) of this paragraph is a consent by the taxpayer and his spouse to have the basis of the interest of either of them in the new residence reduced from what it would have been but for the filing of such consent by an amount by which the gain of either of them on the sale of his interest in the old residence is not recognized solely by reason of the filing of such consent. Such reduction in basis is applicable to the basis of the new residence, whether such basis is that of the husband, of the wife, or divided between them. If the basis is divided between the husband and wife, the reduction in basis shall be divided between them in the same proportion as the basis (determined without regard to such reduction) is divided. Such consent shall be filed with the district director with whom the taxpayer filed the return for the taxable year or years in which the gain from the sale of the old residence was realized.

(3) The following examples will illustrate the application of this rule:

Example 1. A taxpayer, in 1954, sells for an adjusted sales price of \$10,000 the principal residence of himself and his wife, which he owns individually and which has an adjusted basis to him of \$5,000 (no fixing-up expenses are involved, so that \$10,000 is the *amount realized* as well as the *adjusted sales price*). Within a year after such sale he and his wife contribute \$5,000 each from their separate

funds for the purchase of their new principal residence which they hold as tenants in common, each owning an undivided one-half interest therein. If the taxpayer and his wife file the required consent, the gain of \$5,000 upon the sale of the old residence will not be recognized to the taxpayer, and the adjusted basis of the taxpayer's interest in the new residence will be \$2,500 and the adjusted basis of his wife's interest in such property will be \$2,500.

Example 2. A taxpayer and his wife, in 1954, sell for an adjusted sales price of \$10,000 their principal residence, which they own as joint tenants and which has an adjusted basis of \$2,500 to each of them (\$5,000 together) (no fixing-up expenses are involved, so that \$10,000 is the *amount realized* as well as the *adjusted sales price*). Within a year after such sale, the wife spends \$10,000 of her own funds in the purchase of a principal residence for herself and the taxpayer and takes title in her name only. If the taxpayer and his wife file the required consent, the adjusted basis to the wife of the new residence will be \$5,000, and the gain of the taxpayer will be \$2,500 upon the sale of the old residence will not be recognized. The wife, as a taxpayer herself, will have her gain of \$2,500 on the sale of the old residence not recognized under the general rule.

(g) *Members of Armed Forces.* (1) Section 1034(h) provides a special rule for members of the Armed Forces with respect to the period after the sale of the old residence within which the acquisition of a new residence may result in a non-recognition of gain on such sale. The running of the period of 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after the sale of the old residence in the case of the purchase of a new residence, or the period of two years (18 months in the case of a sale of an old residence prior to January 12, 1975) after such sale in the case of the construction of a new residence, is suspended during any time that the taxpayer serves on extended active duty with the Armed Forces of the United States. (This paragraph applies to time served on extended active duty prior to July 1, 1973, only if such extended active duty occurred during an induction period as defined in section 112(c)(5) as in effect prior to July 1, 1973.) However, in no event may such suspension extend for more than four years after the date of the sale of the old residence the period within which the purchase or construction of a new residence may result in a

nonrecognition of gain. For example, if the taxpayer is on extended active duty with the Army from January 1, 1975, to June 30, 1976, and if he sold his old residence on January 10, 1975, the latest date on which the taxpayer may use a new residence constructed by him and have any part of the gain on the sale of his old residence not recognized under this section is June 30, 1978 (the date two years following the taxpayer's termination of active duty). However, if this taxpayer were on extended active duty with the Army from January 1, 1975, to December 31, 1978, the latest date on which he might use a new residence constructed by him and have any part of the gain on the sale of his old residence not recognized under this section would be January 10, 1979 (the date four years following the date of the sale of the old residence).

(2) This suspension covers not only the Armed Forces service of the taxpayer but if the taxpayer and his same spouse used both the old and the new residences as their principal residence, then the extension applies in like manner to the time the taxpayer's spouse is on extended active duty with the Armed Forces of the United States.

(3) The time during which the running of the period is suspended is part of such period. Thus, construction costs during such time are includible in the cost of purchasing the new residence under paragraph (c)(4) of this section.

(4) The running of the period of 18 months (or two years) after the date of sale of the old residence referred to in section 1034(c)(4) and in paragraph (d) of this section is not suspended. The running of the 18-month period prior to the date of the sale of the old residence within which the new residence may be purchased in order to have gain on the sale of the old residence not recognized under this section is also not suspended. In the case of a sale of an old residence prior to January 1, 1975, the periods of 18 months (or two years) referred to in each of the two preceding sentences shall be one year (or 18 months).

(5) The term *extended active duty* means any period of active duty which is served pursuant to a call or order to such duty for a period in excess of 90

days or for an indefinite period. If the call or order is for a period of more than 90 days, it is immaterial that the time served pursuant to such call or order is less than 90 days, if the reason for such shorter period of service occurs after the beginning of such duty. As to what constitutes active service as a member of the Armed Forces of the United States, see paragraph (i) of § 1.112-1. As to who are members of the Armed Forces of the United States, see section 7701(a)(15), and the regulations in part 301 of this chapter (Regulations on Procedure and Administration).

(h) *Special rules for involuntary conversions*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, section 1034 is inapplicable to involuntary conversions of personal residences occurring after December 31, 1953 (section 1034(i)(1)(B)). For purposes of section 1034, an involuntary conversion of a personal residence occurring after December 31, 1950, and before January 1, 1954, is treated as a sale of such residence (section 1034(i)(1)(A); see paragraph (b)(8) of this section). For purposes of this paragraph, an involuntary conversion is defined, as the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, or the sale or exchange of property under threat or imminence thereof. See section 1033 and § 1.1033(a)-3 for treatment of residences involuntarily converted after December 31, 1953.

(2) *Election to treat condemnation of personal residence as sale.* (i) Section 1034(i)(2) provides a special rule which permits a taxpayer to elect to treat the seizure, requisition, or condemnation of his principal residence, or the sale or exchange of such residence under threat or imminence thereof, if occurring after December 31, 1957, as the sale of such residence for purposes of section 1034 (relating to sale or exchange of residence). A taxpayer may thus elect to have section 1034 apply, rather than section 1033 (relating to involuntary conversions), in determining the amount of gain realized on the disposition of his old residence that will not be recognized and the extent to which the basis of his new residence acquired in lieu thereof shall be reduced. Once made, the election shall be irrevocable.

(ii) If the taxpayer elects to be governed by the provisions of section 1034, section 1033 will have no application. Thus, a taxpayer who elects under section 1034(i)(2) to treat the seizure, requisition, or condemnation of his principal residence (but not the destruction), or the sale or exchange of such residence under threat or imminence thereof, as a sale for the purpose of section 1034 must satisfy the requirements of section 1034 and this section. For example, under section 1034 a taxpayer generally must replace his old residence with a new residence which he uses as his principal residence, within a period beginning 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) before the date of disposition of his old residence, and ending 18 months (one year in the case of a sale of an old residence prior to January 1, 1975) after such date. However, in the case of a new residence the construction of which was commenced by the taxpayer within such period, the replacement period shall not expire until 2 years (18 months in the case of a sale of an old residence prior to January 1, 1975) after the date of disposition of the old residence.

(iii) *Time and manner of making election.* The election under section 1034(i)(2) shall be made in a statement attached to the taxpayer's income tax return, when filed, for the taxable year during which the disposition of his old residence occurs. The statement shall indicate that the taxpayer elects under section 1034(i)(2) to treat the disposition of his old residence as a sale for purposes of section 1034, and shall also show—

- (a) The basis of the old residence;
- (b) The date of its disposition;
- (c) The adjusted sales price of the old residence, if known; and
- (d) The purchase price, date of purchase, and date of occupancy of the new residence if it has been acquired prior to the time of making the election.

(i) *Statute of limitations.* (1) Whenever a taxpayer sells property used as his principal residence at a gain, the statutory period prescribed in section 6501(a) for the assessment of a deficiency attributable to any part of such gain shall not expire prior to the expiration

of three years from the date of receipt, by the district director with whom the return was filed for the taxable year or years in which the gain from the sale of the old residence was realized (section 1034(j)), of a written notice from the taxpayer of—

(i) The taxpayer's cost of purchasing the new residence which the taxpayer claims result in nonrecognition of any part of such gain.

(ii) The taxpayer's intention not to purchase a new residence within the period when such a purchase will result in nonrecognition of any part of such gain, or

(iii) The taxpayer's failure to make such a purchase within such period.

Any gain from the sale of the old residence which is required to be recognized shall be included in gross income for the taxable year or years in which such gain was realized. Any deficiency attributable to any portion of such gain may be assessed before the expiration of the 3-year period described in this paragraph, notwithstanding the provisions of any law or rule of law which might otherwise bar such assessment.

(2) The notification required by the preceding subparagraph shall contain all pertinent details in connection with the sale of the old residence and, where applicable, the purchase price of the new residence. The notification shall be in the form of a written statement and shall be accompanied, where appropriate, by an amended return for the year in which the gain from the sale of the old residence was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(j) *Effective date.* Pursuant to section 7851(a)(1)(C), paragraphs (a), (b), (c), (d), (f), (g), and (i) of this section apply in the case of any *sale* (as defined in paragraph (b)(8) of this section) made after December 31, 1953, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939. Similarly, the rule in paragraph (h) of this section that involuntary conversions of personal residences are not to be treated as sales for purposes of section 1034 but are governed by section 1033 applies to any such involuntary conversion made after December 31,

1953, although such involuntary conversion may occur in a taxable year subject to the Internal Revenue Code of 1939. The rule in paragraph (e) of this section requiring an adjustment to the basis of a new residence, the purchase of which results (under section 1034, or section 112(n) of the Internal Revenue Code of 1939) in the nonrecognition of gain on the sale of an old residence, applies in determining the adjusted basis of the new residence at any time following such sale, although such sale may occur in a taxable year subject to the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5924, Apr. 13, 1967; 32 FR 6971, May 6, 1967; T.D. 7404, 41 FR 6758, Feb. 13, 1976; T.D. 7625, 44 FR 31013, May 30, 1979]

§ 1.1035-1 Certain exchanges of insurance policies.

Under the provisions of section 1035 no gain or loss is recognized on the exchange of:

(a) A contract of life insurance for another contract of life insurance or for an endowment or annuity contract (section 1035(a)(1));

(b) A contract of endowment insurance for another contract of endowment insurance providing for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged, or an annuity contract (section 1035(a)(2)); or

(c) An annuity contract for another annuity contract (section 1035(a)(3)), but section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. This section and section 1035 do not apply to transactions involving the exchange of an endowment contract or annuity contract for a life insurance contract, nor an annuity contract for an endowment contract. In the case of such exchanges, any gain or loss shall be recognized. In the case of exchanges which would be governed by section

1035 except for the fact that the property received in exchange consists not only of property which could otherwise be received without the recognition of gain or loss, but also of other property or money, see section 1031 (b) and (c) and the regulations thereunder. Such an exchange does not come within the provisions of section 1035. Determination of the basis of property acquired in an exchange under section 1035(a) shall be governed by section 1031(d) and the regulations thereunder.

§ 1.1036-1 Stock for stock of the same corporation.

(a) Section 1036 permits the exchange, without the recognition of gain or loss, of common stock for common stock, or of preferred stock for preferred stock, in the same corporation. Section 1036 applies even though voting stock is exchanged for nonvoting stock or nonvoting stock is exchanged for voting stock. It is not limited to an exchange between two individual stockholders; it includes a transaction between a stockholder and the corporation. However, a transaction between a stockholder and the corporation may qualify not only under section 1036(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights). The provisions of section 1036(a) do not apply if stock is exchanged for bonds, or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See paragraph (l) of section 1301-1 for certain transactions treated as distributions under section 301. See paragraph (e)(5) of § 1.368-2 for certain transactions which result in deemed distributions under section 305(c) to which sections 305(b)(4) and 301 apply.

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036(a) if as part of the

consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b).

(d) *Nonqualified preferred stock.* See § 1.356-7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 921).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 8904, 65 FR 58652, Oct. 2, 2000]

§ 1.1037-1 Certain exchanges of United States obligations.

(a) *Nonrecognition of gain or loss—(1) In general.* Section 1037(a) provides for the nonrecognition of gain or loss on the surrender to the United States of obligations of the United States issued under the Second Liberty Bond Act (31 U.S.C. 774(2)) when such obligations are exchanged solely for other obligations issued under that Act and the Secretary provides by regulations promulgated in connection with the issue of such other obligations that gain or loss is not to be recognized on such exchange. It is not necessary that at the time of the exchange the obligation which is surrendered to the United States be a capital asset in the hands of the taxpayer. For purposes of section 1037(a) and this subparagraph, a circular of the Treasury Department which offers to exchange obligations of the United States issued under the Second Liberty Bond Act for other obligations issued under that Act shall constitute regulations promulgated by the Secretary in connection with the issue of the obligations offered to be exchanged if such circular contains a declaration by the Secretary that no gain or loss shall be recognized for Federal income tax purposes on the exchange or grants the privilege of continuing to defer the reporting of the income of the bonds exchanged until such time as the bonds received in the exchange are redeemed or disposed of, or have reached final maturity, whichever is earlier.

See, for example, regulations of the Bureau of the Public Debt, 31 CFR part 339, or Treasury Department Circular 1066, 26 FR 8647. The application of section 1037(a) and this subparagraph will not be precluded merely because the taxpayer is required to pay money on the exchange. See section 1031 and the regulations thereunder if the taxpayer receives money on the exchange.

(2) *Recognition of gain or loss postponed.* Gain or loss which has been realized but not recognized on the exchange of a U.S. obligation for another such obligation because of the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as related to section 1037(a)) shall be recognized at such time as the obligation received in the exchange is disposed of, or redeemed, in a transaction other than an exchange described in section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) or reaches final maturity, whichever is earlier, to the extent gain or loss is realized on such later transaction.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. A, the owner of a \$1,000 series E U.S. savings bond purchased for \$750 and bearing an issue date of May 1, 1945, surrenders the bond to the United States in exchange solely for series H U.S. savings bonds on February 1, 1964, when the series E bond has a redemption value of \$1,304.80. In the exchange A pays an additional \$195.20 and obtains three \$500 series H bonds. None of the \$554.80 gain (\$1,304.80 less \$750) realized by A on the series E bond is recognized at the time of the exchange.

Example 2. In 1963, B purchased for \$97 a marketable U.S. bond which was originally issued at its par value of \$100. In 1964 he surrenders the bond to the United States in exchange solely for another marketable U.S. bond which then has a fair market value of

\$95. B's loss of \$2 on the old bond is not recognized at the time of the exchange, and his basis for the new bond is \$97 under section 1031(d). If it has been necessary for B to pay \$1 additional consideration in the exchange, his basis in the new bond would be \$98.

Example 3. The facts are the same as in example (2) except that B also receives \$1 interest on the old bond for the period which has elapsed since the last interest payment date and that B does not pay any additional consideration on the exchange. As in example (2), B has a loss of \$2 which is not recognized at the time of the exchange and his basis in the new bond is \$97. In addition, the \$1 of interest received on the old bond is includible in gross income. B holds the new bond 1 year and sells it in the market for \$99 plus interest. At this time he has a gain of \$2, the difference between his basis of \$97 in the new bond and the sales price of such bond. In addition, the interest received on the new bond is includible in gross income.

Example 4. The facts are the same as in example (2), except that in addition to the new bond B also receives \$1.85 in cash, \$0.85 of which is interest. The \$0.85 interest received is includible in gross income. B's loss of \$1 (\$97 less \$96) on the old bond is not recognized at the time of the exchange by reason of section 1031(c). Under section 1031(d) B's basis in the new bond is \$96 (his basis of \$97 in the old bond, reduced by the \$1 cash received in the exchange).

Example 5. (a) For \$975 D subscribes to a marketable U.S. obligation which has a face value of \$1,000. Thereafter, he surrenders this obligation to the United States in exchange solely for a 10-year marketable \$1,000 obligation which at the time of exchange has a fair market value of \$930, at which price such obligation is initially offered to the public. At the time of issue of the new obligation there was no intention to call it before maturity. Five years after the exchange D sells the new obligation for \$960.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of \$45 (\$975 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is \$975 (the same basis as that of the old obligation).

(d) On the sale of the new obligation D sustains a loss of \$15 (\$975 less \$960), all of which is recognized by reason of section 1002.

Example 6. (a) The facts are the same as in example (5), except that five years after the exchange D sells the new obligation for \$1,020.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of \$45 (\$975 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is

\$975 (the same basis as that of the old obligation). The issue price of the new obligation under section 1232(b)(2) is \$930.

(d) On the sale of the new obligation D realizes a gain of \$45 (\$1,020 less \$975), all of which is recognized by reason of section 1002. Of this gain of \$45, the amount of \$35 is treated as ordinary income and \$10 is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B) on sale of new obligation:	
Stated redemption price of new obligation at maturity	\$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): ($\$70 \times 60 \text{ months} / 120 \text{ months}$)	35
(2) Long-term capital gain (\$45 less \$35)	10

Example 7. (a) The facts are the same as in example (5), except that D retains the new obligation and redeems it at maturity for \$1,000.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of \$45 (\$975 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is \$975 (the same basis as that of the old obligation). The issue price of the new obligation is \$930 under section 1232(b)(2).

(d) On the redemption of the new obligation D realizes a gain of \$25 (\$1,000 less \$975), all of which is recognized by reason of section 1002. Of this gain of \$25, the entire amount is treated as ordinary income, determined as follows:

Ordinary income under first sentence of section 1232(a)(2)(B) on redemption of new obligation:	
Stated redemption price of new obligation at maturity	\$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): ($\$70 \times 120 \text{ months} / 120 \text{ months}$), but such amount not to exceed the \$25 gain recognized on redemption	25

(b) *Application of section 1232 upon disposition or redemption of new obligation—*

(1) *Exchanges involving nonrecognition of gain on obligations issued at a discount.*

If an obligation, the gain on which is subject to the first sentence of section 1232(a)(2)(B), because the obligation was originally issued at a discount, is surrendered to the United States in exchange for another obligation and any part of the gain realized on the exchange is not then recognized because of the provisions of section 1037(a) (or

because of so much of section 1031(b) as relates to section 1037(a)), the first sentence of section 1232(a)(2)(B) shall apply to so much of such unrecognized gain as is later recognized upon the disposition or redemption of the obligation which is received in the exchange as though the obligation so disposed of or redeemed were the obligation surrendered, rather than the obligation received, in such exchange. See the first sentence of section 1037(b)(1). Thus, in effect that portion of the gain which is unrecognized on the exchange but is recognized upon the later disposition or redemption of the obligation received from the United States in the exchange shall be considered as ordinary income in an amount which is equal to the gain which, by applying the first sentence of section 1232(a)(2)(B) upon the earlier surrender of the old obligation to the United States, would have been considered as ordinary income if the gain had been recognized upon such earlier exchange. Any portion of the gain which is recognized under section 1031(b) upon the earlier exchange and is treated at such time as ordinary income shall be deducted from the gain which is treated as ordinary income by applying the first sentence of section 1232(a)(2)(B) pursuant to this subparagraph upon the disposition or redemption of the obligation which is received in the earlier exchange. This subparagraph shall apply only in a case where on the exchange of United States obligations there was some gain not recognized by reason of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)); it shall not apply where, only loss was unrecognized by reason of section 1037(a).

(2) *Rules to apply when a nontransferable obligation is surrendered in the exchange.* For purposes of applying both section 1232(a)(2)(B) and subparagraph (1) of this paragraph to the total gain realized on the obligation which is later disposed of or redeemed, if the obligation surrendered to the United States in the earlier exchange is a nontransferable obligation described in section 454 (a) or (c)—

(i) The aggregate amount considered, with respect to the obligation so surrendered in the earlier exchange, as ordi-

nary income shall not exceed the difference between the issue price of the surrendered obligation and the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, and

(ii) The issue price of the obligation which is received from the United States in the earlier exchange shall be considered to be the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, increased by the amount of other consideration (if any) paid to the United States as part of the earlier exchange.

If the obligation received in the earlier exchange is a nontransferable obligation described in section 454(c) and such obligation is partially redeemed before final maturity or partially disposed of by being partially reissued to another owner, the amount determined by applying subdivision (i) of this subparagraph shall be determined on a basis proportional to the total denomination of obligations redeemed or disposed of. See paragraph (c) of §1.454-1.

(3) *Long-term capital gain.* If, in a case where both subparagraphs (1) and (2) of this paragraph are applied, the total gain realized on the redemption or disposition of the obligation which is received from the United States in the exchange to which section 1037(a) (or so much of section 1031(b) as related to section 1037(a)) applies exceeds the amount of gain which, by applying such subparagraphs, is treated as ordinary income, the gain in excess of such amount shall be treated as long-term capital gain.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

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Example 1. (a) A purchased a noninterest-bearing nontransferable U.S. bond for \$74 which was issued after December 31, 1954, and redeemable in 10 years for \$100. Several years later, when the stated redemption value of such bond is \$94.50, A surrenders it to the United States in exchange for \$1 in cash and a 10-year marketable bond having a face value of \$100. On the date of exchange the bond received in the exchange has a fair market value of \$96. Less than one month after the exchange, A sells the new bond for \$96.

(b) On the exchange of the old bond for the new bond A realizes a gain of \$23, determined as follows:

Amount realized (a new bond worth \$96 plus \$1 cash)	\$97
Less: Adjusted basis of old bond	74
Gain realized	23

Pursuant to so much of section 1031(b) as applies to section 1037(a), the amount of such gain which is recognized is \$1 (the money received). Such recognized gain of \$1 is treated as ordinary income. On the exchange of the old bond a gain of \$22 (\$23 less \$1) is not recognized.

(c) The basis of the new bond in A's hands, determined under section 1031(d) is \$74 (the basis of the old bond, decreased by the \$1 received in cash and increased by the \$1 gain recognized on the exchange).

(d) On the sale of the new bond A realizes a gain of \$22 (\$96 less \$74), all of which is recognized by reason of section 1002. Of this gain of \$22, the amount of \$19.50 is treated as ordinary income and \$2.50 is treated as long-term capital gain, determined as follows:

(1) Ordinary income, treating sale of new bond as though a sale of old bond and applying section 1037(b)(1)(A):	
Stated redemption price of old bond	\$94.50
Less: Issue price of old bond	74.00
Aggregate gain under section 1037(b)(1)(A) (not to exceed \$22 not recognized at time of exchange)	20.50
Less: Amount of such gain recognized at time of exchange	1.00
Ordinary income	19.50

(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(1)(B) to sale of new bond:

Stated redemption price of new bond at maturity	\$100.00
Less: Issue price of new bond under section 1037(b)(1)(B) (\$94.50 plus \$0 additional consideration paid on exchange)	94.50
Original issue discount on new bond	5.50

Proration under section 1232(a)(2)(B)(ii):	
(\$5.50×0 months/120 months)	0

(3) Total ordinary income (sum of subparagraphs (1) and (2))	19.50
(4) Long-term capital gain (\$22 less \$19.50)	2.50

Example 2. (a) The facts are the same as in example (1), except that, less than one month after the exchange of the old bond, the new bond is sold for \$92.

(b) On the sale of the new bond A realizes a gain of \$18 (\$92 less \$74), all of which is recognized by reason of section 1002. Of this gain, the entire amount of \$18 is treated as ordinary income. This amount is determined as provided in paragraph (d)(1) of example (1) except that the ordinary income of \$19.50 is limited to the \$18 recognized on the sale of the new bond.

Example 3. (a) The facts are the same as in example (1), except that 2 years after the exchange of the old bond A sells the new bond for \$98.

(b) On the sale of the new bond A realizes a gain of \$24 (\$98 less \$74), all of which is recognized by reason of section 1002. Of this gain of \$24, the amount of \$20.60 is treated as ordinary income and \$3.40 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	\$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to \$1.10 (\$5.50×24 months/120 months)	1.10
(3) Total ordinary income (sum of subparagraphs (1) and (2))	20.60
(4) Long-term capital gain (\$24 less \$20.60)	3.40

Example 4. (a) The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for \$100.

(b) On the redemption of the new bond A realizes a gain of \$26 (\$100 less \$74), all of which is recognized by reason of section 1002. Of this gain of \$26, the amount of \$25 is treated as ordinary income and \$1 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	\$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to \$5.50 (\$5.50×120 months/120 months)	5.50
(3) Total ordinary income (sum of subparagraphs (1) and (2))	25.00
(4) Long-term capital gain (\$26 less \$25)	1.00

Example 5. (a) In 1958 B purchased for \$7,500 a series E United States savings bond having

a face value of \$10,000. In 1965 when the stated redemption value of the series E bond is \$9,760, B surrenders it to the United States in exchange solely for a \$10,000 series H U.S. savings bond, after paying \$240 additional consideration. B retains the series H bond and redeems it at maturity in 1975 for \$10,000, after receiving all the semiannual interest payments thereon.

(b) On the exchange of the series E bond for the series H bond, B realizes a gain of \$2,260 (\$9,760 less \$7,500), none of which is recognized at such time by reason of section 1037(a).

(c) The basis of the series H bond in B's hands, determined under section 1031(d), is \$7,740 (the \$7,500 basis of the series E bond, plus \$240 additional consideration paid for the series H bond).

(d) On the redemption of the series H bond, B realizes a gain of \$2,260 (\$10,000 less \$7,740), all of which is recognized by reason of section 1002. This entire gain is treated as ordinary income by treating the redemption of the series H bond as though it were a redemption of the series E bond and by applying section 1037(b)(1)(A).

(e) Under section 1037(b)(1)(B) the issue price of the series H bonds is \$10,000 (\$9,760 stated redemption price of the series E bond at time of exchange, plus \$240 additional consideration paid). Thus, with respect to the series H bond, there is no original issue discount to which section 1232(a)(2)(B) might apply.

Example 6. (a) The facts are the same as in example (5), except that in 1970 B submits the \$10,000 series H bond to the United States for partial redemption in the amount of \$3,000 and for reissuance of the remainder in \$1,000 series H savings bonds registered in his name. On this transaction B receives \$3,000 cash and seven \$1,000 series H bonds, bearing the original issue date of the \$10,000 bond which is partially redeemed. The \$1,000, series H bonds are redeemed at maturity in 1975 for \$7,000.

(b) On the partial redemption of the \$10,000 series H bond in 1970 B realizes a gain of \$678 (\$3,000 less \$2,322 [\$7,740×\$3,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of §1.454-1. This entire gain is treated as ordinary income, by treating the partial redemption of the series H bond as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the seven \$1,000 series H bonds B realizes a gain of \$1,582 (\$7,000 less \$5,418 [\$7,740×\$7,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of §1.454-1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

Example 7. (a) The facts are the same as in example (5), except that in 1970 B requests the United States to reissue the \$10,000 series H bond by issuing two \$5,000 series H bonds bearing the original issue date of such \$10,000 bond. One of such \$5,000 bonds is registered in B's name, and the other is registered in the name of C, who is B's son. Each \$5,000 series H bond is redeemed at maturity in 1975 for \$5,000.

(b) On the issuing in 1970 of the \$5,000 series H bond to C, B realizes a gain of \$1,130 (\$5,000 less \$3,870 [\$7,740×\$5,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of §1.454-1. This entire gain is treated as ordinary income by treating the transaction as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the \$5,000 series H bond registered in his name B realizes a gain of \$1,130 (\$5,000 less \$3,870 [\$7,740×\$5,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of §1.454-1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

(d) On the redemption at maturity in 1975 of the \$5,000 series H bond registered in his name C does not realize any gain, since the amount realized on redemption does not exceed his basis in the property, determined as provided in section 1015.

(5) *Exchanges involving nonrecognition of gain or loss on transferable obligations issued at not less than par—(i) In general.* If a transferable obligation of the United States which was originally issued at not less than par is surrendered to the United States for another transferable obligation in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply, the issue price of the obligation received from the United States in the exchange shall be considered for purposes of applying section 1232 to gain realized on the disposition or redemption of the obligation so received, to be the same as the issue price of the obligation which is surrendered to the United States in the exchange, increased by the amount of other consideration, if any, paid to the United States as part of the exchange. This subparagraph shall apply irrespective of whether there is gain or loss unrecognized on the exchange and irrespective of the fair market value, at the

time of the exchange, of either the obligation surrendered to, or the obligation received from, the United States in the exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchases in the market for \$85 a marketable U.S. bond which was originally issued at its par value of \$100. Three months later, A surrenders this bond to the United States in exchange solely for another \$100 marketable U.S. bond which then has a fair market value of \$88. He holds the new bond for 5 months and then sells it on the market for \$92.

(b) On the exchange of the old bond for the new bond A realizes a gain of \$3 (\$88 less \$85), none of which is recognized by reason of section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is \$85 (the same as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be \$100 (the same issue price as that of the old bond).

(d) On the sale of the new bond A realizes a gain of \$7 (\$92 less \$85), all of which is recognized by reason of section 1002. Of this gain of \$7, the entire amount is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B), applicable to old bond:		
Stated redemption price of old bond at maturity	\$100	
Less: Issue price of old bond	100	
Original issue discount on old bond		0
(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(2) to sale of new bond:		
Stated redemption price of new bond at maturity	100	
Less: Issue price of new bond under section 1037(b)(2)	100	
Original issue discount on new bond		0
(3) Long-term capital gain (\$7 less sum of subparagraphs (1) and (2))		\$7

Example 2. The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for \$100. On the redemption of the new bond, A realizes a gain of \$15 (\$100 less \$85), all of which is recognized under section 1002. This entire gain is treated as long-term capital gain, deter-

mined in the same manner as provided in paragraph (d) of example (1).

Example 3. (a) For \$1,000 B subscribes to a marketable U.S. bond which has a face value of \$1,000. Thereafter, he surrenders this bond to the United States in exchange solely for a 10-year marketable \$1,000 bond which at the time of exchange has a fair market value of \$930, at which price such bond is initially offered to the public. Five years after the exchange, B sells the new bond for \$950.

(b) On the exchange of the old bond for the new bond, B sustains a loss of \$70 (\$1,000 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is \$1,000 (the same basis as that of the old bond).

(d) On the sale of the new bond B sustains a loss of \$50 (\$1,000 less \$950), all of which is recognized by reason of section 1002.

Example 4. (a) The facts are the same as in example (3), except that 5 years after the exchange B sells the new bond for \$1,020.

(b) On the exchange of the old bond for the new bond B sustains a loss of \$70 (\$1,000 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in B's hands, determined under section 1031(d), is \$1,000 (the same basis as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be \$1,000 (the same issue price as that of the old bond).

(d) On the sale of the new bond B realizes a gain of \$20 (\$1,020 less \$1,000), all of which is recognized by reason of section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

(6) *Other rules for applying section 1232.* To the extent not specifically affected by the provisions of section 1037(b) and subparagraphs (1) through (5) of this paragraph, any gain realized on the disposition or redemption of any obligation received from the United States in an exchange to which section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) applies shall be treated in the manner provided by section 1232 if the facts and circumstances relating to the acquisition and disposition or redemption of such obligation require the application of section 1232.

(c) *Holding period of obligation received in the exchange.* The holding period of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates

to section 1037(a)) apply shall include the period for which the obligation which was surrendered to the United States in the exchange was held by the taxpayer, but only if the obligation so surrendered was at the time of the exchange a capital asset in the hands of the taxpayer. See section 1223 and the regulations thereunder.

(d) *Basis.* The basis of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall be determined as provided in section 1031(d) and the regulations thereunder.

(e) *Effective date.* Section 1.1037 and this section shall apply only for taxable years ending after September 22, 1959.

[T.D. 6935, 32 FR 15824, Nov. 17, 1967, as amended by T.D. 7154, 36 FR 24998, Dec. 28, 1971]

§ 1.1038-1 Reacquisitions of real property in satisfaction of indebtedness.

(a) *Scope of section 1038—(1) General rule on gain or loss.* If a sale of real property gives rise to indebtedness to the seller which is secured by the real property which is sold, and the seller of such property reacquires such property in a taxable year beginning after September 2, 1964, in partial or full satisfaction of such indebtedness, then, except as provided in paragraphs (b) and (f) of this section, no gain or loss shall result to the seller from such reacquisition. The treatment so provided is mandatory; however, see § 1.1038-3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957. It is immaterial, for purposes of applying this subparagraph, whether the seller realized a gain or sustained a loss on the sale of the real property, or whether it can be ascertained at the time of the sale whether gain or loss occurs as a result of the sale. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale of the real property or whether at the time of reacquisition such property has depreciated or appreciated in value since the time of the original sale. Moreover, the character of the gain realized on the original sale

of the property is immaterial for purposes of applying this subparagraph. The provisions of this section shall apply, except as provided in § 1.1038-2, to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034.

(2) *Sales giving rise to indebtedness—(i) Sale defined.* For purposes of this section, it is not necessary for title to the property to have passed to the purchaser in order to have a sale. Ordinarily, a sale of property has occurred in a transaction in which title to the property has not passed to the purchaser, if the purchaser has a contractual right to retain possession of the property so long as he performs his obligations under the contract and to obtain title to the property upon the completion of the contract. However, a sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if S contracts to sell real property to P, and if S promises to convey title to P upon the completion of all of the payments due under the contract and to allow P to obtain possession of the property after 10 percent of the purchase price has been paid, there has been a sale on the date of the contract for purposes of this section. This section shall not apply to a disposition of real property which constituted an exchange of property or was treated as a sale under section 121(d)(4) or section 1034(i); nor shall it apply to a sale of stock in a cooperative housing corporation described in section 121(d)(3) or section 1034(f).

(ii) *Secured indebtedness defined.* An indebtedness to the seller is secured by the real property for purposes of this section whenever the seller has the right to take title or possession of the property or both if there is a default with respect to such indebtedness. A sale of real property may give rise to an indebtedness to the seller although the seller is limited in his recourse to the property for payment of the indebtedness in the case of a default.

(3) *Reacquisitions in partial or full satisfaction of indebtedness*—(i) *Purpose of reacquisition.* This section applies only where the seller reacquires the real property in partial or full satisfaction of the indebtedness to him that arose from the sale of the real property and was secured by the property. That is, the reacquisition must be in furtherance of the seller's security rights in the property with respect to indebtedness to him that arose at the time of the sale. Accordingly, if the seller in reacquiring the real property does not pay consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by such property, this section shall apply to the reacquisition even though the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. If in addition to discharging the purchaser's indebtedness to him that arose from the sale the seller pays consideration in reacquiring the real property, this section shall generally apply to the reacquisition if the reacquisition and the payment of additional consideration is provided for in the original contract for the sale of the property. This section generally shall apply to a reacquisition of real property if the seller reacquires the property either when the purchaser has defaulted in his obligations under the contract or when such a default is imminent. This section generally shall not apply to a reacquisition of real property where the seller pays consideration in addition to discharging the purchaser's indebtedness to him that arose from the sale if the reacquisition and payment of additional consideration was not provided for in the original contract for the sale of the property and if the purchaser has not defaulted in his obligations under the contract or such a default is not imminent. Thus, for example, if the purchaser is in arrears on the payment of interest or principal or has in any other way defaulted on his contract for the purchase of the property, or if the facts of the case indicate that the purchaser is unable satisfactorily to perform his obligations under the contract, and the seller reacquires the property from the purchaser in a transaction in which the seller pays consid-

eration in addition to discharging the purchaser's indebtedness to him that arose from the sale and was secured by the property, this section shall apply to the reacquisition. Additional consideration paid by the seller includes money and other property paid or transferred by the seller. Also, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of indebtedness) which arose subsequent to the original sale shall be considered as a payment by the seller of additional consideration. However, the reacquisition by the seller of real property subject to an indebtedness (or the assumption, upon the reacquisition, of an indebtedness) which arose prior to or arose out of the original sale shall not be considered as a payment by the seller of additional consideration.

(ii) *Manner of reacquisition.* For purposes of applying section 1038 and this section there must be a reacquisition by the seller of the real property itself, but the manner in which the seller so reduces the property to ownership or possession, as the case may be, shall generally be immaterial. Thus, the seller may reduce the real property to ownership or possession or both, as the case may require, by agreement or by process of law. The reduction of the real property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the purchaser and abandonment to the seller. The reduction of the real property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(4) *Persons from whom real property may be reacquired.* The real property reacquired in satisfaction of the indebtedness need not be reacquired from the purchaser but may be reacquired from the purchaser's transferee or assignee, or from a trustee holding title to such

property pending the purchaser's satisfaction of the terms of the contract, so long as the indebtedness that is partially or completely satisfied in the reacquisition of such property arose in the original sale of the property and was secured by the property so reacquired. In such a case, a reference in this section to the purchaser shall, where appropriate, include the purchaser's transferee or assignee. Thus, for example, this section will apply if the seller reacquires the property from a purchaser from the original purchaser and either the property is subject to, or the subsequent purchaser assumes, the liability to the seller on the indebtedness.

(5) *Reacquisitions not included.* This section shall not apply to reacquisitions of real property by mutual savings banks, domestic building and loan associations, and cooperative banks, described in section 593(a). However, for rules respecting the reacquisition of real property by such organizations, see § 1.595-1.

(b) *Amount of gain resulting from a reacquisition—(1) Determination of amount—(i) In general.* As a result of a reacquisition to which paragraph (a) of this section applies gain shall be derived by the seller to the extent that the amount of money and the fair market value of other property (other than obligations of the purchaser arising with respect to the sale) which are received by the seller, prior to such reacquisition, with respect to the sale of the property exceed the amount of the gain derived by the seller on the sale of such property which is returned as income for periods prior to the reacquisition. However, the amount of gain so determined shall in no case exceed the amount determined under paragraph (c) of this section with respect to such reacquisition.

(ii) *Amount of gain returned as income for prior periods.* For purposes of this subparagraph and paragraph (c)(1) of this section, the amount of gain on the sale of the property which is returned as income for periods prior to the reacquisition of the real property does not include any amount of income determined under paragraph (f)(2) of this section which is considered to be received at the time of the reacquisition

of the property. However, the amount of gain on the sale of the property which is returned as income for such periods does include gain on the sale resulting from payments received in the taxable year in which the date of reacquisition occurs if such payments are received prior to such reacquisition. The application of this subdivision may be illustrated by the following example:

Example: In 1965 S, who uses the calendar year as the taxable year, sells to P for \$10,000 real property which has an adjusted basis of \$3,000. S properly elects under section 453 to report the income from the sale on the installment method. In 1965 and 1966, S receives a total of \$4,000 on the contract. On May 15, 1967, S receives \$1,000 on the contract. Because of P's default, S reacquires the property on August 31, 1967. The gain on the sale which is returned as income for periods prior to the reacquisition is \$3,500 (\$5,000×\$7,000/\$10,000).

(2) *Amount of money and other property received with respect to the sale—(i) In general.* Amounts of money and other property received by the seller with respect to the sale of the property include payments made by the purchaser for the seller's benefit, as well as payments made and other property transferred directly to the seller. If the purchaser of the real property makes payments on a mortgage or other indebtedness to which the property is subject at the time of the sale of such property to him, or on which the seller was personally liable at the time of such sale, such payments are considered amounts received by the seller with respect to the sale. However, if after the sale the purchaser borrows money and uses the property as security for the loan, payments by the purchaser in satisfaction of the indebtedness are not considered as amounts received by the seller with respect to the sale, although the seller does in fact receive some indirect benefit when the purchaser makes such payments.

(ii) *Payments by purchaser at time of reacquisition.* All payments made by the purchaser at the time of the reacquisition of the real property that are with respect to the original sale of the property shall be treated, for purposes of subparagraph (1) of this paragraph, by the seller as having been received prior to the reacquisition with respect to

such sale. For example, if the purchaser, at the time of the reacquisition by the seller, pays money or other property to the seller in partial or complete satisfaction of the purchaser's indebtedness on the original sale, the seller shall treat such amounts as having been received prior to the reacquisition with respect to the sale.

(iii) *Interest received.* For purposes of this subparagraph and paragraph (c)(1) of this section any amounts received by the seller as interest, stated or unstated, are excluded from the computation of gain on the sale of the property and are not considered amounts of money or other property received with respect to the sale.

(iv) *Amounts received on sale of purchaser's indebtedness.* Money or other property received by the seller on the sale of the purchaser's indebtedness that arose at the time of the sale of the real property are amounts received by the seller with respect to the sale of such real property, except that the amounts so received from the sale of such indebtedness shall be reduced by the amount of money and the fair market value of other property paid or transferred by the seller, before the reacquisition of the real property, to reacquire such indebtedness. For example, if S sells real property to P for \$25,000, and under the contract receives \$10,000 down and a note from P for \$15,000, S would receive \$22,000 with respect to the sale if he were to discount the note for \$12,000. If before the reacquisition of the real property S were to reacquire the discounted note for \$8,000, he would receive \$14,000 with respect to the sale.

(3) *Obligations of the purchaser arising with respect to the sale.* The term *obligations of the purchaser arising with respect to the sale* of the real property includes, for purposes of subparagraph (1) of this paragraph, only that indebtedness on which the purchaser is liable to the seller and which arises out of the sale of such property. Thus, the term does not include any indebtedness in respect of the property that the seller owes to a third person which the purchaser assumes, or to which the property is subject, at the time of the sale of the property to the purchaser. Nor does the

term include any indebtedness on which the purchaser is liable to the seller if such indebtedness arises subsequent to the sale of such property.

(c) *Limitation upon amount of gain*—(1) *In general.* Except as provided by subparagraph (2) of this paragraph, the amount of gain on a reacquisition of real property, as determined under paragraph (b) of this section, shall in no case exceed—

(i) The amount by which the price at which the real property was sold exceeded its adjusted basis at the time of the sale, as determined under § 1.1011-1, reduced by

(ii) The amount of gain on the sale of such real property which is returned as income for periods prior to the reacquisition, and by

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property.

(2) *Cases where limitation does not apply.* The limitation provided by subparagraph (1) of this paragraph shall not apply in a case where the selling price of property is indefinite in amount and cannot be ascertained at the time of the reacquisition of such property, as, for example, where the selling price is stated as a percentage of the profits to be realized from the development of the property which is sold. Moreover, the limitation so provided shall not apply to a reacquisition of real property occurring in a taxable year beginning before September 3, 1964, to which the provisions of this section are applied pursuant to an election under § 1.1038-3.

(3) *Determination of sales price.* The price at which the real property was sold shall be, for purposes of subparagraph (1) of this paragraph, the gross sales price reduced by the selling commissions, legal fees, and other expenses incident to the sale of such property which are properly taken into account in determining gain or loss on the sale. For example, the amount of selling commissions paid by a nondealer will be deducted from the gross sales price in determining the price at which the real property was sold; on the other

hand, selling commissions paid by a real estate dealer will be deducted as a business expense. Examples of other expenses incident to the sale of the property are expenses for appraisal fees, advertising expense, cost of preparing maps, recording fees, and documentary stamp taxes. Payments on indebtedness to the seller which are for interest, stated or unstated, are not included in determining the price at which the property was sold. See paragraph (b)(2)(iii) of this section.

(4) *Determination of amounts paid or transferred in connection with a reacquisition*—(i) *In general.* Amounts of money or property paid or transferred by the seller of the real property in connection with the reacquisition of such property include payments of money, or transfers of property, to persons from whom the real property is reacquired as well as to other persons. Payments or transfers in connection with the reacquisition of the property do not include money or property paid or transferred by the seller to reacquire obligations of the purchaser to the seller which were received by the seller with respect to the sale of the property or which arose subsequent to the sale. Amounts of money or property paid or transferred by the seller in connection with the reacquisition of the property include payments or transfers for such items as court costs and fees for services of an attorney, master, trustee, or auctioneer, or for publication, acquiring title, clearing liens, or filing and recording.

(ii) *Assumption of indebtedness.* The assumption by the seller, upon reacquisition of the real property, of any indebtedness to another person which at such time is secured by such property will be considered a payment of money by the seller in connection with the reacquisition. Also, if at the time of reacquisition such property is subject to an indebtedness which is not an indebtedness of the purchaser to the seller, the seller shall be considered to have paid money, in an amount equal to such indebtedness, in connection with the reacquisition of the property. Thus, for example, if at the time of the sale the purchaser executes in connection with the sale a first mortgage to a bank and a second mortgage to the seller and at

the time of reacquisition the seller reacquires the property subject to the first mortgage which he does not assume, the seller will be considered to have paid money, in an amount equal to the unpaid amount of the first mortgage, in connection with the reacquisition.

(d) *Character of gain resulting from a reacquisition.* Paragraphs (b) and (c) of this section set forth the extent to which gain shall be derived from a reacquisition to which paragraph (a) of this section applies, but the rule provided by section 1038 and this section do not affect the character of the gain so derived. The character of the gain resulting from such a reacquisition is determined on the basis of whether the gain on the original sale was returned on the installment method or, if not, on the basis of whether title to the real property was transferred to the purchaser; and, if title was transferred to the purchaser in a deferred-payment sale, whether the reconveyance of the property to the seller was voluntary. For example, if the gain on the original sale of the reacquired property was returned on the installment method, the character of the gain on reacquisition by the seller shall be determined in accordance with the rules provided in paragraph (a) of §1.453-9. If the original sale was not on the installment method but was a deferred-payment sale, as described in §1.453-6(a), where title to the real property was transferred to the purchaser and the seller accepts a voluntary reconveyance of the property, the gain on the reacquisition shall be ordinary income; however, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain resulting from the reacquisition is capital gain subject to the provisions of subchapter P of chapter 1 of the Code.

(e) *Recognition of gain.* The entire amount of the gain determined under paragraphs (b) and (c) of this section with respect to a reacquisition to which paragraph (a) of this section applies shall be recognized notwithstanding any other provisions of subtitle A (relating to income taxes) of the Code.

(f) *Special rules applicable to worthless indebtedness*—(1) *Worthlessness resulting*

from reacquisition. No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which paragraph (a) of this section applies. Accordingly, no deduction for a bad debt and no charge against a reserve for bad debts shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property.

(2) *Indebtedness treated as worthless prior to reacquisition*—(i) *Prior taxable years.* If for any taxable year ending before the taxable year in which occurs a reacquisition of real property to which paragraph (a) of this section applies the seller of such property has treated any indebtedness of the purchaser which is secured by such property as having become worthless or partially worthless by taking a bad debt deduction under section 166(a), he shall be considered as receiving, at the time of such reacquisition, income in an amount equal to the amount of such indebtedness previously treated by him as having become worthless. The amount so treated as income received shall be treated as a recovery of a bad debt previously deducted as worthless or partially worthless. Accordingly, the amount of such income shall be excluded from gross income, as provided in § 1.111-1, to the extent of the *recovery exclusion* with respect to such item. For purposes of § 1.111-1, if the indebtedness was treated as partially worthless in a prior taxable year, the amount treated under this subparagraph as a recovery shall be considered to be with respect to the part of the indebtedness that was previously deducted as worthless. The seller shall not be considered to have treated an indebtedness as worthless in any taxable year for which he took the standard deduction under section 141 or paid the tax imposed by section 3 if a deduction in respect of such indebtedness was not allowed in determining adjusted gross income for such year under section 62.

(ii) *Current taxable year.* No deduction shall be allowed under section 166 (a), for the taxable year in which occurs a

reacquisition of real property to which paragraph (a) of this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(3) *Basis adjustment.* The basis of any indebtedness described in subparagraph (2)(i) of this paragraph shall be increased (as of the date of the reacquisition) by an amount equal to the amount which, under such subparagraph of this paragraph, is treated as income received by the seller with respect to such indebtedness, but only to the extent the amount so treated as received is not excluded from gross income by reason of the application of § 1.111-1.

(g) *Rules for determining gain or loss on disposition of reacquired property*—(1) *Basis of reacquired real property.* The basis of any real property acquired in a reacquisition to which paragraph (a) of this section applies shall be the sum of the following amounts, determined as of the date of such reacquisition:

(i) The amount of the adjusted basis, determined under sections 453 and 1011, and the regulations thereunder, of all indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such property, including any increase by reason of paragraph (f)(3) of this section,

(ii) The amount of gain determined under paragraphs (b) and (c) of this section with respect to such reacquisition, and

(iii) The amount of money and the fair market value of other property (other than obligations of the purchaser to the seller which are secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property, determined as provided in paragraph (c) of this section even though such paragraph does not apply to the reacquisition.

(2) *Basis of undischarged indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property described in subparagraph (1) of this paragraph, to the extent that such indebtedness is not discharged upon the

reacquisition of such property, shall be zero. Therefore, to the extent not discharged upon the reacquisition of the real property, indebtedness on the original obligation of the purchaser, a substituted obligation of the purchaser, a deficiency judgment entered in a court of law into which the purchaser's obligation has merged, or any other obligation of the purchaser to the seller, shall be zero if such indebtedness constitutes an indebtedness to the seller which was secured by such property.

(3) *Holding period of reacquired property.* Since the reacquisition described in subparagraph (1) of this paragraph is in a sense considered a nullification of the original sale of the real property, for purposes of determining gain or loss on a disposition of such property after its reacquisition the period for which the seller has held the real property at the time of such disposition shall include the period for which such property is held by him prior to the original sale. However, the holding period shall not include the period of time commencing with the date following the date on which the property is originally sold to the purchaser and ending with the date on which the property is reacquired by the seller. The period for which the property was held by the seller prior to the original sale shall be determined as provided in §1.1223-1. For example, if under paragraph (a) of §1.1223-1 real property, which was acquired as the result of an involuntary conversion, has been held for five months on January 1, 1965, the date of its sale, and such property is reacquired on July 2, 1965, and resold on July 3, 1965, the seller will be considered to have held such property for five months and one day for purposes of this subparagraph.

(h) *Illustrations.* The application of this section may be illustrated by the following examples in which it is assumed that the reacquisition is in satisfaction of secured indebtedness arising out of the sale of the real property:

Example 1. (a) S purchases real property for \$20 and sells it to P for \$100, the property not being mortgaged at the time of sale. Under the contract P pays \$10 down and executes a note for \$90, with stated interest at 6 percent, to be paid in nine annual installments.

S properly elects to report the gain on the installment method. After the second \$10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays \$5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is \$110.

(b) The gain derived by S on the reacquisition of the property is \$6, determined as follows:

Gain before application of limitation:	
Money with respect to the sale received by S prior to the reacquisition	\$30
Less: Gain returned by S as income for periods prior to the reacquisition (\$30×[(100 - \$20)/\$100])	24
Gain before application of limitation	6
Limitation on amount of gain:	
Sales price of real property	100
Less:	
Adjusted basis of the property at the time of sale	\$20
Gain returned by S as income for periods prior to the reacquisition	24
Amount of money paid by S in connection with the reacquisition	5
Limitation on amount of gain	51
Gain resulting from the reacquisition of the property	6

(c) The basis of the reacquired real property at the date of the reacquisition is \$25, determined as follows:

Adjusted basis of P's indebtedness to S (\$70 - [\$70×\$80/\$100])	\$14
Gain resulting from the reacquisition of the property	6
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	25

Example 2. (a) The facts are the same as in example (1) except that S purchased the property for \$80.

(b) The gain derived by S on the reacquisition of the property is \$9, determined as follows:

Gain before application of limitation:	
Money with respect to the sale received by S prior to the reacquisition	\$30
Less: Gain returned by S as income for periods prior to the reacquisition (\$30×[(100 - \$80)/\$100])	\$6
Gain before application of limitation	24
Limitation on amount of gain:	
Sales price of real property	100
Less:	
Adjusted basis of the property at the time of sale	\$80
Gain returned by S as income for periods prior to the reacquisition	6

Amount of money paid by S in connection with the reacquisition	5	91
Limitation on amount of gain		9
Gain resulting from the reacquisition of the property		9

(c) The basis of the reacquired real property at the date of the reacquisition is \$70, determined as follows:

Adjusted basis of P's indebtedness to S (\$70 - [\$70 × \$20/\$100])	\$56
Gain resulting from the reacquisition of the property	9
Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	70

Example 3. (a) S purchases real property for \$70 and sells it to P for \$100, the property not being mortgaged at the time of sale. Under the contract P pays \$10 down and executes a note for \$90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report the gain on the installment method. After the first \$10 annual payment P defaults and S accepts a voluntary reconveyance of the property in complete satisfaction of the indebtedness. S pays \$5 in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is \$50.

(b) The gain derived by S on the reacquisition of the property is \$14, determined as follows:

Gain before application of limitation:	
Money with respect to the sale received by S prior to the reacquisition	\$20
Less: Gain returned by S as income for periods prior to the reacquisition (\$20 × [(100 - \$70)/\$100])	6
Gain before application of limitation	14

Limitation on amount of gain:	
Sales price of real property	100
Less:	
Adjusted basis of the property at time of sale	\$70
Gain returned by S as income for periods prior to the reacquisition	6
Amount paid by S in connection with the reacquisition	5
Limitation on amount of gain	19

(c) The basis of the reacquired real property at the date of the reacquisition is \$75, determined as follows:

Adjusted basis of P's indebtedness to S (\$80 - [\$80 × \$30/\$100])	\$56
Gain resulting from the reacquisition of the property	14

Amount of money paid by S in connection with the reacquisition	5
Basis of reacquired property	75

Example 4. (a) S purchases real property for \$20 and sells it to P for \$100, the property not being mortgaged at the time of sale. Under the contract P pays \$10 down and executes a note for \$90, with stated interest at 6 percent, to be paid in nine annual installments. S properly elects to report gain on the installment method. After the second \$10 annual payment P defaults and S accepts from P in complete satisfaction of the indebtedness a voluntary reconveyance of the property plus cash in the amount of \$20. S does not pay any amount in connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is \$30.

(b) The gain derived by S on the reacquisition of the property is \$10, determined as follows:

Gain before application of the limitation:	
Money with respect to the sale received by S prior to the reacquisition (\$30 + \$20)	\$50
Less: Gain returned by S as income for periods prior to the reacquisition (\$50 × [(100 - \$20)/\$100])	40
Gain before application of limitation	10

Limitation on amount of gain:	
Sales price of real property	100
Less:	
Adjusted basis of the property at time of sale	\$20
Gain returned by S as income for periods prior to the reacquisition	40
Limitation on amount of gain	60

Gain resulting from the reacquisition of the property	10
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(c) The basis of the reacquired real property at the date of the reacquisition is \$20, determined as follows:

Adjusted basis of P's indebtedness to S (\$50 - [\$50 × \$80/\$100])	\$10
Gain resulting from the reacquisition of the property	10
Basis of reacquired property	20

Example 5. (a) S purchases real property for \$80 and sells it to P for \$100, the property not being mortgaged at the time of sale. Under the contract P pays \$10 down and executes a note for \$90, with stated interest at 6 percent, to be paid in nine annual installments. At the time of sale P's note has a fair market value of \$90. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale. After the third \$10 annual payment P defaults and S forecloses. Under the foreclosure sale S bids in the property at \$70, cancels P's obligation of \$60, and pays \$10 to P. There are no other amounts paid by S in

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connection with the reacquisition of the property. The fair market value of the property at the time of the reacquisition is \$70.

(b) The gain derived by S on the reacquisition of the property is \$0, determined as follows:

Gain before application of the limitation:		
Money with respect to the sale received by S prior to the reacquisition		\$40
Less: Gain returned by S as income for periods prior to the reacquisition (\$10+\$90) - \$80	20	
Gain before application of limitation	20	
Limitation on amount of gain:		
Sales price of real property		100
Less:		
Adjusted basis of the property at the time of sale	\$80	
Gain returned by S as income for periods prior to the reacquisition	20	
Amount of money paid by S in connection with the reacquisition	10	110
Limitation on amount of gain (not to be less than zero)		0
Gain resulting from the reacquisition of the property		0
(c) The basis of the reacquired real property at the date of the reacquisition is \$70, determined as follows:		
Adjusted basis of P's indebtedness to S (face value at time of reacquisition)		\$60
Gain resulting from the reacquisition of the property		0
Amount of money paid by S in connection with the reacquisition	10	
Basis of reacquired property		70

[T.D. 6916, 32 FR 5925, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038-2 Reacquisition and resale of property used as a principal residence.

(a) *Application of special rules*—(1) *In general.* If paragraph (a) of § 1.1038-1 applies to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034, the provisions of § 1.1038-1 (other than paragraph (a) thereof) shall not, and this section shall, apply to the reacquisition of such property if the property is resold by the seller within one year after the date of the reacquisition. For purposes of this section an election under section 121 shall be considered to be in effect with respect to the sale of the

property if, at the close of the last day for making such an election under section 121(c) with respect to such sale, an election under section 121 has been made and not revoked. Thus, a taxpayer who properly elects, subsequent to the reacquisition, to have section 121 apply to a sale of his residence may be eligible for the treatment provided in this section. The treatment provided by this section is mandatory; however, see § 1.1038-3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957.

(2) *Sale and resale treated as one transaction.* In the case of a reacquisition to which this section applies, the resale of the reacquired property shall be treated, for purposes of applying sections 121 and 1034, as part of the transaction constituting the original sale of such property. In effect, the reacquisition is generally disregarded pursuant to this section and, for purposes of applying sections 121 and 1034, the resale of the property is considered to constitute a sale of such property occurring on the date of the original sale of such property.

(b) *Transactions not included.* (1) If with respect to the original sale of the property there was no nonrecognition of gain under section 1034 and an election under section 121 is not in effect, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition. Thus, for example, if in the case of a taxpayer not entitled to the benefit of section 121 there is no gain on the original sale of the property, the provisions of § 1.1038-1, and not this section, shall apply even though a redetermination of gain under this section would result in the nonrecognition of gain on the sale under section 1034. Also, if in the case of such a taxpayer there was gain on the original sale of the property but after the application of section 1034 all of such gain was recognized, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition.

(2) If the original sale of the property was not eligible for the treatment provided by section 121 and section 1034, the provisions of § 1.1038-1, and not this section, shall apply to the reacquisition of the property even though the

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resale of such property is eligible for the treatment provided by either or both of sections 121 and 1034.

(c) *Redetermination of gain required—*

(1) *Sale of old residence.* The amount of gain excluded under section 121 on the sale of the property and the amount of gain recognized under section 1034 on the sale of the property shall be redetermined under this section by recomputing the adjusted sales price and the adjusted basis of the property, and any adjustments resulting from the redetermination of the gain on the sale of such property shall be reflected in the income of the seller for his taxable year in which the resale of the property occurs.

(2) *Sale of new residence.* If gain was not recognized under section 1034 on the original sale of the property, the adjusted basis of the new residence shall be redetermined under this section. If the new residence has been sold, the amount of gain returned on such sale of the new residence which is affected by the redetermination of the recognized gain on the sale of the old residence shall be redetermined under this section, and any adjustments resulting from the redetermination of the gain on the sale of the new residence shall be reflected in income of the seller for his taxable year in which the resale of the old residence occurs.

(d) *Redetermination of adjusted sales price.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted sales price of the reacquired real property shall be redetermined by taking into account both the sale and the resale of the property and shall be—

(1) The amount realized, which for purposes of section 1001 shall be—

(i) The amount realized on the resale of the property, as determined under paragraph (b)(4) of § 1.1034-1, plus

(ii) The amount realized on the original sale of the property, determined as provided in paragraph (b)(4) of § 1.1034-1, less that portion of any obligations of the purchaser arising with respect to such sale which at the time of reacquisition is secured by such property and is unpaid, less

(iii) The amount of money and the fair market value of other property (other than obligations of the pur-

chaser to the seller secured by the real property) paid or transferred by the seller in connection with the reacquisition of such real property, reduced by

(2) The total of the fixing-up expenses (as defined in par. (b)(6) of § 1.1034-1) incurred for work performed on such real property to assist in both its original sale and its resale.

For purposes of applying paragraph (b)(6) of § 1.1034-1, there shall be two 90-day periods, the first ending on the day on which the contract to sell is entered into in connection with the original sale of the property, and the second ending on the day on which the contract to sell is entered into in connection with the resale of the property. There shall also be two 30-day periods for such purposes, the first ending on the 30th day after the date of the original sale, and the second ending on the 30th day after the date of the resale. For determination of the obligations of the purchaser arising with respect to the original sale of the property, see paragraph (b)(3) of § 1.1038-1. For determination of amounts paid or transferred by the seller in connection with the reacquisition of the property, see paragraph (c)(4) of § 1.1038-1.

(e) *Determination of adjusted basis at time of resale.* For purposes of applying sections 121 and 1034 pursuant to this section, the adjusted basis of the reacquired real property at the time of its resale shall be—

(1) The sum of—

(i) The adjusted basis of such property at the time of the original sale, with proper adjustment under section 1016(a) in respect of such property for the period occurring after the reacquisition of such property, and

(ii) Any indebtedness of the purchaser to the seller which arose subsequent to the original sale of such property and which at the time of reacquisition was secured by such property, reduced by

(2) Any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by the reacquired real property and which, for any taxable year ending before the taxable year in which occurs the reacquisition to the seller which was secured by the

seller as having become worthless or partially worthless by taking a bad debt deduction under section 166(a).

The reduction under the preceding sentence by reason of having treated indebtedness as worthless or partially worthless shall not exceed the amount by which there would be an increase in the basis of such indebtedness under paragraph (f)(3) of §1.1038-1 if section 1038(d) had been applicable to the reacquisition of such property.

(f) *Treatment of indebtedness secured by the property*—(1) *Year of reacquisition.* No debt of the purchaser to the seller which was secured by the reacquired real property shall be considered as becoming worthless or partially worthless as a result of a reacquisition of such real property to which this section applies. Accordingly, no deduction for a bad debt shall be allowed, as a result of the reacquisition, in order to reflect the noncollectibility of any indebtedness of the purchaser to the seller which at the time of reacquisition was secured by such real property. In addition, no deduction shall be allowed, for the taxable year in which occurs a reacquisition of real property to which this section applies, in respect of any indebtedness of the purchaser secured by such property which has been treated by the seller as having become worthless or partially worthless in such taxable year but prior to the date of such reacquisition.

(2) *Prior taxable years.* For reduction of the basis of the real property for indebtedness treated as worthless or partially worthless for taxable years ending before the taxable year in which occurs the reacquisition, see paragraph (e) of this section.

(3) *Basis of indebtedness.* The basis of any indebtedness of the purchaser to the seller which was secured by the reacquired real property, to the extent that such indebtedness is not discharged upon the reacquisition of such property, shall be zero.

(g) *Date of sale.* Since the resale of the property, by being treated as part of the transaction constituting the original sale of the property, is treated as having occurred on the date of the original sale, in determining whether any of the time requirements of section 121 or section 1034 are satisfied for pur-

poses of this section the date of the original sale is used, except to the extent provided in paragraph (d)(2) of this section.

(h) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. (a) On June 30, 1964, S, a single individual over 65 years of age, sells his principal residence to P for \$25,000, the property not being mortgaged at the time of sale. S properly elects to apply the provisions of section 121 to the sale. Under the contract, P pays \$5,000 down and executes a note for \$20,000 with stated interest at 6 percent, the principal being payable in installments of \$5,000 each on January 1 of each year and the note being secured by the real property which is sold. At the time of sale P's note has a fair market value of \$20,000. S does not elect to report the gain on the installment method but treats the transaction as a deferred-payment sale, title to the property being transferred to P at the time of sale. S uses the calendar year as the taxable year and the cash receipts and disbursements method of accounting. After making two annual payments of \$5,000 each on the note, P defaults on the contract, and on March 1, 1967, S reacquires the real property in full satisfaction of P's indebtedness, title to the property being voluntarily reconveyed to S. On November 1, 1967, S sells the property to T for \$35,000. The assumption is made that no fixing-up expenses are incurred for work performed on the principal residence in order to assist in the sale of the property in 1964 or in the resale of the property in 1967. At the time of sale in 1964 the property has an adjusted basis of \$15,000. S does not treat any indebtedness with respect to the sale in 1964 as being worthless or partially worthless or make any capital expenditures with respect to the property after such sale. In his return for 1964, S includes in income \$2,000 capital gain from the sale of his residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Adjusted sales price:		
\$5,000+\$20,000	\$25,000	.....
\$15,000+\$35,000 .....	.....	\$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121:		
\$10,000×\$20,000/\$25,000	8,000
\$35,000×\$20,000/\$50,000	14,000

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	Before reacquisition	After reacquisition
Gain included in income after applying section 121:		
\$10,000 - \$8,000	2,000	.....
\$35,000 - \$14,000 .....	.....	21,000

(c) S is required to show the additional inclusion of \$19,000 capital gain (\$21,000 - \$2,000) in income on his return for 1967.

Example 2. (a) The facts are the same as in example (1) except that on April 1, 1965, S purchases a new residence at a cost of \$30,000 and qualifies for the nonrecognition of gain under section 1034 in respect of the sale of his principal residence on June 30, 1964. In his return for 1964, S does not include any capital gain in income as a result of the sale of the old residence.

(b) The results obtained before and after the reacquisition of the property are as follows:

	Before reacquisition	After reacquisition
Application of section 121 (see example (1)):		
Adjusted sales price	\$25,000	\$50,000
Less: Adjusted basis of property at time of sale	15,000	15,000
Gain on sale	10,000	35,000
Gain excluded from income under section 121	8,000	14,000
Gain not excluded from income under section 121	2,000	21,000
Application of section 1034: Adjusted sales price:		
\$25,000 - \$8,000	17,000	.....
\$50,000 - \$14,000 .....	.....	36,000
Less: Cost of new residence	30,000	30,000
Gain recognized under section 1034 on sale of old residence	0	6,000
Gain not recognized under section 1034 on sale of old residence:		
(\$10,000 - [\$8,000 + \$0])	2,000	.....
(\$35,000 - [\$14,000 + \$6,000]) .....	.....	15,000
Adjusted basis of new residence on April 1, 1965:		
\$30,000 - \$2,000	28,000	.....
\$30,000 - \$15,000 .....	.....	15,000

(c) The \$6,000 of capital gain on the sale of the old residence is required to be included in income on the return for 1967. The adjusted basis on April 1, 1965, for determining gain on a sale or exchange of the new residence at any time on or after that date is \$15,000, after taking into account the reacquisition and resale of the old residence.

Example 3. The facts are the same as in example (2) except that S sells the new residence on June 20, 1965, for \$40,000 and includes \$12,000 of capital gain (\$40,000 - \$28,000) on its sale in his income on the return for 1965. S is required to include the ad-

ditional capital gain of \$13,000 [(\$40,000 - \$15,000) - \$12,000] on the sale of the new residence in his income on the return for 1967. For this purpose, the assumption is also made that there are no additional adjustments to the basis of the new residence after April 1, 1965.

[T.D. 6916, 32 FR 5929, Apr. 13, 1967; 32 FR 6971, May 6, 1967]

§ 1.1038-3 Election to have section 1038 apply for taxable years beginning after December 31, 1957.

(a) *In general.* If an election is made in the manner provided by paragraph (b) of this section, the applicable provisions of §§ 1.1038-1 and 1.1038-2 shall apply to all reacquisitions of real property occurring in each and every taxable year beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law. The election so made shall apply to all taxable years beginning after December 31, 1957, and before September 3, 1964, for which the assessment of a deficiency, or the credit or refund of an overpayment, is not prevented on September 2, 1964, by the operation of any law or rule of law and shall apply to every reacquisition occurring in such taxable years. The fact that the assessment of a deficiency, or the credit or refund of an overpayment, is prevented for any other taxable year or years affected by the election will not prohibit the making of an election under this section. For example, if an individual who uses the calendar year as the taxable year were to sell in 1960 real property used as his principal residence in respect of the sale of which gain is not recognized under section 1034, and if such property were reacquired by the seller in 1962 and resold within 1 year, he would be permitted to make an election under this section with respect to such reacquisition even though on September 2, 1964, the period of limitations on assessment or refund has run for 1960. An election under this section shall be deemed a consent to the application of the provisions of this section.

(b) *Time and manner of making election*—(1) *In general.* (i) An election to have the provisions of § 1.1038-2 apply

to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which the resale of such real property occurs. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(ii) An election to have the provisions of §1.1038-1 apply to reacquisitions of real property occurring in taxable years beginning after December 31, 1957, and before September 3, 1964, shall be made by filing on or before September 3, 1965, a return, an amended return, or a claim for refund, whichever is proper, for each taxable year in which such reacquisitions occur. If the return for any such year is not due on or before such date and has not been filed, the election with respect to such taxable year shall be made by filing on or before such date the statement described in subparagraph (2) of this paragraph.

(iii) If the facts are such that §1.1038-2 applies to a reacquisition of property except that the reacquisition occurs in a taxable year beginning after December 31, 1957, and before September 3, 1964, an election may not be made under this paragraph to have the provisions of §1.1038-1 apply to such reacquisition.

(iv) Once made, an election under this paragraph may not be revoked after September 3, 1965. To any return, amended return, or claim for refund filed under this subparagraph there shall be attached the statement described in subparagraph (2) of this paragraph.

(2) *Statement to be attached.* The statement described in subparagraph (1) of this paragraph shall indicate—

(i) The name, address and account number of the taxpayer, and the fact that the taxpayer is electing to have the provisions of section 1038 apply to the reacquisitions of real property,

(ii) The taxable years in which the reacquisitions of property occur and any other taxable year or years the tax for which is affected by the application of section 1038 to such reacquisitions,

(iii) The office of the district director where the return or returns for such taxable year or years were or will be filed,

(iv) The dates on which such return or returns were filed and on which the tax for such taxable year or years was paid,

(v) The type of real property reacquired, the terms under which such property was sold and reacquired, and an indication of whether the taxpayer is applying the provisions of §1.1038-2 to the reacquisition of such property,

(vi) If §1.1038-2 is being applied to the reacquisition, the terms under which the old residence was resold and, if applicable, the terms under which the new residence was sold, and

(vii) The office where, and the date when, the election to apply section 121 in respect to any sale of such property was or will be made.

(3) *Place for filing.* Any claim for refund, amended return, or statement, filed under this paragraph in respect of any taxable year, whether the taxable year in which occurs the reacquisition of property or the taxable year in which occurs the resale of the old residence, shall be filed in the office of the district director in which the return for such taxable year was or will be filed.

(c) *Extension of period of limitations on assessment or refund*—(1) *Assessment of tax.* If an election is properly made under paragraph (b) of this section and the assessment of a deficiency for the taxable years to which such election applies is not prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a deficiency for such taxable years may be assessed shall, to the extent such deficiency is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(2) *Refund of tax.* If an election is properly made under paragraph (b) of this section and the credit or refund of any overpayment for the taxable years to which such election applies is not

prevented on September 2, 1964, by the operation of any law or rule of law, the period within which a claim for credit or refund of an overpayment for such taxable years may be filed shall, to the extent such overpayment is attributable to the application of section 1038, not expire prior to one year after the date on which such election is made.

(d) *Payment of interest for period prior to September 2, 1964.* No interest shall be payable with respect to any deficiency attributable to the application of the provisions of section 1038, and no interest shall be allowed with respect to any credit or refund of any overpayment attributable to the application of such section, for any period prior to September 2, 1964. See section 2(c)(3) of the Act of September 2, 1964 (Pub. L. 88-750, 78 Stat. 856).

[T.D. 6916, 32 FR 5930, Apr. 13, 1967]

§ 1.1039-1 Certain sales of low-income housing projects.

(a) *Nonrecognition of gain.* Section 1039 provides rules under which the taxpayer may elect not to recognize gain in certain cases where a qualified housing project is sold or disposed of after October 9, 1969, in an approved disposition and another such qualified housing project or projects (referred to as the *replacement project*) is acquired, constructed, or reconstructed within a specified reinvestment period. If the requirements of section 1039 are met, and if the taxpayer makes an election in accordance with the provisions of paragraph (b)(4) of this section, then the gain realized upon the sale or disposition is recognized only to the extent that the net amount realized on such sale or disposition exceeds the cost of the replacement project. However, notwithstanding section 1039, gain may be recognized by reason of the application of section 1245 or 1250 to the sale or disposition. (See § 1.1245-6(b) and § 1.1250-3(h). The terms *qualified housing project*, *approved disposition*, *reinvestment period*, and *net amount realized* are defined in paragraph (c) of this section.

(b) *Rules of application*—(1) *In general.* The election under section 1039(a) may be made only by the taxpayer owning the qualified housing project disposed of. Thus, if the qualified housing

project disposed of is owned by a partnership, the partnership must make the election. (See section 703(b).) Similarly, if the qualified housing project disposed of is owned by a corporation or trust, the corporation or trust must make the election. In addition, the reinvestment of the taxpayer must be in such a manner that the taxpayer would be entitled to a deduction for depreciation on the replacement project. Thus, if the qualified housing project disposed of is owned by individual A, the purchase by A of stock in a corporation owning or constructing such a project or of an interest in a partnership owning or constructing such a project will not be considered as the purchase or construction by A of such a project.

(2) *Special rules.* (i) The cost of a replacement project acquired before the approved disposition of a qualified housing project shall be taken into account under section 1039 only if such property is held by the taxpayer on the date of the approved disposition.

(ii) Except as provided in section 1039(d), no property acquired by the taxpayer shall be taken into account for purposes of section 1039(a)(2) unless the unadjusted basis of such property is its cost within the meaning of section 1012. For example, if a qualified housing project is acquired in an exchange under section 1031, relating to exchange of property held for productive use or investment, such property will not be taken into account under section 1039(a)(2) because its basis is determined by reference to the basis of the property exchanged. (See section 1031(d).)

(3) *Cost of replacement project.* The taxpayer's cost for the replacement project includes only amounts properly treated as capital expenditures by the taxpayer that are attributable to acquisition, construction, or reconstruction made within the reinvestment period (as defined in paragraph (c)(4) of this section). See section 263 for rules as to what constitutes capital expenditures. Thus, assume that a calendar year taxpayer realizes gain in 1970 upon the approved disposition of a qualified housing project occurring on January 1, 1970. If the taxpayer had begun construction of another qualified housing

project on January 1, 1969, and completes such construction on June 1, 1972, only that portion of the cost attributable to the period before January 1, 1972, constitutes the cost of the replacement project for purposes of section 1039. For purposes of determining the cost of a replacement project attributable to a particular period, the total cost of the project may be allocated to such period on the basis of the portion of the total project actually constructed during such period.

(4) *Election.* (i) An election not to recognize the gain realized upon an approved disposition of a qualified housing project to the extent provided in section 1039(a) may be made by attaching a statement to the income tax return filed for the first taxable year in which any portion of the gain on such disposition is realized. Such a statement shall contain the information required by subdivision (iii) of this subparagraph. If the taxpayer does not file such a statement for the first taxable year in which any portion of the gain is realized, but fails to report a portion of the gain realized upon the approved disposition as income for such year or for any subsequent taxable year, then an election shall be deemed to be made under section 1039 (a) with respect to that portion of the gain not reported as income.

(ii) An election may be made under section 1039(a) even though the replacement project has not been acquired or constructed at the time of election. However, if an election has been made and (a) a replacement project is not constructed, reconstructed, or acquired, (b) the cost of the replacement project is lower than the net amount realized from the approved disposition, or (c) a decision is made not to construct, reconstruct, or acquire a replacement project, then the tax liability for the year or years for which the election was made shall be recomputed and an amended return filed. An election may be made even though the taxpayer has filed his return and recognized gain upon the disposition provided that the period of limitation on filing claims for credit or refund prescribed by section 6511 has not expired. In such case, a statement containing the information required by subdivi-

sion (iii) of this subparagraph should be filed together with a claim for credit or refund for the taxable year or years in which gain was recognized.

(iii) The statement referred to in subdivisions (i) and (ii) of this subparagraph shall contain the following information:

(a) The date of the approved disposition;

(b) If a replacement project has been acquired, the date of acquisition and cost of the project;

(c) If a replacement project has been constructed or reconstructed by or for the taxpayer, the date construction was begun, the date construction was completed, and the percentage of construction completed within the reinvestment period;

(d) If no replacement project has been constructed, reconstructed, or acquired prior to the time of filing of the statement, the estimated cost of such construction, reconstruction, or acquisition;

(e) The adjusted basis of the project disposed of; and

(f) The amount realized upon the approved disposition and a description of the expenses directly connected with the disposition and the taxes (other than income taxes) attributable to the disposition.

(c) *Definitions*—(1) *General.* The definitions contained in subparagraphs (2) through (5) of this paragraph shall apply for purposes of this section.

(2) *Qualified housing project.* The term *qualified housing project* means a rental or cooperative housing project for lower income families that has been constructed, reconstructed, or rehabilitated pursuant to a mortgage which is insured under section 221(d)(3) or 236 of the National Housing Act, provided that with respect to the housing project disposed of and the replacement project constructed, reconstructed, or acquired, the owner of the project at the time of the approved disposition and prior to the close of the reinvestment period is, under such sections or regulations issued thereunder,

(i) Limited as to rate of return on his investment in the project, and

(ii) Limited as to rentals or occupancy charges for units in the project.

If the owner of the project is organized and operated as a nonprofit cooperative or other nonprofit organization, then such owner shall be considered to meet the requirement of subdivision (i) of this subparagraph.

(3) *Approved disposition.* The term *approved disposition* means a sale or other disposition of a qualified housing project to the tenants or occupants of units in such project, or to a nonprofit cooperative or other nonprofit organization formed and operated solely for the benefit of such tenants or occupants, provided that it is approved by the Secretary of Housing and Urban Development or his delegate under section 221 (d)(3) or 236 of the National Housing Act or regulations issued under such sections. Evidence of such approval should be attached to the tax return or statement in which the election under section 1039 is made.

(4) *Reinvestment period.* (i) The term *reinvestment period* means the period beginning 1 year before the date of the disposition and ending 1 year after the close of the first taxable year in which any part of the gain from such disposition is realized, or at such later date as may be designated pursuant to an application made by the taxpayer. Such application shall be made before the expiration of one year after the close of the first taxable year in which any part of the gain from such disposition is realized, unless the taxpayer can show to the satisfaction of the district director that—

(a) Reasonable cause exists for not having filed the application within the required period, and

(b) The filing of such application was made within a reasonable time after the expiration of the required period.

The application shall contain all the information required by paragraph (b)(4) of this section and shall be made to the district director for the internal revenue district in which the return is filed for the first taxable year in which any of the gain from the approved disposition is realized.

(ii) Ordinarily, requests for extension of the reinvestment period will not be granted until near the end of such period and any extension will usually be limited to a period not exceeding one year. Although granting of an exten-

sion depends upon the facts and circumstances of a particular case, if a predominant portion of the construction of the replacement project has been completed or is reasonably expected to be completed within the reinvestment period (determined without regard to any extension thereof), an extension of the reinvestment period will ordinarily be granted. The fact that there is a scarcity of replacement property for acquisition will not be considered sufficient grounds for granting an extension.

(5) *Net amount realized.* (i) The *net amount realized* from the approved disposition of a qualified housing project is the amount realized from such disposition, reduced by—

(a) The expenses paid or incurred by the taxpayer which are directly connected with the approved disposition, and

(b) The amount of taxes (other than income taxes) paid or incurred by the taxpayer which are attributable to the approved disposition.

(ii) Examples of expenses directly connected with an approved disposition of a qualified housing project include amounts paid for sales or other commissions, advertising, and for the preparation of a deed or other legal services in connection with the disposition. An amount paid for a repair to the building will be considered as an expense directly connected with the approved disposition under subdivision (i)(a) of this subparagraph only if such repair is required as a condition of sale, or is required by the Secretary of Housing and Urban Development or his delegate as a condition of approval of the disposition.

(iii) Examples of taxes that are attributable to the approved disposition include local property transfer taxes and stamp taxes. A local real property tax is not so attributable.

(d) *Basis and holding period of replacement project*—(1) *Basis.* If the taxpayer makes an election under section 1039, the basis of the replacement housing project shall be its cost (including costs incurred subsequent to the reinvestment period) reduced by the amount of gain not recognized under section 1039 (a). If the replacement consists of more than one housing project,

the basis determined under this subparagraph shall be allocated to the properties in proportion to their respective costs.

(2) *Holding period.* The holding period of the replacement housing project shall begin on the date the taxpayer acquires such project, that is, on the date the taxpayer first acquires possession or control of such project and bears the burdens and enjoys the benefits of ownership of the replacement project. (For special rule regarding the holding period of property for purposes of section 1250, see section 1250(e)(4).)

(e) *Assessment of deficiencies*—(1) *Deficiency attributable to gain.* If a taxpayer makes an election under section 1039(a) with respect to an approved disposition, any deficiency attributable to the gain on such disposition, for any taxable year in which any part of such gain is realized, may be assessed at any time before the expiration of 3 years after the date the district director or director of the regional service center with whom the return for such year has been filed is notified by the taxpayer of the acquisition or the completion of construction or reconstruction of the replacement qualified housing project or of the failure to acquire, construct, or reconstruct a replacement qualified housing project, as the case may be. Such a deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment. If replacement has been made, such notification shall contain the information required by paragraph (b)(4)(iii) of this section. Such notification shall be attached to the return filed for the taxable year or years in which the replacement occurs, or in which the period for the replacement expires, and a copy of such notification shall be filed with the district director or director of regional service center with whom the election under section 1039(a) was required to be filed, if the return is not filed with such director.

(2) *Deficiency attributable to election.* If gain upon an approved disposition is realized in two (or more) taxable years, and the replacement qualified housing project was acquired, constructed, or

reconstructed before the beginning of the last such year, any deficiency, for any taxable year before such last year, which is attributable to an election by the taxpayer under section 1039(a) may be assessed at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed, notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any law or rule of law which would otherwise prevent such assessment. Thus, if gain upon an approved disposition is realized in 1971 and 1975, and if a replacement project is purchased in 1971, any deficiency for 1971 may be assessed within the period for assessing a deficiency for 1975.

[T.D. 7191, 37 FR 12951, June 30, 1972; 37 FR 14385, July 20, 1972, as amended by T.D. 7400, 41 FR 5101, Feb. 4, 1976]

§ 1.1041-1T Treatment of transfer of property between spouses or incident to divorce (temporary).

Q-1: How is the transfer of property between spouses treated under section 1041?

A-1: Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if the transfer is incident to a divorce, a former spouse. The following questions and answers describe more fully the scope, tax consequences and other rules which apply to transfers of property under section 1041.

(a) *Scope of section 1041 in general.*

Q-2: Does section 1041 apply only to transfers of property incident to divorce?

A-2: No. Section 1041 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange otherwise governed by another nonrecognition provision of the Code). A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.

Example 1. A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer which is subject to the rules of section 1041.

Example 2. A and B are married and file separate returns. A is the owner of an independent sole proprietorship, X Company. In the ordinary course of business, X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of section 1041.

Example 3. Assume the same facts as in example (2), except that X Company is a corporation wholly owned by A. This sale is not a sale between spouses subject to the rules of section 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction.

Q-3: Do the rules of section 1041 apply to a transfer between spouses if the transferee spouse is a nonresident alien?

A-3: No. Gain or loss (if any) is recognized (assuming no other nonrecognition provision applies) at the time of a transfer of property if the property is transferred to a spouse who is a nonresident alien.

Q-4: What kinds of transfers are governed by section 1041?

A-4: Only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041. Transfers of services are not subject to the rules of section 1041.

Q-5: Must the property transferred to a former spouse have been owned by the transferor spouse during the marriage?

A-5: No. A transfer of property acquired after the marriage ceases may be governed by section 1041.

(b) *Transfer incident to the divorce.*

Q-6: When is a transfer of property *incident to the divorce*?

A-6: A transfer of property is *incident to the divorce* in either of the following 2 circumstances—

(1) The transfer occurs not more than one year after the date on which the marriage ceases, or

(2) The transfer is related to the cessation of the marriage.

Thus, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for section 1041 treatment. (See A-7 for transfers occurring

more than one year after the cessation of the marriage.)

Q-7: When is a transfer of property *related to the cessation of the marriage*?

A-7: A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

Q-8: Do annulments and the cessations of marriages that are void *ab initio* due to violations of state law constitute divorces for purposes of section 1041?

A-8: Yes.

(c) *Transfers on behalf of a spouse.*

Q-9: May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9: Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written

request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for non-recognition of gain under section 1041. This A-9 shall not apply to transfers to which § 1.1041-2 applies.

(d) *Tax consequences of transfers subject to section 1041.*

Q-10: How is the transferor of property under section 1041 treated for income tax purposes?

A-10: The transferor of property under section 1041 recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration. This rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property. Thus, the result under section 1041 differs from the result in *United States v. Davis*, 370 U.S. 65 (1962).

Q-11: How is the transferee of property under section 1041 treated for income tax purposes?

A-11: The transferee of property under section 1041 recognizes no gain or loss upon receipt of the transferred property. In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. Even if the transfer is a bona fide sale, the transferee does not acquire a basis in the transferred prop-

erty equal to the transferee's cost (the fair market value). This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in section 1015(a) for determining the basis of property acquired by gift.

Q-12: Do the rules described in A-10 and A-11 apply even if the transferred property is subject to liabilities which exceed the adjusted basis of the property?

A-12: Yes. For example, assume A owns property having a fair market value of \$10,000 and an adjusted basis of \$1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows \$5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the \$5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is \$1,000.

Q-13: Will a transfer under section 1041 result in a recapture of investment tax credits with respect to the property transferred?

A-13: In general, no. Property transferred under section 1041 will not be treated as being disposed of by, or ceasing to be section 38 property with respect to, the transferor. However, the transferee will be subject to investment tax credit recapture if, upon or after the transfer, the property is disposed of by, or ceases to be section 38 property with respect to, the transferee. For example, as part of a divorce property settlement, B receives a car from A that has been used in A's business for two years and for which an investment tax credit was taken by A. No part of A's business is transferred to B and B's use of the car is solely personal. B is subject to recapture of the investment tax credit previously taken by A.

(e) *Notice and recordkeeping requirement with respect to transactions under section 1041.*

Q-14: Does the transferor of property in a transaction described in section 1041 have to supply, at the time of the transfer, the transferee with records sufficient to determine the adjusted basis and holding period of the property at the time of the transfer and (if applicable) with notice that the property transferred under section 1041 is potentially subject to recapture of the investment tax credit?

A-14: Yes. A transferor of property under section 1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer. In addition, in the case of a transfer of property which carries with it a potential liability for investment tax credit recapture, the transferor must, at the time of the transfer, supply the transferee with records sufficient to determine the amount and period of such potential liability. Such records must be preserved and kept accessible by the transferee.

(f) *Property settlements—effective dates, transitional periods and elections.*

Q-15: When does section 1041 become effective?

A-15: Generally, section 1041 applies to all transfers after July 18, 1984. However, it does not apply to transfers after July 18, 1984 pursuant to instruments in effect on or before July 18, 1984. (See A-16 with respect to exceptions to the general rule.)

Q-16: Are there any exceptions to the general rule stated in A-15 above?

A-16: Yes. Two transitional rules provide exceptions to the general rule stated in A-15. First, section 1041 will apply to transfers after July 18, 1984 under instruments that were in effect on or before July 18, 1984 if both spouses (or former spouses) elect to have section 1041 apply to such transfers. Second, section 1041 will apply to all transfers after December 31, 1983 (including transfers under instruments in effect on or before July 18, 1984) if both spouses (or former spouses) elect to have section 1041 apply. (See A-18 relating to the time and manner of mak-

ing the elections under the first or second transitional rule.)

Q-17: Can an election be made to have section 1041 apply to some, but not all, transfers made after December 31, 1983, or some but not all, transfers made after July 18, 1984 under instruments in effect on or before July 18, 1984?

A-17: No. Partial elections are not allowed. An election under either of the two elective transitional rules applies to all transfers governed by that election whether before or after the election is made, and is irrevocable.

(g) *Property settlements—time and manner of making the elections under section 1041.*

Q-18: How do spouses (or former spouses) elect to have section 1041 apply to transfers after December 31, 1983, or to transfers after July 18, 1984 under instruments in effect on or before July 18, 1984?

A-18: In order to make an election under section 1041 for property transfers after December 31, 1983, or property transfers under instruments that were in effect on or before July 18, 1984, both spouses (or former spouses) must elect the application of the rules of section 1041 by attaching to the transferor's first filed income tax return for the taxable year in which the first transfer occurs, a statement signed by both spouses (or former spouses) which includes each spouse's social security number and is in substantially the form set forth at the end of this answer.

In addition, the transferor must attach a copy of such statement to his or her return for each subsequent taxable year in which a transfer is made that is governed by the transitional election. A copy of the signed statement must be kept by both parties.

The election statements shall be in substantially the following form:

In the case of an election regarding transfers after 1983:

SECTION 1041 ELECTION

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after December 31, 1983. The undersigned understand that section 1041 applies to all property transferred between

spouses, or former spouses incident to divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

In the case of an election regarding preexisting decrees:

SECTION 1041 ELECTION

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after July 18, 1984 under any instrument in effect on or before July 18, 1984. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to the divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

(Secs. 1041(d)(4), (98 Stat. 798, 26 U.S.C. 1041(d)(4)), 152(e)(2)(A) (98 Stat. 802, 26 U.S.C. 152(e)(2)(A)), 215(c) (98 Stat. 800, 26 U.S.C. 215(c)) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954)

[T.D. 7973, 49 FR 34452, Aug. 31, 1984; T.D. 9035, 68 FR 1536, Jan. 13, 2003]

§ 1.1041-2 Redemptions of stock.

(a) *In general*—(1) *Redemptions of stock not resulting in constructive distributions.* Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock

owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (non-transferor spouse), then the form of the stock redemption shall be respected for Federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.

(2) *Redemptions of stock resulting in constructive distributions.* Notwithstanding Q&A-9 of § 1.1041-1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(b) *Tax consequences*—(1) *Transfers described in paragraph (a)(1) of this section.* Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this section. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(2) *Transfers described in paragraph (a)(2) of this section.* The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually

made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(c) *Special rules in case of agreements between spouses or former spouses—(1) Transferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) *Nontransferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for

purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for Federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(3) *Execution of agreements.* For purposes of this paragraph (c), a divorce or separation instrument must be effective, or a valid written agreement must be executed by both spouses or former spouses, prior to the date on which the transferor spouse (in the case of paragraph (c)(1) of this section) or the nontransferor spouse (in the case of paragraph (c)(2) of this section) files such spouse's first timely filed Federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

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

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for \$100x. Corporation X redeems A's shares for \$100x. Assume that, under applicable tax law, B has a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption results in a constructive distribution to B. Also assume that the special rule of paragraph (c)(1) of this section does not apply. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for \$100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the \$100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as *Example 1*, except that the divorce instrument provides as follows: “A and B agree that the redemption will be treated for Federal income tax purposes as a redemption distribution to A.” The divorce instrument further provides that it “supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.” By virtue of the special rule of paragraph (c)(1) of this section and under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A’s shares by Corporation X and shall not be treated as resulting in a constructive distribution to B. See section 302.

Example 3. Assume the same facts as *Example 1*, except that the divorce instrument requires A to sell A’s shares to Corporation X in exchange for a note. B guarantees Corporation X’s payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A’s stock, and therefore the stock redemption does not result in a constructive distribution to B. Also assume that the special rule of paragraph (c)(2) of this section does not apply. Accordingly, under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A’s shares by Corporation X. See section 302.

Example 4. Assume the same facts as *Example 3*, except that the divorce instrument provides as follows: “A and B agree the redemption shall be treated, for Federal income tax purposes, as resulting in a constructive distribution to B.” The divorce instrument further provides that it “supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.” By virtue of the special rule of paragraph (c)(2) of this section, the redemption is treated as resulting in a constructive distribution to B for purposes of paragraph (a)(2) of this section. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A’s stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for a note in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the note to A in a transfer to which section 1041 applies.

(e) *Effective date.* Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock

on or after January 13, 2003, except for redemptions of stock that are pursuant to instruments in effect before January 13, 2003. For redemptions of stock before January 13, 2003 and redemptions of stock that are pursuant to instruments in effect before January 13, 2003, see § 1.1041-1T(c), A-9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (e) if the spouses or former spouses execute a written agreement on or after August 3, 2001 that satisfies the requirements of one of the special rules in paragraph (c) of this section with respect to such redemption. A divorce or separation instrument or valid written agreement executed on or after August 3, 2001, and before May 13, 2003 that meets the requirements of the special rule in Regulations Project REG-107151-00 published in 2001-2 C.B. 370 (see § 601.601(d)(2) of this chapter) will be treated as also meeting the requirements of the special rule in paragraph (c)(2) of this section.

[T.D. 9035, 68 FR 1536, Jan. 13, 2003]

§ 1.1042-1T Questions and answers relating to the sales of stock to employee stock ownership plans or certain cooperatives (temporary).

Q-1: What does section 1042 provide?

A-1: (a) Section 1042 provides rules under which a taxpayer may elect not to recognize gain in certain cases where *qualified securities* are sold to a qualifying employee stock ownership plan or worker-owned cooperative in taxable years of the seller beginning after July 18, 1984, and *qualified replacement property* is purchased by the taxpayer within the *replacement period*. If the requirements of Q&A-2 of this section are met, and if the taxpayer makes an election under section 1042(a) in accordance with Q&A-3 of this section, the gain realized by the taxpayer on the sale of the qualified securities is recognized only to the extent that the amount realized on such sale exceeds the cost to the taxpayer of the qualified replacement property.

(b) Under section 1042, the term *qualified securities* means employer securities (as defined in section 409(1)) with respect to which each of the following

requirements is satisfied: (1) The employer securities were issued by a domestic corporation; (2) for at least one year before and immediately after the sale, the domestic corporation that issued the employer securities (and each corporation that is a member of a *controlled group of corporations* with such corporation for purposes of section 409(l)) has no stock outstanding that is readily tradeable on an established market; (3) as of the time of the sale, the employer securities have been held by the taxpayer for more than 1 year; and (4) the employer securities were not received by the taxpayer in a distribution from a plan described in section 401(a) or in a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

(c) The term *replacement period* means the period which begins 3 months before the date on which the sale of qualified securities occurs and which ends 12 months after the date of such sale. A replacement period may include any period which occurs prior to July 19, 1984.

(d) The term *qualified replacement property* means any securities (as defined in section 165(g)(2)) issued by a domestic corporation which does not, for the taxable year of such corporation in which the securities are purchased by the taxpayer, have passive investment income (as defined in section 1362(d)(3)(D)) that exceeds 25 percent of the gross receipts of such corporation for the taxable year preceding the taxable year of purchase. In addition, securities of the domestic corporation that issued the employer securities qualifying under section 1042 (and of any corporation that is a member of a *controlled group of corporations* with such corporation for purposes of section 409(l)) will not qualify as *qualified replacement property*.

(e) For purposes of section 1042(a), there is a *purchase* of qualified replacement property only if the basis of such property is determined by reference to its cost to the taxpayer. If the basis of the qualified replacement property is determined by reference to its basis in the hands of the transferor thereof or another person, or by reference to the basis of property (other than cash or

its equivalent) exchanged for such property, then the basis of such property is not determined solely by reference to its cost to the taxpayer.

Q-2: What is a sale of qualified securities for purposes of section 1042(b)?

A-2: (a) Under section 1042(b), a sale of qualified securities is one under which all of the following requirements are met:

(1) The qualified securities are sold to an employee stock ownership plan (as defined in section 4975(e)(7)) maintained by the corporation that issued the qualified securities (or by a member of the *controlled group of corporations* with such corporation for purposes of section 409(l)) or to an eligible worker-owned cooperative (as defined in section 1042(c)(2));

(2) The employee stock ownership plan or eligible worker-owned cooperative owns, immediately after the sale, 30 percent or more of the total value of the employer securities (within the meaning of section 409(l) outstanding as of such time;

(3) No portion of the assets of the employee stock ownership plan or eligible worker-owned cooperative attributable to qualified securities that are sold to the plan or cooperative by the taxpayer or by any other person in a sale with respect to which an election under section 1042(a) is made accrue under the plan or are allocated by the cooperative, either directly or indirectly and either concurrently with or at any time thereafter, for the benefit of (i) the taxpayer; (ii) any person who is a member of the family of the taxpayer (within the meaning of section 267(c)(4)); or (iii) any person who owns (after the application of section 318(a)), at any time after July 18, 1984, and until immediately after the sale, more than 25 percent of in value of the outstanding portion of any class of stock of the corporation that issued the qualified securities (or of any member of the *controlled group of corporations* with such corporation for purposes of section 409(l)). For purposes of this calculation, stock that is owned, directly or indirectly, by or for a qualified plan shall not be treated as outstanding.

(4) The taxpayer files with the Secretary (as part of the required election described in Q&A-3 of this section) a

verified written statement of the domestic corporation (or corporations) whose employees are covered by the plan acquiring the qualified securities or of any authorized officer of the eligible worker-owned cooperative, consenting to the application of section 4978(a) with respect to such corporation or cooperative.

(b) For purposes of determining whether paragraph (a)(2) of this section is satisfied, sales of qualified securities by two or more taxpayers may be treated as a single sale if such sales are made as part of a single, integrated transaction under a prearranged agreement between the taxpayers.

(c) For purposes of determining whether paragraph (a)(3) of this section is satisfied with respect to the prohibition against an accrual or allocation of qualified securities, the accrual or allocation of any benefits or contributions or other assets that are not attributable to qualified securities sold to the employee stock ownership plan or eligible worker-owned cooperative in a sale with respect to which an election under section 1042(a) is made (including any accrual or allocation under any other plan or arrangement maintained by the corporation or any member of the *controlled group of corporations* with such corporation for purposes of section 409(l)) must be made without regard to the allocation of such qualified securities. Paragraph (a)(3) of this section above may be illustrated in part by the following example: Individuals A, B, and C own 50, 25, and 25, respectively, of the 100 outstanding shares of common stock of Corporation X. Such shares constitute qualified securities as defined in Q&A-1 of this section. A and B, but not C, are employees of Corporation X. For the benefit of all its employees, Corporation X establishes an employee stock ownership plan that obtains a loan meeting the exemption requirements of section 4975(d)(3). The loan proceeds are used by the plan to purchase the 100 shares of qualified securities from A, B, and C, all of whom elect nonrecognition treatment under section 1042(a) with respect to the gain realized on their sale of such securities. Under the requirements of paragraph (a)(3) of this section, no part of the assets of the plan attributable to the 100

shares of qualified securities may accrue under the plan (or under any other plan or arrangement maintained by Corporation X) for the benefit of A or B or any person who is a member of the family of A or B (as determined under section 267(c)(4)). Furthermore, no other assets of the plan or assets of the employer may accrue for the benefit of such individuals in lieu of the receipt of assets attributable to such qualified securities.

(d) A sale under section 1042(a) shall not include any sale of securities by a dealer or underwriter in the ordinary course of its trade or business as a dealer or underwriter, whether or not guaranteed.

Q-3: What is the time and manner for making the election under section 1042(a)?

A-3: (a) The election not to recognize the gain realized upon the sale of qualified securities to the extent provided under section 1042(a) shall be made in a *statement of election* attached to the taxpayer's income tax return filed on or before the due date (including extensions of time) for the taxable year in which the sale occurs. If a taxpayer does not make a timely election under this section to obtain section 1042(a) nonrecognition treatment with respect to the sale of qualified securities, it may not subsequently make an election on an amended return or otherwise. Also, an election once made is irrevocable.

(b) The statement of election shall provide that the taxpayer elects to treat the sale of securities as a sale of qualified securities under section 1042(a), and shall contain the following information:

(1) A description of the qualified securities sold, including the type and number of shares;

(2) The date of the sale of the qualified securities;

(3) The adjusted basis of the qualified securities;

(4) The amount realized upon the sale of the qualified securities;

(5) The identity of the employee stock ownership plan or eligible worker-owned cooperative to which the qualified securities were sold; and

(6) If the sale was part of a single, interrelated transaction under a pre-arranged agreement between taxpayers involving other sales of qualified securities, the names and taxpayer identification numbers of the other taxpayers under the agreement and the number of shares sold by the other taxpayers. See Q&A-2 of this section.

If the taxpayer has purchased qualified replacement property at the time of the election, the taxpayer must attach as part of the statement of election a *statement of purchase* describing the qualified replacement property, the date of the purchase, and the cost of the property, and declaring such property to be the qualified replacement property with respect to the sale of qualified securities. Such statement of purchase must be notarized by the later of thirty days after the purchase or March 6, 1986. In addition, the statement of election must be accompanied by the verified written statement of consent required under Q&A-2 of this section with respect to the qualified securities sold.

(c) If the taxpayer has not purchased qualified replacement property at the time of the filing of the statement of election, a timely election under this Q&A shall not be considered to have been made unless the taxpayer attaches the notarized statement of purchase described above to the taxpayer's income tax return filed for the taxable year following the year for which the election under section 1042(a) was made. Such notarized statement of purchase shall be filed with the district director or the director of the regional service center with whom such election was originally filed, if the return is not filed with such director.

Q-4: What is the basis of qualified replacement property?

A-4: If a taxpayer makes an election under section 1042(a), the basis of the qualified replacement property purchased by the taxpayer during the replacement period shall be reduced by an amount equal to the amount of gain which was not recognized. If more than one item of qualified replacement property is purchased, the basis of each of such items shall be reduced by an amount determined by multiplying the total gain not recognized by reason of

the application of section 1042(a) by a fraction, the numerator of which is the cost of such item of property and the denominator of which is the total cost of all such items of property. For the rule regarding the holding period of qualified replacement property, see section 1223(13).

Q-5: What is the statute of limitations for the assessment of a deficiency relating to the gain on the sale of qualified securities?

A-5: (a) If any gain is realized by the taxpayer on the sale of any qualified securities and such gain has not been recognized under section 1042(a) in accordance with the requirements of this section, the statutory period provided in section 6501(a) for the assessment of any deficiency with respect to such gain shall not expire prior to the expiration of 3 years from the date of receipt, by the district director or director of regional service center with whom the statement of election under 1042(a) was originally filed, of:

(1) A notarized statement of purchase as described in Q&A-3;

(2) A written statement of the taxpayer's intention not to purchase qualified replacement property within the replacement period; or

(3) A written statement of the taxpayer's failure to purchase qualified replacement property within the replacement period.

In those situations when a taxpayer is providing a written statement of an intention not to purchase or of a failure to purchase qualified replacement property, the statement shall be accompanied, where appropriate, by an amended return for the taxable year in which the gain from the sale of the qualified securities was realized, in order to reflect the inclusion in gross income for that year of gain required to be recognized in connection with such sale.

(b) Any gain from the sale of qualified securities which is required to be recognized due to a failure to meet the requirements under section 1042 shall be included in the gross income for the taxable year in which the gain was realized. If any gain from the sale of qualified securities is not recognized under section 1042(a) in accordance with the requirements of this section,

any deficiency attributable to any portion of such gain may be assessed at any time before the expiration of the 3-year period described in this Q&A, notwithstanding the provision of any law or rule of law which would otherwise prevent such assessment.

Q-6: When does section 1042 become effective?

A-6: Section 1042 applies to sales of qualified securities in taxable years of sellers beginning after July 18, 1984.

[T.D. 8073, 51 FR 4333, Feb. 4, 1986]

§ 1.1044(a)-1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 1044(a), as added by section 13114 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66, 107 Stat. 430), generally allows individuals and C corporations that sell publicly traded securities after August 9, 1993, to elect not to recognize certain gain from the sale if the taxpayer purchases common stock or a partnership interest in a specialized small business investment company (SSBIC) within the 60-day period beginning on the date the publicly traded securities are sold.

(b) *Time and manner for making the election.* The election under section 1044(a) must be made on or before the due date (including extensions) for the income tax return for the year in which the publicly traded securities are sold. The election is to be made by reporting the entire gain from the sale of publicly traded securities on Schedule D of the income tax return in accordance with instructions for Schedule D, and by attaching a statement to Schedule D showing—

- (1) How the nonrecognized gain was calculated;
- (2) The SSBIC in which common stock or a partnership interest was purchased;
- (3) The date the SSBIC stock or partnership interest was purchased; and
- (4) The basis of the SSBIC stock or partnership interest.

(c) *Revocability of election.* The election described in this section is revocable with the consent of the Commissioner.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

§ 1.1045-1 Application to partnerships.

(a) *Overview of section.* A partnership that holds qualified small business stock (QSB stock) (as defined in paragraph (g)(1) of this section) for more than 6 months, sells such QSB stock, and purchases replacement QSB stock (as defined in paragraph (g)(2) of this section) may elect to apply section 1045. An eligible partner (as defined in paragraph (g)(3) of this section) of a partnership that sells QSB stock, may elect to apply section 1045 if the eligible partner purchases replacement QSB stock directly or through a purchasing partnership (as defined in paragraph (c)(1)(i) of this section). A taxpayer (other than a C corporation) that holds QSB stock for more than 6 months, sells such QSB stock and purchases replacement QSB stock through a purchasing partnership may elect to apply section 1045. A section 1045 election is revocable only with the prior written consent of the Commissioner. To obtain the Commissioner's prior written consent, the person who made the section 1045 election must submit a request for a private letter ruling. (For further guidance, see Rev. Proc. 2007-1, 2007-1 CB 1 (or any applicable successor) and § 601.601(d)(2)(ii)(b) of this chapter.) Paragraph (b) of this section provides rules for partnerships that elect to apply section 1045. Paragraph (c) of this section provides rules for certain taxpayers other than C corporations and for eligible partners that elect to apply section 1045. Paragraph (d) of this section provides a limitation on the amount of gain that an eligible partner does not recognize under section 1045. Paragraph (e) of this section provides rules for partnership distributions of QSB stock to an eligible partner. Paragraph (f) of this section provides rules for contributions of QSB stock or replacement QSB stock to a partnership. Paragraph (g) of this section provides definitions of certain terms used in section 1045 and this section. Paragraph (h) of this section provides reporting rules for partnerships

and partners that elect to apply section 1045. Paragraph (i) of this section provides examples illustrating the provisions of this section. Paragraph (j) of this section contains the effective/applicability date.

(b) *Partnership election*—(1) *Partnership purchase of replacement QSB stock.* A partnership that holds QSB stock for more than 6 months, sells such QSB stock, and purchases replacement QSB stock may elect in accordance with paragraph (h) of this section to apply section 1045. If the partnership elects to apply section 1045, then, subject to the provisions of paragraphs (b)(4) and (d) of this section, each eligible partner shall not recognize its distributive share of any partnership section 1045 gain (as determined under paragraph (b)(2) of this section). For this purpose, partnership section 1045 gain equals the partnership's gain from the sale of the QSB stock reduced by the greater of—

(i) The amount of the gain from the sale of the QSB stock that is treated as ordinary income; or

(ii) The excess of the amount realized by the partnership on the sale over the total cost of all replacement QSB stock purchased by the partnership (excluding the cost of any replacement QSB stock purchased by the partnership that is otherwise taken into account under section 1045).

(2) *Partner's distributive share of partnership section 1045 gain.* A partner's distributive share of partnership section 1045 gain shall be in the same proportion as the partner's distributive share of the partnership's gain from the sale of the QSB stock. For this purpose, the partnership's gain from the sale of QSB stock and the partner's distributive share of that gain are determined without regard to basis adjustments under section 743(b) and paragraph (b)(3)(ii) of this section.

(3) *Basis adjustments*—(i) *Partner's interest in a partnership.* The adjusted basis of an eligible partner's interest in a partnership shall not be increased under section 705(a)(1) by gain from a partnership's sale of QSB stock that is not recognized by the partner as the result of a partnership election under paragraph (b)(1) of this section.

(ii) *Partnership's replacement QSB stock*—(A) *Rule.* The basis of a partner-

ship's replacement QSB stock is reduced (in the order acquired) by the amount of gain from the partnership's sale of QSB stock that is not recognized by an eligible partner as a result of the partnership's election under section 1045. The basis adjustment with respect to any amount described in this paragraph (b)(3)(ii) constitutes an adjustment to the basis of the partnership's replacement QSB stock with respect to that partner only. The effect of such a basis adjustment is determined under the principles of §1.743-1(g), (h), and (j) except as modified in this paragraph (b)(3)(ii)(A). If a partnership sells QSB stock with respect to which a basis adjustment has been made under this paragraph (b)(3)(ii), and the partnership makes an election under paragraph (b)(1) of this section with respect to the sale and purchases replacement QSB stock, the basis adjustment shall carry over to the replacement QSB stock except to the extent otherwise provided in this paragraph (b)(3)(ii). The basis adjustment that carries over to the replacement QSB stock shall be reduced (but not below zero) by the eligible partner's distributive share of the excess, if any, of the greater of the amount determined under paragraph (b)(1)(i) or (ii) of this section from the sale of the QSB stock, over the partnership's gain from the sale of the QSB stock (determined without regard to basis adjustments under section 743 or paragraph (b)(3)(ii) of this section). The excess amount that reduces the basis adjustment shall be accounted for as gain in accordance with §1.743-1(j)(3). See *Example 5* of paragraph (i) of this section. For purposes of this paragraph (b)(3)(ii), a partnership must presume that a partner did not recognize that partner's distributive share of the partnership section 1045 gain as a result of the partnership's section 1045 election unless the partner notifies the partnership to the contrary as described in paragraph (b)(5)(ii) of this section. However, if a partnership knows that a particular partner is classified, for Federal tax purposes, as a C corporation, then the partnership may presume that the partner did not defer recognition of its distributive share of the partnership section 1045 gain, even in the absence

of a notification by the partner. If a partnership makes an election under section 1045, but an eligible partner opts out of the election under paragraph (b)(4) of this section and provides to the partnership the notification required under paragraph (b)(5)(ii) of this section, no basis adjustments under this paragraph (b)(3)(ii) are required with respect to that partner as a result of the section 1045 election by the partnership.

(B) *Tiered-partnership rule.* If a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that makes an election under section 1045, the portion of the lower-tier partnership's basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the replacement QSB stock must be segregated and allocated to the upper-tier partnership and any eligible partner as defined in paragraph (g)(3)(iii) of this section. Similarly, that portion of the basis of the upper-tier partnership's interest in the lower-tier partnership attributable to the basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the lower-tier partnership's replacement QSB stock must be segregated and allocated solely to any eligible partner as defined in paragraph (g)(2)(iii) of this section.

(C) *Statement of adjustments.* A partnership that must adjust the basis of replacement QSB stock under this paragraph (b) must attach a statement to the partnership return for the taxable year in which the partnership purchases replacement QSB stock setting forth the computation of the adjustment, the replacement QSB stock to which the adjustment has been made, the date(s) on which such QSB stock was acquired by the partnership, and the amount of the adjustment that is allocated to each partner.

(4) *Eligible partners may opt out of partnership's section 1045 election.* An eligible partner may opt out of the partnership's section 1045 election with respect to QSB stock either by recognizing the partner's distributive share of the partnership section 1045 gain, or by making a partner section 1045 election under paragraph (c) of this section with respect to the partner's distributive share of the partnership section

1045 gain. See paragraph (b)(5)(ii) of this section for applicable notification requirements. Opting out of a partnership's section 1045 election under this paragraph (b)(4) does not constitute a revocation of the partnership's election, and such election shall continue to apply to other partners of the partnership.

(5) *Notice requirements—(i) Partnership notification to partners.* A partnership that makes an election under paragraph (b)(1) of this section must notify all of its partners of the election and the purchase of replacement QSB stock, in accordance with the applicable forms and instructions, and separately state each partner's distributive share of partnership section 1045 gain from the sale of QSB stock under section 702. Each partner shall determine whether the partner is an eligible partner within the meaning of paragraph (g)(3) of this section and report the partner's distributive share of partnership section 1045 gain from the partnership's sale of QSB stock, including gain not recognized, in accordance with the applicable forms and instructions.

(ii) *Partner notification to partnership.* Any partner that must recognize all or part of the partner's distributive share of partnership section 1045 gain must notify the partnership, in writing, of the amount of partnership section 1045 gain that is recognized by the partner. Similarly, an eligible partner that opts out of a partnership's section 1045 election under paragraph (b)(4) of this section must notify the partnership, in writing, that the partner is opting out of the partnership's section 1045 election.

(c) *Partner election—(1) In general—(i) Rule.* An eligible partner of a partnership that sells QSB stock (selling partnership) may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by the eligible partner. An eligible partner of a selling partnership may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a partnership in which the taxpayer is a partner (directly or through an upper-tier partnership) on

the date on which the partnership acquires the replacement QSB stock (purchasing partnership). A taxpayer other than a C corporation that sells QSB stock held for more than 6 months at the time of the sale may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a purchasing partnership (including a selling partnership).

(ii) *Partner purchase of replacement QSB stock.* Subject to paragraph (d) of this section, an eligible partner of a selling partnership that elects to apply section 1045 with respect to the eligible partner's purchase of replacement QSB stock must recognize its distributive share of gain from the sale of QSB stock by the selling partnership only to the extent of the greater of—

(A) The amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or

(B) The excess of the eligible partner's share of the selling partnership's amount realized (as determined under paragraph (c)(2) of this section) on the sale by the selling partnership of the QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the cost of any replacement QSB stock purchased by the eligible partner (excluding the cost of any replacement QSB stock that is otherwise taken into account under section 1045).

(iii) *Partnership purchase of replacement QSB stock—(A) Partner of a selling partnership.* Subject to paragraph (d) of this section, an eligible partner that treats its interest in QSB stock purchased by a purchasing partnership as a purchase of replacement QSB stock by the eligible partner and that elects to apply section 1045 with respect to such purchase must recognize its total gain (the eligible partner's distributive share of gain from the selling partnership's sale of QSB stock and any gain taken into account under paragraph (c)(5) of this section from the sale of replacement QSB stock) only to the extent of the greater of—

(1) The amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the

QSB stock that is treated as ordinary income; or

(2) The excess of the eligible partner's share of the selling partnership's amount realized (as determined under paragraph (c)(2) of this section) on the sale by the selling partnership of the QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the eligible partner's share of the purchasing partnership's cost of the replacement QSB stock, as determined under paragraph (c)(3) of this section (excluding the cost of any QSB stock that is otherwise taken into account under section 1045).

(B) *Taxpayer other than a C corporation.* Subject to paragraph (d) of this section, a taxpayer other than a C corporation that treats its interest in QSB stock purchased by a purchasing partnership with respect to which the taxpayer is a partner as a purchase of replacement QSB stock by the taxpayer must recognize its gain from the sale of the QSB stock only to the extent of the greater of—

(1) The amount of gain from the sale of the QSB stock that is treated as ordinary income; or

(2) The excess of the amount realized by the taxpayer on the sale of the QSB stock over the partner's share of the purchasing partnership's cost of the replacement QSB stock, as determined under paragraph (c)(3) of this section (excluding the cost of any QSB stock that is otherwise taken into account under section 1045).

(2) *Eligible partner's share of amount realized by partnership—(i) General rule.* The eligible partner's share of the amount realized by the selling partnership is the amount realized by the partnership on the sale of the QSB stock (excluding the cost of any replacement QSB stock otherwise taken into account under section 1045) multiplied by the following fraction—

(A) The numerator of which is the eligible partner's distributive share of the partnership's realized gain from the sale of the QSB stock; and

(B) The denominator of which is the partnership's realized gain on the sale of the QSB stock.

(ii) *General rule modified for determining eligible partner's share of amount*

realized by purchasing partnership upon a sale of replacement QSB stock in certain situations—(A) No gain realized or loss realized on sale of replacement QSB stock. If a purchasing partnership does not realize a gain or realizes a loss from the sale of replacement QSB stock for which an election under this section was made for purposes of applying paragraph (c)(1)(iii)(A) of this section, the eligible partner's share of the amount realized is—

(1) The greater of—

(i) The amount determined in paragraph (c)(2)(i) of this section from a prior sale of QSB stock (that is not otherwise taken into account under paragraph (c)(2) of this section) in which the eligible partner had a distributive share of gain allocated to the eligible partner that was not recognized under paragraph (c)(1)(iii)(A) of this section; or

(ii) The amount realized by a taxpayer other than a C corporation from a prior sale of QSB stock (that is not otherwise taken into account under paragraph (c)(2) of this section) in which the taxpayer realized gain that was not recognized under paragraph (c)(1)(iii)(B) of this section; less

(2) The eligible partner's distributive share of any loss recognized on the sale of replacement QSB stock, if applicable.

(B) *Eligible partner's interest in purchasing partnership is reduced and gain realized on sale of replacement QSB stock.* If an eligible partner's interest in a purchasing partnership is reduced subsequent to the sale of QSB stock and the purchasing partnership realizes a gain from the sale of the replacement QSB stock, the eligible partner's share of the amount realized upon a sale of replacement QSB stock must be determined under paragraph (c)(2)(i) of this section based on the distributive share of the partnership's realized gain that would have been allocated to the eligible partner if the eligible partner's interest in the partnership had not been reduced.

(iii) *Eligible partner's share of the amount realized.* For purposes of determining the eligible partner's share of the amount realized by the partnership, the partnership's realized gain from the sale of QSB stock and the eli-

gible partner's distributive share of that gain are determined without regard to basis adjustments under section 743(b) and paragraphs (b)(3)(ii) and (c) of this section.

(3) *Partner's share of the cost of QSB stock purchased by a purchasing partnership.* The partner's share of the cost (adjusted basis) of replacement QSB stock purchased by a purchasing partnership is the percentage of the partnership's future income and gain, if any, that is reasonably expected to be allocated to the partner (determined without regard to any adjustment under section 1045) with respect to the replacement QSB stock that was purchased by the partnership, multiplied by the cost of that replacement QSB stock. The assumptions made by a partnership in determining the reasonably expected allocation of income and gain must be consistent for each partner. For example, a partnership may not treat the same item of income or gain as being reasonably expected to be allocated to more than one partner.

(4) *Basis adjustments—(i) Eligible partner's interest in selling partnership.* Under section 705(a)(1), the adjusted basis of an eligible partner's interest in a selling partnership that sells QSB stock is increased by the partner's distributive share of gain without regard to paragraph (c)(1) of this section. However, if the selling partnership is also a purchasing partnership, the adjusted basis of an eligible partner's interest in a partnership that sells QSB stock may be reduced under paragraph (c)(4)(iii) of this section.

(ii) *Replacement QSB stock.* A partner's basis in any replacement QSB stock that is purchased by the partner, as well as the adjusted basis of any replacement QSB stock that is purchased by a purchasing partnership and that is treated as the partner's replacement QSB stock must be reduced (in the order replacement QSB stock is acquired by the partner and purchasing partnership, as applicable) by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner under paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not

recognized by the partner under section 1045, as applicable. If replacement QSB stock is purchased by the purchasing partnership, the purchasing partnership shall maintain its adjusted basis in the replacement QSB stock without regard to any basis adjustments required by this paragraph (c)(4)(ii). The eligible partner, however, shall in computing its distributive share of income, gain, loss and deduction from the purchasing partnership with respect to the replacement QSB stock take into account the variation between the adjusted basis in the QSB stock as determined under this paragraph (c)(4)(ii) and the adjusted basis determined without regard to this paragraph (c)(4)(ii). A partner must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment has been made, and the date(s) on which such stock was acquired. See *Examples 7 and 8* of paragraph (i) of this section.

(iii) *Partner's basis in purchasing partnership interest.* A partner that treats the partner's interest in QSB stock purchased by a purchasing partnership as the partner's replacement QSB stock must reduce (in the order replacement QSB stock is acquired) the adjusted basis of the partner's interest in the purchasing partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by the partner under section 1045, as applicable. Similarly, a partner of an upper-tier partnership that treats the partner's interest in QSB stock purchased by a lower-tier purchasing partnership as the partner's replacement QSB stock must reduce (in the order replacement QSB stock is acquired) the adjusted basis of the partner's interest in the upper-tier partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by

the partner under section 1045, as applicable.

(iv) *Increase in basis on sale of QSB stock by purchasing partnership.* A partner that recognizes gain under paragraph (c)(5) of this section must increase the adjusted basis of the partner's interest in the purchasing partnership under section 705(a)(1) by the amount of the gain recognized by that partner. Similarly, a partner in an upper-tier partnership that recognizes gain under paragraph (c)(5) of this section must increase the adjusted basis of the partner's interest in the upper-tier partnership under section 705(a)(1) by the amount of the gain recognized by that partner.

(5) *Partner recognition of gain.* At the time that either the partner or the purchasing partnership (whichever applies) sells or exchanges replacement QSB stock, the amount recognized by the partner is determined by taking into account the basis adjustments described in paragraph (c)(4)(ii) of this section. Similarly, a partner of an upper-tier partnership that owns an interest in a lower-tier partnership that holds replacement QSB stock must take into account the basis adjustments described in paragraph (c)(4)(ii) of this section in determining the amount recognized by the partner on a sale of the interest in the lower-tier partnership by the upper-tier partnership or the partner's distributive share of gain from the upper-tier partnership. See paragraph (e)(4) of this section for rules applicable to certain distributions of replacement QSB stock.

(d) *Nonrecognition limitation—(1) In general.* For purposes of this section, the amount of gain that an eligible partner does not recognize under paragraphs (b)(1) and (c)(1) of this section cannot exceed the nonrecognition limitation. Except as otherwise provided in paragraph (d)(2) of this section, the nonrecognition limitation is equal to the product of—

(i) The partnership's realized gain from the sale of the QSB stock, determined without regard to any basis adjustment under section 734(b) or section 743(b) (other than basis adjustments described in paragraph (b)(3)(ii) of this section); and

(ii) The eligible partner's smallest percentage interest in partnership capital as determined in paragraph (d)(2) of this section. See *Example 9* of paragraph (i) of this section.

(2) *Eligible partner's smallest percentage interest in partnership capital.* An eligible partner's smallest percentage interest in partnership capital is the eligible partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is sold to reflect any reduction in the capital of the eligible partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest by the eligible partner, but excluding income and loss allocations.

(3) *Special rule for tiered partnerships.* For purposes of paragraph (d)(1)(ii) of this section, if an eligible partner is treated as owning an interest in a lower-tier purchasing partnership through an upper-tier partnership, the eligible partner's percentage interest in the purchasing partnership shall be proportionately adjusted to reflect the eligible partner's percentage interest in the upper-tier partnership.

(e) *Partnership distribution of QSB stock to a partner—(1) In general.* Subject to paragraphs (e)(2) and (3) of this section, in the case of a partnership distribution of QSB stock to a partner, the partner shall be treated for purposes of this section as—

(i) Having acquired such stock in the same manner as the partnership; and

(ii) Having held such stock during any continuous period immediately preceding the distribution during which it was held by the partnership. See *Examples 10* and *11* of paragraph (i) of this section.

(2) *Eligibility under section 1202(c).* Paragraph (e)(1) of this section does not apply unless all eligibility requirements with respect to QSB stock as defined in section 1202(c) are met by the distributing partnership with respect to its investment in QSB stock.

(3) *Distribution nonrecognition limitation—(i) Generally.* The amount of gain that an eligible partner does not recognize under this section on the sale of

QSB stock that was distributed by the partnership to the partner cannot exceed the distribution nonrecognition limitation. For this purpose, the distribution nonrecognition limitation is—

(A) The partner's section 1045 amount realized (determined under paragraph (e)(3)(ii) of this section); reduced by

(B) The partner's section 1045 adjusted basis (determined under paragraph (e)(3)(iii) of this section).

(ii) *Section 1045 amount realized—(A) QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives QSB stock from the partnership in a distribution in liquidation of the partner's interest in the partnership or as part of a series of related distributions by the partnership in which the partnership distributes all of the partnership's QSB stock of a particular type, then the partner's section 1045 amount realized is the partner's amount realized from the sale of the distributed QSB stock, multiplied by a fraction—

(1) The numerator of which is the partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section; and

(2) The denominator of which is the partner's percentage interest in that type of QSB stock immediately after the distribution (determined under paragraph (e)(3)(iv) of this section).

(B) *Partner's smallest percentage interest in partnership capital.* A partner's smallest percentage interest in partnership capital is the partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is distributed to the partner to reflect any reduction in the capital of the partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the partner, or the transfer of a capital interest by the partner, but excluding income and loss allocations.

(C) *QSB stock received in other distributions.* If a partner receives QSB stock in a distribution from the partnership that is not described in paragraph

(e)(3)(ii)(A) of this section, the partner's section 1045 amount realized is the partner's amount realized from the sale of the distributed QSB stock multiplied by the partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section.

(iii) *Section 1045 adjusted basis*—(A) *QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives QSB stock from the partnership in a distribution in liquidation of the partner's interest in the partnership or as part of a series of related distributions by the partnership in which the partnership distributes all of the partnership's QSB stock of a particular type, then the partner's section 1045 adjusted basis is the product of—

(1) The partnership's basis in all of the QSB stock of the type distributed (without regard to basis adjustments under section 734(b) or section 743(b), other than basis adjustments described in paragraphs (b)(3)(ii) and (c)(4)(ii) of this section);

(2) The partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section; and

(3) The proportion of the distributed QSB stock that was sold by the partner.

(B) *QSB stock received in other distributions.* If a partner receives QSB stock in a distribution from the partnership that is not described in paragraph (e)(3)(iii)(A) of this section, the partner's section 1045 adjusted basis is the product of—

(1) The partnership's basis in the QSB stock sold by the partner (without regard to basis adjustments under section 734(b) or section 743(b), other than basis adjustments described in paragraphs (b)(3)(ii) and (c)(4)(ii) of this section); and

(2) The partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section.

(iv) *Partner's percentage interest in distributed QSB stock.* For purposes of this paragraph (e)(3), a partner's percentage interest in a type of QSB stock immediately after a partnership distribution is the value (as of the date of the dis-

tribution) of the QSB stock distributed to the partner divided by the value (as of the date of the distribution) of all of that type of QSB stock that was acquired by the partnership.

(v) *QSB stock of the same type.* For purposes of this paragraph (e)(3), QSB stock will be of the same type as the distributed QSB stock if it has the same issuer and the same rights and preferences as the distributed QSB stock and was acquired by the partnership at original issue.

(4) *Distribution of replacement QSB stock to a partner that reduces another partner's interest in the replacement QSB stock.* For purposes of this section, a partner must recognize gain upon a distribution of replacement QSB stock to another partner that reduces the partner's share of the replacement QSB stock held by a partnership. The amount of gain that the partner must recognize is determined based on the amount of gain that the partner would recognize upon a sale of the distributed replacement QSB stock for its fair market value on the date of the distribution but not to exceed the amount that was previously not recognized by the partner under section 1045 with respect to the distributed replacement QSB stock. Any gain recognized by a partner whose interest is reduced must be taken into account in determining the adjusted basis of the partner's interest in the partnership and also taken into account in determining the partnership's adjusted basis in the QSB stock distributed to another partner under paragraph (e)(3) of this section.

(f) *Contribution of QSB stock or replacement QSB stock to a partnership.* Section 721 applies to a contribution of QSB stock to a partnership. Except as provided in section 721(b), any gain that was not recognized by the taxpayer under section 1045 is not recognized when the taxpayer contributes QSB stock to a partnership in exchange for a partnership interest. Stock that is contributed to a partnership is not QSB stock in the hands of the partnership. See *Example 12* of paragraph (i) of this section.

(g) *Definitions.* For purposes of section 1045 and this section, the following terms are defined as follows:

(1) *Qualified small business stock.* The term *qualified small business stock* (QSB stock) has the meaning provided in section 1202(c). The term “QSB stock” does not include an interest in a partnership that purchases or holds QSB stock. See *Example 1* of paragraph (i) of this section.

(2) *Replacement QSB stock.* The term *replacement QSB stock* is any QSB stock purchased within 60 days beginning on the date of a sale of QSB stock.

(3) *Eligible partner*—(i) *In general.* Except as provided in paragraphs (e)(1), (g)(3)(ii), (iii) and (iv) of this section, an eligible partner with respect to QSB stock is a taxpayer other than a C corporation that holds an interest in a partnership on the date the partnership acquires the QSB stock and at all times thereafter for more than 6 months until the partnership sells or distributes the QSB stock.

(ii) *Acquisition by gift or at death.* For purposes of paragraph (g)(3)(i) of this section, a taxpayer who acquires from a partner (other than a C corporation) by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the partnership during the period the partner (other than a C corporation) held the interest in the partnership.

(iii) *Tiered partnership.* For purposes of paragraph (g)(3)(i) of this section, if a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that holds QSB stock, then the upper-tier partnership’s ownership of the lower-tier partnership is disregarded and each partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership directly. The partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership during the period in which both—

(A) The partner of the upper-tier partnership held an interest in the upper-tier partnership; and

(B) The upper-tier partnership held an interest in the lower-tier partnership. See *Examples 3* and *4* of paragraph (i) of this section.

(iv) *Multiple tiers of partnerships.* Principles similar to those described in paragraph (g)(3)(iii) of this section

apply where a taxpayer holds an interest in a lower-tier partnership through multiple tiers of partnerships.

(4) *Month(s).* For purposes of this section, the term *month(s)* means a period commencing on the same numerical day of any calendar month as the day on which the QSB stock is sold and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the last day of the succeeding calendar month.

(h) *Reporting and election rules*—(1) *Time and manner of making election.* A partnership making an election under section 1045 (as described under paragraph (b)(1) of this section) must do so on the partnership’s timely filed (including extensions) Federal income tax return for the taxable year during which the sale of QSB stock occurs. A partner making an election under section 1045 (as described under paragraph (c)(1) of this section) must do so on the partner’s timely filed (including extensions) Federal income tax return for the taxable year during which the partner’s distributive share of the partnership’s gain from the sale of the QSB stock is taken into account by such partner under section 706. In addition, a partnership or partner making an election under section 1045 must make such election in accordance with the applicable forms and instructions.

(2) *Purchases, distributions, and sales of QSB stock or replacement QSB stock by partnerships.* A partnership that purchases, distributes to a partner, or sells or exchanges QSB stock or replacement QSB stock must provide information to the Commissioner and to the partnership’s partners to the extent provided by the applicable forms and instructions.

(3) *Nonrecognition of gain by eligible partners.* An eligible partner that does not recognize gain under section 1045 must provide information to the Commissioner to the extent provided by the applicable forms and instructions.

(i) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Sale of a partnership interest. On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS,

a partnership. A, X, and Y each contribute \$250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for \$750 on February 1, 2008. On November 4, 2008, A sells A's interest in PRS for \$500, realizing \$250 of capital gain. Under paragraph (g)(1) of this section, an interest in a partnership that holds QSB stock is not treated as QSB stock. Therefore, the sale of an interest in a partnership that holds QSB stock is not treated as a sale of QSB stock, and A may not elect to apply section 1045 with respect to A's \$250 gain from the sale of A's interest in PRS.

Example 2. Election by partner; replacement by partnership. (i) Assume the same facts as in *Example 1*, except that A does not sell A's interest in PRS. Instead, PRS sells the QSB stock (QSB1 stock) for \$1,500 on November 3, 2008. PRS realizes \$750 of gain from the sale of the QSB1 stock (none of which is treated as ordinary income) and allocates \$250 of gain to each of A, X, and Y. PRS does not make a section 1045 election. On November 30, 2008, A contributes \$500 to ABC, a partnership, in exchange for a 10 percent interest in ABC. ABC then purchases QSB stock (QSB2 stock) for \$5,000 on December 1, 2008. ABC has no other assets. A makes an election under paragraph (c)(1) of this section and treats A's percentage interest in ABC's QSB2 stock as replacement QSB stock under paragraph (c)(1)(iii) of this section with respect to the \$250 gain PRS allocated to A. Under paragraph (c)(3) of this section, A's share of the cost of QSB2 stock purchased by ABC is \$500 (A's reasonably expected income and gain with respect to QSB2 stock, or 10 percent multiplied by the cost of the QSB2 stock, \$5,000). Under paragraph (c)(1)(iii) of this section, A will not recognize the \$250 gain PRS allocated to A, because A's share of the amount realized by PRS, \$500 (the total amount realized by the partnership on the sale of the QSB1 stock (\$1,500) multiplied by A's share of the gain from the sale of the QSB1 stock (\$250) over the total gain realized by the partnership on the sale of the QSB1 stock (\$750)), does not exceed A's share of ABC's cost of the QSB2 stock acquired by ABC, \$500. Under paragraph (c)(4)(ii) of this section, A must reduce A's share of ABC's basis in the QSB2 stock by \$250. Under paragraph (c)(4)(iii) of this section, A must reduce A's basis in A's interest in ABC by \$250. Under paragraph (c)(4)(i) of this section, A's basis in A's interest in PRS is increased by \$250.

(ii) Assume the same facts as in paragraph (i) of this *Example 2*, except that A does not contribute \$500 to ABC in exchange for a partnership interest. Instead, on November 30, 2008, EFG, a partnership in which A has an existing 10 percent partnership interest, purchases QSB stock for \$5,000. Under paragraph (c)(1) of this section, A may treat A's 10 percent interest in EFG's QSB stock as re-

placement QSB stock with respect to the \$250 of gain PRS allocated to A.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that ABC owns QSB stock that ABC purchased on November 10, 2008, and ABC does not purchase QSB stock on December 1, 2008. Under paragraph (c)(1) of this section, ABC is not a purchasing partnership with respect to A for the QSB stock ABC purchased on November 10, 2008. A may not treat A's percentage interest in ABC's QSB stock as replacement QSB stock to defer the \$250 gain PRS allocated to A, because A acquired its interest in ABC after ABC acquired the QSB stock.

(iv) Assume the same facts as in paragraph (i) of this *Example 2*, except that ABC sells QSB2 stock on July 30, 2009, for \$5,000. ABC realizes no gain or loss on the sale of QSB2 stock. A desires to continue to rollover the \$250 gain from the sale of QSB1 stock. Under paragraph (c)(2)(ii)(A) of this section, A's share of the amount realized is \$500, which was A's share of the amount realized on the prior sale of QSB1 stock. Accordingly, A must elect to apply section 1045 and purchase \$500 of replacement QSB stock either directly or through a purchasing partnership to continue to defer the \$250 gain from the sale of QSB1 stock.

Example 3. Tiered partnerships; partnership election. (i) On January 1, 2008, A, an individual, and B, an individual, each contribute \$500 to UTP (upper-tier partnership) for equal partnership interests. On February 1, 2008, UTP and C, an individual, each contribute \$1,000 to LTP (lower-tier partnership) for equal partnership interests. On March 1, 2008, LTP purchases QSB stock for \$500. On April 1, 2008, D, an individual, joins UTP by contributing \$500 to UTP for a 1/3 interest in UTP. On December 1, 2008, LTP sells the QSB stock for \$2,000. Under paragraph (g)(3)(iii) of this section, A, B, and D are treated as owning an interest in LTP during the period in which each of the partners held an interest in UTP and UTP held an interest in LTP. Therefore, under paragraphs (g)(3)(i) and (iii) of this section, A and B are eligible partners, and D and UTP are not eligible partners with respect to the QSB stock sold by LTP. Under paragraph (g)(3)(i) of this section, C is also an eligible partner with respect to the QSB stock sold by LTP.

(ii) Assume the same facts as in paragraph (i) of this *Example 3*. LTP realizes a gain of \$1,500 on the December 1, 2008, sale of QSB stock. LTP allocates \$750 of gain to each of UTP and C. UTP, in turn, allocates \$250 (of the \$750 of gain allocated to UTP) to each of A, B, and D. LTP makes a section 1045 election. On January 1, 2009, LTP purchases replacement QSB stock for \$2,000. Under paragraph (b)(5)(ii) of this section, D notifies UTP that it recognizes \$250 of gain and UTP notifies LTP. Because A, B, and C are eligible partners with respect to the QSB stock

sold by LTP, A and B may each defer \$250 of LTP's section 1045 gain and C may defer \$750 of LTP's section 1045 gain. LTP must decrease its basis in the replacement QSB stock by the \$750 of partnership section 1045 gain that was allocated to C and by \$500 of the partnership section 1045 gain that was allocated to UTP. These basis reductions are with respect to UTP (A and B) and C only. Under paragraph (b)(3)(ii)(B) of this section, the basis of UTP's interest in LTP attributable to the LTP's replacement QSB stock must be segregated and allocated to A and B. In addition, A and B each have a \$250 negative basis adjustment in their respective interests in UTP. If UTP sells its interest in LTP for \$1,250, A and B would each recognize \$250 of gain from the sale of the LTP interest. D would not recognize any gain or loss from the sale.

Example 4. Tiered partnerships; partner election. (i) On January 1, 2008, A, an individual, and X, a C corporation, form UTP, a partnership. A and X each contribute \$250 to UTP and agree to share all partnership items equally. Also, on January 1, 2008, UTP and Y, a C corporation, form LTP, a partnership. UTP and Y contribute \$500 and \$250, respectively, to LTP. UTP and Y agree to share all partnership items equally. LTP purchases QSB stock for \$750 on February 1, 2008. On November 3, 2008, LTP sells the QSB stock for \$1,500. LTP realizes \$750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$250 gain to Y and \$500 gain to UTP. Of the \$500 gain allocated to UTP from the sale of QSB stock, \$250 is allocated to A and \$250 is allocated to X. LTP purchases replacement QSB stock (replacement QSB1 stock) for \$1,350 on December 15, 2008. LTP does not make an election under section 1045. Under the rules provided in paragraph (c) of this section, A makes an election under section 1045 on its timely filed return for the taxable year for which the distributive share of gain from the sale of QSB stock is taken into account by A under section 706. Under paragraph (c)(1)(iii) of this section, A treats A's interest in replacement QSB1 stock as replacement stock with respect to A's distributive share of LTP's section 1045 gain. On March 30, 2009, LTP sells replacement QSB1 stock for \$1,650. LTP realizes \$300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates \$100 to Y and \$200 to UTP.

(ii) Under paragraph (c)(1)(iii) of this section, A must recognize its distributive share of gain from LTP's sale of QSB stock (\$250) only to the extent of the greater of A's distributive share of LTP's gain from the sale of QSB stock that is treated as ordinary income (\$0) or the amount by which A's share of the amount realized by LTP's sale of QSB stock exceeds A's share of LTP's cost of the replacement QSB1 stock, \$50 ($\frac{1}{3}$ of \$1,500, or

\$500, minus $\frac{1}{3}$ of \$1,350, or \$450). Because Y is not an eligible partner of LTP under paragraph (g)(3) of this section, Y must recognize its \$250 distributive share of partnership gain from the sale of the QSB stock. Also, X is not an eligible partner under paragraph (g)(3) of this section, and it must recognize its \$250 distributive share of gain from UTP attributable to UTP's distributive share of \$500 of LTP's gain from the sale of QSB stock.

(iii) Under section 705(a)(1), the adjusted basis of Y's interest in LTP is increased by \$250, and the adjusted basis of UTP's interest in LTP is increased by \$500. Under section 705(a)(1), the adjusted basis of X's interest in UTP is increased by \$250, and the adjusted basis of A's interest in UTP is increased by \$250. However, under paragraph (c)(4)(iii) of this section, the adjusted basis of A's interest in UTP is reduced by the \$200 of partnership section 1045 gain that was not recognized by A.

(iv) Under paragraph (c)(4)(ii) of this section, the LTP's adjusted basis in replacement QSB1 stock is reduced by the \$200 of gain from the sale of QSB stock that is not recognized by A, as a result of A's election under section 1045. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired. LTP's adjusted basis in the replacement QSB1 stock is maintained without regard to the eligible partner's adjustment provided in paragraph (c)(4)(ii) of this section.

(v) On the sale of replacement QSB1 stock, LTP realizes a gain of \$300, \$100 of which is allocated to Y and \$200 of which is allocated to UTP. UTP allocates \$100 of this gain to A. Under paragraph (c)(5) of this section, in determining A's amount recognized upon the sale of replacement QSB1 stock by LTP, A must take into account A's basis adjustment of \$200. Accordingly, A recognizes a total gain of \$300 upon the sale of replacement QSB1 stock, absent an additional section 1045 election by A or LTP. Under paragraph (c)(4)(iv) of this section, the adjusted basis of A's interest in UTP is increased by \$300 under section 705(a)(1).

(vi) Assume the same facts as in paragraph (i) of this *Example 4*, except that UTP sells its entire interest in LTP on March 30, 2009, for \$1,200. UTP realizes a gain of \$200 on the sale of its interest in LTP (\$1,200 amount realized less \$1,000 adjusted basis) and allocates \$100 of this gain to A. Under paragraph (c)(5) of this section, in determining A's amount recognized upon the sale of UTP's interest in LTP, A must take into account A's basis adjustment of \$200. Accordingly, A recognizes a total gain of \$300 upon the sale of the interest in LTP. Under paragraph (c)(4)(iv) of this section, the adjusted basis in A's interest in UTP is increased by \$300 under section 705(a)(1).

Example 5. Partnership sale of QSB stock and purchase and sale of replacement QSB stock. (i) On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS, a partnership. A, X, and Y each contribute \$250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for \$750 on February 1, 2008. On November 3, 2008, PRS sells the QSB stock for \$1,500. PRS realizes \$750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$250 of gain to each of A, X, and Y. PRS purchases replacement QSB stock (replacement QSB1 stock) for \$1,350 on December 15, 2008. On its timely filed return for the taxable year during which the sale of the QSB stock occurs, PRS makes an election to apply section 1045. A does not make an election to apply section 1045 with respect to the November 3, 2008, sale of QSB stock. PRS knows that X and Y are C corporations. On March 30, 2009, PRS sells replacement QSB1 stock for \$1,650. PRS realizes \$300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates \$100 of gain to each of A, X, and Y. A does not make an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock.

(ii) Under paragraph (b)(1) of this section, the partnership section 1045 gain from the November 3, 2008, sale of QSB stock is \$600 (\$750 gain less \$150 (\$1,500 amount realized on the sale of QSB stock less \$1,350 cost of replacement QSB1 stock)). This amount must be allocated among the partners in the same proportions as the entire gain from the sale of QSB stock is allocated to the partners, $\frac{1}{3}$ (\$200) to A, $\frac{1}{3}$ (\$200) to X, and $\frac{1}{3}$ (\$200) to Y.

(iii) Because neither X nor Y is an eligible partner under paragraph (g)(3) of this section, X and Y must each recognize its \$250 distributive share of partnership gain from the sale of QSB stock. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's \$200 distributive share of partnership section 1045 gain. A is not required to separately elect to apply section 1045. A must recognize A's remaining \$50 distributive share of the partnership's gain from the sale of QSB stock.

(iv) Under section 705(a)(1), the adjusted bases of X's and Y's interests in PRS are each increased by \$250. Under section 705(a)(1) and paragraph (b)(3)(i) of this section, the adjusted basis of A's interest in PRS is not increased by the \$200 of partnership section 1045 gain that was not recognized by A, but is increased by A's remaining \$50 distributive share of gain.

(v) PRS must decrease its basis in the replacement QSB1 stock by the \$200 of partnership section 1045 gain that was allocated to A. This basis reduction is a reduction with respect to A only. PRS then adjusts A's distributive share of gain from the sale of re-

placement QSB1 stock to reflect the effect of A's basis adjustment under paragraph (b)(3)(ii) of this section. In accordance with the principles of § 1.743-1(j)(3), the amount of A's gain from the March 30, 2009, sale of replacement QSB1 stock in which A has a \$200 negative basis adjustment equals \$300 (A's share of PRS' gain from the sale of replacement QSB1 stock (\$100), increased by the amount of A's negative basis adjustment for replacement QSB1 stock (\$200)). Accordingly, upon the sale of replacement QSB1 stock, A recognizes \$300 of gain, and X and Y each recognize \$100 of gain.

(vi) Assume the same facts as in paragraph (i) of this *Example 5*, except that PRS purchases replacement QSB stock (replacement QSB2 stock) on April 15, 2009, for \$1,150 and PRS makes an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock. Under paragraph (b)(3)(ii)(A) of this section, PRS' \$200 basis adjustment in QSB1 stock relating to the November 3, 2008, sale of QSB stock carries over to the basis adjustment for QSB2 stock. This basis adjustment is an adjustment with respect to A only. The \$200 basis adjustment is reduced by A's distributive share of the excess of \$500 (the greater of the amount determined under paragraph (b)(1)(i), \$0, or (ii) of this section, \$500 (\$1,650 amount realized on the sale of QSB1 stock less \$1,150 cost of replacement QSB2 stock)) over \$300 (PRS' gain from the sale of QSB1 stock), or \$67 (\$200 (\$500 minus \$300) divided by 3). Under paragraph (b)(3)(ii)(A), A must account for the \$67 excess amount that reduces PRS' basis adjustment in QSB2 stock as gain in accordance with § 1.743-1(j)(3). Therefore, A now has a \$133 negative basis adjustment with respect to replacement QSB2 stock ((\$200) negative basis adjustment from the November 3, 2008, sale of QSB stock plus \$67 positive basis adjustment from the March 30, 2009, sale of QSB1 stock). A also recognizes the \$100 of gain allocated by PRS to A from the March 30, 2009, sale of replacement QSB1 stock for total gain recognition of \$167 (\$100 plus \$67).

Example 6. Partnership sale of QSB stock; election by eligible partner; replacement QSB stock purchased by purchasing partnership. (i) Assume the same facts as in *Example 5* except that PRS does not make an election under section 1045 with respect to the sale of either the QSB stock on November 3, 2008, or the QSB1 stock on March 30, 2009. However, A makes an election under section 1045 with respect to the sale of QSB stock and treats the purchase of QSB1 stock on December 15, 2008, by PRS, as the purchase of replacement QSB stock. Additionally, A makes an election under section 1045 with respect to the sale of QSB1 stock and treats the purchase of QSB2 stock on April 15, 2009, by PRS, as the purchase of replacement QSB stock.

(ii) A's distributive share of gain from the November 3, 2008, sale of QSB stock is \$250

(A's $\frac{1}{3}$ interest in \$750 of total PRS gain). Under paragraph (c)(1)(iii) of this section, A must recognize only \$50 of A's distributive share of PRS' gain of \$250, that is the excess of A's share of the amount realized on the sale of QSB stock, or \$500 (the total amount realized by PRS on the sale of QSB stock (\$1,500) multiplied by A's share of the gain from the sale of QSB stock (\$250) over the total gain realized by PRS on the sale of QSB stock (\$750)), minus A's share of PRS' cost of QSB1 stock, or \$450 ($\frac{1}{3}$ of \$1,350). Under section 705(a)(1) and paragraph (c)(4)(i) of this section, A's adjusted basis in its interest in PRS is increased by \$250. However, under paragraph (c)(4)(iii) of this section, because PRS is a purchasing partnership, A's adjusted basis of its interest in PRS is then reduced by the deferred gain of \$200. Also under paragraph (c)(4)(ii) of this section, PRS' adjusted basis in QSB1 stock is reduced by the gain not recognized of \$200 and A must take into account such adjusted basis in computing A's income, gain, loss or deduction with respect to QSB1 stock. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired.

(iii) A's distributive share of gain from the March 30, 2009, sale of QSB1 stock is \$100 (A's $\frac{1}{3}$ interest in \$300 of total PRS gain) and under paragraph (c)(5) of this section, A must take into account A's \$200 basis adjustment with respect to the QSB1 stock that was sold. Accordingly, A's total gain from the sale of QSB1 stock is \$300. Under paragraph (c)(1)(iii) of this section, A must recognize only \$167 of A's total gain of \$300, that is, the excess of A's share of the amount realized on the sale of QSB1 stock, or \$550 (the total amount realized by PRS on the sale of QSB1 stock (\$1,650) multiplied by A's share of the gain from the sale of QSB1 stock (\$100) over the total gain realized by PRS on the sale of QSB1 stock (\$300)) minus A's share of PRS' cost of QSB2 stock, or \$383 ($\frac{1}{3}$ of \$1,150). Under section 705(a)(1), A's adjusted basis in A's interest in PRS is increased by A's \$100 distributive share of gain from the sale of QSB1 stock. Under paragraph (c)(4)(iv) of this section, A's adjusted basis of A's interest in PRS is increased by the additional \$67 of gain recognized under paragraph (c)(5) of this section. Also, under paragraph (c)(4)(ii) of this section, PRS' adjusted basis in QSB2 stock is reduced by the gain not recognized of \$133 (\$300 minus \$167) and A must take into account such adjusted basis in computing A's income, gain, loss or deduction with respect to QSB2 stock. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired.

Example 7. Partnership sale of QSB stock and partner purchase of replacement QSB stock. (i)

Assume the same facts as in paragraph (i) of *Example 5*, except that PRS does not make an election under section 1045 with respect to the sale of the QSB stock and does not purchase replacement QSB stock. On November 30, 2008, A, an eligible partner under paragraph (g)(3) of this section, purchases replacement QSB stock for \$500. A elects pursuant to paragraph (c) of this section to apply section 1045 on A's timely filed return for the taxable year that A is required to include A's distributive share of PRS' gain from the sale of the QSB stock.

(ii) Under paragraph (c)(2) of this section, A's share of the amount realized from PRS' sale of the QSB stock is \$500 (the total amount realized by the partnership on the sale of the QSB stock (\$1,500) multiplied by A's share of the gain from the sale of the QSB stock (\$250) over the total gain realized by the partnership on the sale of the QSB stock (\$750)). Because A purchased, within 60 days of PRS' sale of the QSB stock, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of the QSB stock, and because A made an election pursuant to paragraph (c) of this section to apply section 1045, A defers recognition of A's \$250 distributive share of gain from PRS' sale of the QSB stock. Under section 705(a)(1) and paragraph (c)(4)(i) of this section, the adjusted basis of A's interest in PRS is increased by \$250. Under paragraph (c)(4)(ii) of this section, A's adjusted basis in the replacement QSB stock is \$250 (\$500 cost minus \$250 nonrecognition amount).

Example 8. Partial replacement by partnership; partial replacement by partner. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute \$500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for \$1,000 and subsequently sells the QSB stock on January 31, 2010, for \$3,000. PRS realizes \$2,000 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$1,000 of gain to each of A and X. On February 10, 2010, PRS purchases replacement QSB stock for \$2,200. On March 20, 2010, A purchases replacement QSB stock for \$400. PRS makes an election to apply section 1045 under paragraph (b)(1) of this section with respect to the partnership section 1045 gain from the sale of QSB stock and A does not opt out of PRS' section 1045 election under paragraph (b)(4) of this section. Also, A makes an election under paragraph (c)(1) of this section with respect to the remaining gain from the sale of the QSB stock.

(ii) Under paragraph (b)(1) of this section, partnership section 1045 gain is \$1,200 (\$2,000 less \$800 (\$3,000 amount realized on the sale of the QSB stock minus \$2,200 cost of the replacement QSB stock)). This amount is allocated among the partners in the same proportions as the entire gain from the sale of

the QSB stock is allocated to the partners, 1/2 to A (\$600), and 1/2 to X (\$600). Because A is an eligible partner, A defers recognition of A's \$600 distributive share of partnership section 1045 gain.

(iii) A also made an election under section 1045 and purchased, within 60 days of PRS' sale of the QSB stock, replacement QSB stock for \$400. Therefore, under paragraph (c)(1) of this section, A may defer a portion of A's distributive share of the remaining gain from the partnership's sale of the QSB stock. A must recognize that remaining gain to the extent that A's share of the amount realized by PRS on the sale of the QSB stock (excluding the cost of the QSB stock that was replaced by PRS) exceeds the cost of the replacement QSB stock purchased by A during the 60-day period following the sale of the QSB stock. The amount realized by PRS on the sale of the QSB stock (excluding the cost of the QSB stock that was replaced by PRS) is \$800 (\$3,000 minus \$2,200). Under paragraph (c)(2) of this section, A's share of that amount realized is \$400 (\$1,000 (A's share of the realized gain from the sale of the QSB stock) + \$2,000 (PRS total realized gain from the sale of the QSB stock) multiplied by \$800). Because the replacement QSB stock purchased by A cost \$400, A defers recognition of all of the remaining gain from the sale of the QSB stock.

(iv) The adjusted basis of A's interest in PRS is not increased by the \$600 gain that was not recognized pursuant to paragraph (b)(1) of this section, but is increased by the \$400 gain that was not recognized pursuant to paragraph (c)(1) of this section. See paragraphs (b)(3)(i) and (c)(4)(i) of this section. PRS must decrease its basis in the replacement QSB stock by the \$600 of partnership section 1045 gain that was allocated to A. See paragraph (b)(3)(ii) of this section. A must decrease A's basis in the replacement QSB stock purchased by A by the \$400 not recognized pursuant to paragraph (c)(1) of this section. See paragraph (c)(4)(ii) of this section.

Example 9. Change in partner's interest in partnership while partnership holds QSB stock.

(i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute \$500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for \$1,000. On August 2, 2008, A sells a 25 percent interest in PRS to Z. On July 10, 2009, A repurchases the 25 percent interest from Z for \$500. PRS makes a timely election under section 754 for the 2008 taxable year. Under section 743(b), A has a positive basis adjustment of \$250. On January 31, 2011, PRS sells the QSB stock for \$3,000. PRS realizes \$2,000 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$1,000 of gain to each of A and X. On February 10, 2010, PRS purchases replacement QSB stock for \$3,000. PRS makes

an election to apply section 1045 under paragraph (b)(1) of this section with respect to the partnership section 1045 gain from the sale of QSB stock.

(ii) Of the \$2,000 of realized gain from the sale of the QSB stock, PRS allocates \$1,000 to A and \$1,000 to X. However, A has a positive basis adjustment of \$250 under section 743(b) as a result of the purchase of the 25 percent interest in PRS from Z; therefore, A's share of the gain is reduced to \$750. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's distributive share of gain from the sale of the QSB stock subject to the nonrecognition limitation described in paragraph (d) of this section. The smallest percentage interest that A held in PRS capital during the time that PRS held the QSB stock is 25 percent. Under the nonrecognition limitation, A may not defer more than 25 percent of the partnership gain realized from the sale of the QSB stock (determined without regard to any basis adjustment under section 734(b) or section 743(b), other than a basis adjustment described in paragraph (b)(3)(ii) of this section). Because the partnership's realized gain determined without regard to A's basis adjustment under section 743(b) is \$2,000, A may defer recognition of \$500 (25 percent of \$2,000) of the gain from the sale of the QSB stock. A must recognize the remaining \$250 of that gain.

Example 10. Sale by partner of QSB stock received in a liquidating distribution. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute \$1,500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for \$3,000. On May 1, 2008, when the QSB stock has appreciated in value to \$4,000, A contributes \$1,000 to PRS, increasing A's interest in PRS capital to 60 percent. On June 1, 2011, when the QSB stock is still worth \$4,000, PRS makes a liquidating distribution of \$3,000 worth of QSB stock to A. Under section 732, A's basis in the distributed QSB stock is \$2,500. A sells the QSB stock on August 4, 2011, for \$6,000, realizing a gain of \$3,500 (none of which is treated as ordinary income). A purchases replacement QSB stock on August 30, 2011, for \$5,500, and makes an election under section 1045 with respect to the August 4, 2011, sale of QSB stock.

(ii) A is an eligible partner under paragraph (g)(3) of this section. Therefore, under paragraph (e)(1) of this section, A is treated as having acquired the distributed QSB stock in the same manner as PRS and as having held the QSB stock since February 1, 2008, its original issue date. Because A purchased, within 60 days of A's sale of the QSB stock, replacement QSB stock, A is eligible to defer a portion of A's gain from the sale of the QSB stock. A must recognize gain, however, to the extent that A's amount realized on

the sale of the QSB stock, \$6,000, exceeds the cost of the replacement QSB stock purchased by A during the 60-day period beginning on the date of the sale of the QSB stock, \$5,500. Accordingly, A must recognize \$500 of the gain from the sale of the QSB stock. A defers recognition of the remaining \$3,000 of gain to the extent that such gain does not exceed the distribution nonrecognition limitation under paragraph (e)(3) of this section.

(iii) Under paragraph (e)(3)(i) of this section, A's nonrecognition limitation with respect to the sale of the QSB stock is A's section 1045 amount realized with respect to the stock, reduced by A's section 1045 adjusted basis with respect to the stock. A's amount realized from the sale is the product of A's amount realized from the sale, \$6,000; and a fraction—

(1) The numerator of which is A's smallest percentage interest in PRS capital with respect to such stock, 50 percent; and

(2) The denominator of which is A's percentage interest in that type of partnership QSB stock immediately after the distribution, 75 percent (the value of the stock distributed to A, \$3,000, divided by the value of all QSB stock of that type acquired by PRS, \$4,000).

(iv) Therefore, A's section 1045 amount realized is \$4,000 (\$6,000 multiplied by 50/75). Because PRS distributed the QSB stock to A in liquidation of A's interest in PRS, A's section 1045 adjusted basis is the product of PRS' basis in all of the QSB stock of the type distributed, \$3,000; A's smallest percentage interest in PRS capital with respect to QSB stock of the type distributed, 50 percent; and the percentage of the distributed QSB stock that was sold by A, 100 percent. Therefore, A's section 1045 adjusted basis is \$1,500 (the product of \$3,000, 50 percent, and 100 percent) and A's nonrecognition limitation amount on the sale of the QSB stock is \$2,500 (\$4,000 section 1045 amount realized minus \$1,500 section 1045 adjusted basis). Accordingly, A defers recognition of \$2,500 of the remaining \$3,000 gain from the sale of the QSB stock and must recognize \$500 of the remaining \$3,000 gain. Accordingly, A's total gain recognized from the sale of the QSB stock is \$1,000.

(v) A's basis in the replacement QSB stock is \$3,000 (cost of the replacement QSB stock, \$5,500, reduced by the gain not recognized under section 1045, \$2,500).

Example 11. Sale by partner of QSB stock received in a nonliquidating distribution. (i) The facts are the same as in *Example 10*, except that, on June 1, 2011, PRS distributes only \$2,000 of the QSB stock to A, reducing A's interest in PRS capital from 60 percent to 33 percent. PRS' basis in the distributed QSB stock is \$1,500. On November 1, 2011, A sells for \$2,500 the QSB stock distributed by PRS to A and purchases, within 60 days of the date of sale of the QSB stock, replacement

QSB stock for \$2,500. A makes a timely election to apply section 1045 with respect to A's sale of the distributed QSB stock.

(ii) Under section 732, A's basis in the distributed QSB stock is \$1,500. Therefore, A realizes a gain on the sale of the distributed QSB stock of \$1,000. Because A made an election to apply section 1045 to the sale, and because A purchased, within 60 days of A's sale of the QSB stock, replacement QSB stock at a cost equal to the amount realized on the sale of the distributed QSB stock, A defers recognition of the gain from the sale of the QSB stock to the extent that such gain does not exceed the distribution nonrecognition limitation.

(iii) Under paragraph (e)(3) of this section, the nonrecognition limitation with respect to A's sale of the QSB stock is A's section 1045 amount realized reduced by A's section 1045 adjusted basis. Because PRS did not distribute all of the particular type of QSB stock and the distribution of the QSB stock to A was not in liquidation of A's interest in PRS, under paragraph (e)(3)(ii)(C) of this section A's section 1045 amount realized is \$1,250 (A's amount realized from the sale of the distributed QSB stock, \$2,500, multiplied by A's smallest percentage interest in PRS capital with respect to such stock, 50 percent). Under paragraph (e)(3)(iii)(B) of this section, A's section 1045 adjusted basis is the product of the partnership's basis in the QSB stock sold by the partner, \$1,500, and A's smallest percentage interest in the partnership capital with respect to such stock, 50 percent. Therefore, A's section 1045 adjusted basis is \$750 (50 percent of \$1,500), and A's nonrecognition limitation amount on the sale of the QSB stock is \$500 (\$1,250 section 1045 amount realized minus \$750 section 1045 adjusted basis). As this amount is less than the amount of gain that A is eligible to defer under section 1045, \$1,000, A defers recognition of only \$500 of the gain from the sale of the QSB stock. A must recognize the remaining \$500 of that gain.

(iv) A's basis in the replacement QSB stock is \$2,000 (cost of the replacement QSB stock, \$2,500, reduced by the gain not recognized under section 1045, \$500).

Example 12. Contribution of replacement QSB stock to a partnership. (i) On January 1, 2008, A, an individual, B, an individual, and X, a C corporation, form PRS, a partnership. A, B, and X each contribute \$250 to PRS and agree to share all partnership items equally. On February 1, 2008, PRS purchases QSB stock for \$750. PRS sells the QSB stock on November 3, 2008, for \$1,050. PRS realizes \$300 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$100 of gain to each of its partners. PRS informs the partners that it does not intend to make an election under section 1045 with respect to the sale of the QSB stock. Each partner's share of the amount realized

from the sale of the QSB stock is \$350. On November 30, 2008, A, an eligible partner within the meaning of paragraph (g)(3) of this section, purchases replacement QSB stock for \$350 and makes a section 1045 election under paragraph (c)(1) of this section. Subsequently, A transfers the replacement QSB stock to ABC, a partnership, in exchange for an interest in ABC.

(i) Because A purchased within 60 days of PRS' sale of the QSB stock, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of the QSB stock, and because A made a valid election to apply section 1045 with respect to A's share of the gain from PRS' sale of the QSB stock, A does not recognize A's \$100 distributive share of the gain from PRS' sale of the QSB stock. Before the contribution of the replacement QSB stock to ABC, A's adjusted basis in the replacement QSB stock is \$250 (\$350 cost minus \$100 nonrecognition amount). A does not recognize gain upon the contribution of QSB stock to ABC under section 721(a). Upon the contribution of the replacement QSB stock to ABC, A's basis in the ABC partnership interest is \$250, and ABC's basis in the replacement QSB stock is \$250. However, the replacement QSB stock does not qualify as QSB stock in ABC's hands. Neither A nor ABC will be eligible to defer gain under section 1045 on a subsequent sale of the replacement QSB stock.

(j) *Effective date/applicability—In general.* This section applies to sales of QSB stock on or after August 14, 2007.

[T.D. 9353, 72 FR 45349, Aug. 14, 2007, as amended by T.D. 9353, 72 FR 57487, Oct. 10, 2007]

SPECIAL RULES

§ 1.1051-1 Basis of property acquired during affiliation.

(a)(1) The basis of property acquired by a corporation during a period of affiliation from a corporation with which it was affiliated shall be the same as it would be in the hands of the corporation from which acquired. This rule is applicable if the basis of the property is material in determining tax liability for any year, whether a separate return or a consolidated return is made in respect of such year. For the purpose of this section, the term *period of affiliation* means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto), but does not include any taxable year beginning on or after January 1, 1922, unless a consoli-

dated return was made, nor any taxable year after the taxable year 1928.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example: The X Corporation, the Y Corporation, and the Z Corporation were affiliated for the taxable year 1920. During that year the X Corporation transferred assets to the Y Corporation for \$120,000 cash, and the Y Corporation in turn transferred the assets during the same year to the Z Corporation for \$130,000 cash. The assets were acquired by the X Corporation in 1916 at a cost of \$100,000. The basis of the assets in the hands of the Z Corporation is \$100,000.

(b) The basis of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return was made or was required under the regulations governing the making of consolidated returns, shall be determined in accordance with such regulations. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made or is required under the regulations governing the making of consolidated returns, shall be adjusted in respect of any items relating to such period in accordance with such regulations.

(c) Except as otherwise provided in the regulations promulgated under section 1502 of the Internal Revenue Code of 1954 or the regulations under section 141 of the Internal Revenue Code of 1939 or the Revenue Act of 1938 (52 Stat. 447), 1936 (49 Stat. 1652), 1934 (48 Stat. 683), 1932 (47 Stat. 169), or 1928 (45 Stat. 791), the basis of property after a consolidated return period shall be the same as the basis immediately prior to the close of such period.

§ 1.1052-1 Basis of property established by Revenue Act of 1932.

Section 1052(a) provides that if property was acquired after February 28, 1913, in any taxable year beginning before January 1, 1934, and the basis of the property, for the purposes of the Revenue Act of 1932 (47 Stat. 169), was prescribed by section 113(a) (6), (7), or (9) of that act, then for purposes of subtitle A of the Code, the basis shall be