which a tax is imposed under section 2056A(b)(1)(A) is treated as a transfer by gift, and any estate tax paid on the distribution under section 2056A(b)(1)(A) is treated as a gift tax. The rules under this paragraph apply in determining the extent to which the basis in the assets distributed is increased by the tax imposed under section 2056A(b)(1)(A).

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

Example 1. (i) Prior to 1995, X exhausts X's gift tax unified credit available under section 2505. In 1995, X makes a gift to X's child Y, of a parcel of real estate having a fair market value of $100,000. X's adjusted basis in the real estate immediately before making the gift was $70,000. Also in 1995, X makes a gift to X's child Z, of a painting having a fair market value of $70,000. X timely files a gift tax return for 1995 and pays gift tax in the amount of $55,500, computed as follows:

Value of real estate transferred to Y	$100,000	
Less: Annual exclusion	10,000	
Included amount of gift (C)		$90,000
Value of painting transferred to Z	$70,000	
Less: annual exclusion	10,000	
Included amount of gift		60,000
Total included gifts (D)		$150,000
Total gift tax liability for 1995 gifts (B)		$55,500

(ii) The gift tax paid with respect to the real estate transferred to Y, is determined as follows:

$$\frac{\$90{,}000\ (\mathrm{C})}{\$150{,}000\ (\mathrm{D})} \times \$55{,}500\ (\mathrm{B}) = \$33{,}300$$

(iii)(A) The amount by which Y's basis in the real property is increased is determined as follows:

$$\frac{\$30{,}000\ (\text{net appreciation})}{\$90{,}000\ (\text{amount of gift})} \times \$33{,}300 = \$11{,}100$$

(B) Y's basis in the real property is $70,000 plus $11,100, or $81,100. If X had not exhausted any of X's unified credit, no gift tax would have been paid and, as a result, Y's basis would not be increased.

Example 2. (i) X dies in 1995. X's spouse, Y, is not a United States citizen. In order to obtain the marital deduction for property passing to X's spouse, X established a QDOT in X's will. In 1996, the trustee of the QDOT makes a distribution of principal from the QDOT in the form of shares of stock having a fair market value of $70,000 on the date of distribution. The trustee's basis in the stock (determined under section 1014) is $50,000. An estate tax is imposed on the distribution under section 2056A(b)(1)(A) in the amount $38,500, and is paid. Y's basis in the shares of stock is increased by a portion of the section 2056A estate tax paid determined as follows:

$$\frac{\$20{,}000\ (\text{net appreciation})}{\$70{,}000\ (\text{distribution})} \times \$38{,}500\ (\text{section 2056A estate tax}) = \$11{,}000$$

(ii) Y's basis in the stock is $50,000 plus $11,000, or $61,000.

(6) *Effective date.* The provisions of this paragraph (c) are effective for gifts made after August 22, 1995.

(d) *Treatment as adjustment to basis.* Any increase in basis under section 1015(d) and this section shall, for purposes of section 1016(b) (relating to adjustments to a substituted basis), be treated as an adjustment under section 1016(a) to the basis of the donee's property to which such increase applies. See paragraph (p) of § 1.1016–5.

[T.D. 6693, 28 FR 12818, Dec. 3, 1963, as amended by T.D. 7238, 37 FR 28715, Dec. 29, 1972; T.D. 7910, 48 FR 40372, Sept. 7, 1983; T.D. 8612, 60 FR 43537, Aug. 22, 1995]

§ 1.1016–1 Adjustments to basis; scope of section.

Section 1016 and §§ 1.1016–2 to 1.1016–10, inclusive, contain the rules relating to the adjustments to be made to the basis of property to determine the adjusted basis as defined in section 1011. However, if the property was acquired from a decedent before his death, see § 1.1014–6 for adjustments on account of certain deductions allowed the taxpayer for the period between the date of acquisition of the property and the date of death of the decedent. If an election has been made under the Retirement-Straight Line Adjustment Act of 1958 (26 U.S.C. 1016 note), see § 1.9001–1 for special rules for determining adjusted basis in the case of a taxpayer who has changed from the retirement to the straight-line method of computing depreciation allowances.

§ 1.1016–2 Items properly chargeable to capital account.

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income. See the regulations under section 263(c).

(b) The application of the foregoing provisions may be illustrated by the following example:

Example: A, who makes his returns on the calendar year basis, purchased property in 1941 for $10,000. He subsequently expended $6,000 for improvements. Disregarding, for the purpose of this example, the adjustments required for depreciation, the adjusted basis of the property is $16,000. If A sells the property in 1954 for $20,000, the amount of his gain will be $4,000.

(c) Adjustments to basis shall be made for carrying charges such as taxes and interest, with respect to property (whether real or personal, improved or unimproved, and whether productive or unproductive), which the taxpayer elects to treat as chargeable to capital account under section 266, rather than as an allowable deduction. The term *taxes* for this purpose includes duties and excise taxes but does not include income taxes.

(d) Expenditures described in section 173 to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical are chargeable to capital account only in accordance with and in the manner provided in the regulations under section 173.

§ 1.1016–3 Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

(a) *In general*—(1) *Adjustment where deduction is claimed.* (i) For taxable periods beginning on or after January 1, 1952, the cost or other basis of property shall be decreased for exhaustion, wear and tear, obsolescence, amortization, and depletion by the greater of the following two amounts:

(*a*) The amount allowed as deductions in computing taxable income, to the extent resulting in a reduction of the taxpayer's income taxes, or

(*b*) The amount allowable for the years involved.

See paragraph (b) of this section. Where the taxpayer makes an appropriate election the above rule is applicable for periods since February 28, 1913, and before January 1, 1952. See paragraph (d) of this section. For rule for such periods where no election is made, see paragraph (c) of this section.

(ii) The determination of the amount properly allowable for exhaustion, wear and tear, obsolescence, amortization, and depletion shall be made on the basis of facts reasonably known to exist at the end of the taxable year. A taxpayer is not permitted to take advantage in a later year of his prior failure to take any such allowance or his taking an allowance plainly inadequate under the known facts in prior years. In the case of depreciation, if in prior years the taxpayer has consistently taken proper deductions under one method, the amount allowable for such prior years shall not be increased even though a greater amount would have been allowable under another proper method. For rules governing losses on