

(3) Certain tax-free transactions to which section 1250(d)(3) applies. For application of section 1250 (d)(3) and (e)(2) to a distribution by a partnership to a partner, see paragraph (f)(1) of §1.1250-3.

(4) A transfer described in paragraph (e)(4) of §1.1250-3 (relating to transaction under section 1081(d)(1)(A)).

(d) *Principal residence acquired in certain transactions.* The holding period of a principal residence acquired in a transaction to which section 1034 and paragraph (g)(6) of §1.1250-3 apply includes the holding period of the principal residence disposed of in such transaction. See section 1250(e)(3). The holding period of a principal residence acquired does not include the period beginning on the day after the date of the disposition and ending on the date of the acquisition.

(e) *Application of transferred basis and principal residence rules.* The determination of holding period under this section shall be made without regard to whether a transaction occurred prior to the effective date of section 1250 and without regard to whether there was any gain upon the transaction. Thus, for example, under paragraph (c) of this section a donee's holding period for property includes his donor's holding period notwithstanding that the gift occurred on or before December 31, 1963, or that there was no additional depreciation in respect of the property at the time of the gift.

(f) *Qualified low-income housing project acquired in certain transactions.* The holding period of a *reinvestment element* (and of subelements thereof) of section 1250 property (as defined in paragraph (h) (2) of §1.1250-3) acquired in a transaction to which sections 1039(a) and 1250(d)(8)(A) apply includes the holding period of the corresponding element of the section 1250 property disposed of. See section 1250(e)(4). The holding period of the *additional cost element* (as defined in paragraph (h)(2) of §1.1250-3) begins on the date the replacement project is acquired. The holding period of a *reinvestment element* of section 1250 property does not include the period beginning on the day after the date of the disposition and ending (1) on the date of the acquisition of the replacement housing project, or (2) on the date

the replacement housing project constructed or reconstructed by the taxpayer is placed in service.

(g) *Cross reference.* If the adjusted basis of the property in the hands of the transferee immediately after a transaction to which paragraph (c) or (d) of this section applies exceeds its adjusted basis in the hands of the transferor immediately before the transaction, the excess is an addition to capital account under paragraph (d)(2)(ii) of §1.1250-5 (relating to property with two or more elements).

[T.D. 7084, 36 FR 281, Jan. 8, 1971, as amended by T.D. 7400, 41 FR 5103, Feb. 4, 1976]

§1.1250-5 Property with two or more elements.

(a) *Dispositions before January 1, 1970—*
(1) *Amount treated as ordinary income.* If section 1250 property consisting of two or more elements (described in paragraph (c) of this section) is disposed of before January 1, 1970, the amount of gain taken into account under section 1250(a)(2) shall be the sum, determined in three steps under subparagraphs (2), (3), and (4) of this paragraph, of the amounts of gain for each element.

(2) *Step 1.* The first step is to make the following computations:

(i) In respect of the property as a whole, compute the additional depreciation (as defined in section 1250(b)), and the gain realized. For purposes of this paragraph, in the case of a transaction other than a sale, exchange or involuntary conversion, the gain realized shall be considered to be the excess of the fair market value of the property over its adjusted basis.

(ii) In respect of each element as if it were a separate property, compute the additional depreciation for the element, and the applicable percentage (as defined in section 1250(a)(2)) for the element. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the

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purpose of determining applicable percentage, the holding period for an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250-4.

(3) *Step 2.* The second step is to determine the amount of gain for each element in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole is equal to the sum of the additional depreciation in respect of each element having additional depreciation, and if such amount is not more than the gain realized, then the amount of gain to be taken into account for an element is the product of the additional depreciation for the element, multiplied by the applicable percentage for the element.

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account for an element is the product of:

(a) The additional depreciation for the element, multiplied by

(b) The applicable percentage for the element, and multiplied by

(c) A ratio, computed by dividing (1) the lower of the additional depreciation in respect of the property as a whole or the gain realized, by (2) the sum of the additional depreciation in respect of each element having additional depreciation.

(4) *Step 3.* The third step is to compute the sum of the amounts of gain for each element, as determined in step 2.

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

Example 1 Gain of \$35,000 is realized upon a sale, before January 1, 1970, of section 1250 property which consists of four elements (W, X, Y, and Z). Since on the date of the sale the amount of additional depreciation in respect of the property as a whole (\$24,000) is equal to the sum of the additional depreciation in respect of each element having additional depreciation and is less than the gain realized, the additional depreciation for each element is determined under subparagraph (3)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(2) is \$7,500, as determined in the following table in accordance with the additional facts assumed.

Element	Additional depreciation×	Applicable percentage=	Gain for element
W	\$12,000×	0=	0
X	6,000×	50=	\$3,000
Y	0×	63=	0
Z	6,000×	75=	4,500
Totals	24,000		7,500

Example 2. Assume the same facts as in example (1), except that in respect of the property as a whole the additional depreciation is \$20,000 because with respect to element Y additional depreciation allowed was \$4,000 less than straight line. Accordingly, the sum of the additional depreciation for each element having additional depreciation is \$24,000, that is, \$4,000 greater than the additional depreciation in respect of the property as a whole. Thus, the additional depreciation for each element is determined under subparagraph (3)(ii) of this paragraph. The ratio referred to in subparagraph (3)(ii)(c) of this paragraph is twenty twenty-fourths, that is, the lower of additional depreciation in respect of the property as a whole (\$20,000) or the gain realized (\$35,000), divided by the sum of the additional depreciation in respect of each element having additional depreciation (\$24,000). The amount of gain taken into account under section 1250(a)(2) is \$6,250, as determined in the following table:

Element	Additional depreciation×	Applicable percentage×	Ratio=	Gain for element
W	\$12,000×	0×	20:24=	0
X	6,000×	50×	20:24=	\$2,500
Y	0×	63×	20:24=	0
Z	6,000×	75×	20:24=	3,750
Totals	24,000			6,250

(b) *Dispositions after December 31, 1969—(1) Amount treated as ordinary income.* If section 1250 property consisting of two or more elements (described in paragraph (c) of this section) is disposed of after December 31, 1969, the amount of gain taken into account under section 1250(a) shall be the sum, determined in 5 steps under subparagraphs (2), (3), (4), (5), and (6) of this paragraph, of the amount of gain for each element. Steps 3 and 4 are used only if the gain realized exceeds the additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole.

(2) *Step 1.* The first step is to make the following computations:

(i) In respect of the property as a whole, compute the additional depreciation (as defined in section 1250(b)) attributable to periods after December 31, 1969, and the gain realized. For purposes of this paragraph, in the case of a transaction other than a sale, exchange, or involuntary conversion, the gain realized shall be considered to be the excess of the fair market value of the property over its adjusted basis.

(ii) In respect of each element as if it were a separate property, compute the additional depreciation for the element attributable to periods after December 31, 1969, and the applicable percentage (as defined in section 1250(a)(1)) for the element. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period for an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250-4.

(3) *Step 2.* The second step is to determine the amount of gain recognized for each element under section 1250(a)(1) in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969, is equal to the sum of the additional depreciation in respect of each element having such additional depreciation, and if such amount is not more than the gain realized, then the amount of gain to be taken into account for an element under section 1250(a)(1) is the product of the additional depreciation attributable to periods after December 31, 1969, for the element, multiplied by the applicable percentage for the element determined under section 1250(a)(1).

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account under section 1250(a)(1) for an element is the product of:

(a) The additional depreciation attributable to periods after December 31, 1969, for the element multiplied by

(b) The applicable percentage for the element determined under section 1250(a)(1) for the element, and multiplied by

(c) A ratio, computed by dividing (1) the lower of the additional depreciation in respect of the property as a whole which is attributable to periods after December 31, 1969, or the gain realized, by (2) the sum of the additional depreciation attributable to periods after December 31, 1969, in respect of each element having such additional depreciation.

(4) *Step (3).* If the gain realized exceeds the additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969.

(i) Compute the additional depreciation attributable to periods before January 1, 1970, and the remaining gain (or remaining potential gain in the case of a transaction other than a sale, exchange, or involuntary conversion), in respect of the property as a whole.

(ii) Compute the additional depreciation attributable to periods before January 1, 1970, and the applicable percentage determined under section 1250(a)(2) in respect of each element as if it were a separate property. For additional depreciation in respect of an element of property acquired in certain transactions, see paragraph (e) of this section. For purposes of determining additional depreciation, the holding period of an element shall be determined under section 1223, applied by treating the element as a separate property. However, for the purpose of determining applicable percentage, the holding period of an element shall, except to the extent provided in paragraphs (c)(5), (e), and (f) of this section, be determined in accordance with the rules prescribed in § 1.1250-4.

(5) *Step (4).* The fourth step is to compute the gain recognized under section 1250(a)(2) for each element (if computation was required under step (3)) in the following manner:

(i) If the amount of additional depreciation in respect of the property as a whole attributable to periods before January 1, 1970, is equal to the sum of

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the additional depreciation in respect of each element having such additional depreciation, and if such amount is not more than the remaining gain (or remaining potential gain), then the amount of gain to be taken into account for an element under section 1250(a)(2) is the product of the additional depreciation attributable to periods before January 1, 1970, for the element, multiplied by the applicable percentage determined under section 1250(a)(2) for the element.

(ii) If subdivision (i) of this subparagraph does not apply, the amount of gain to be taken into account for an element under section 1250(a)(2) is the product of:

(a) The additional depreciation attributable to periods before January 1, 1970, for the element, multiplied by,

(b) The applicable percentage for the element determined under section 1250(a)(2), and multiplied by,

(c) A ratio, computed by dividing (1) the lower of the additional depreciation in respect of the property as a whole which is attributable to periods before January 1, 1970,

or the remaining gain (or remaining potential gain), by (2) the sum of the additional depreciation attributable to periods before January 1, 1970, in respect of each element having additional depreciation.

(6) *Step (5)*. The fifth step is to compute the sum of the amount of gain for each element, as determined in steps (2) and (4).

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

Example 1. Gain of \$60,000 is realized upon a sale, after the December 31, 1969, of section 1250 property which was constructed by the taxpayer after such date. The property consists of four elements (W, X, Y, and Z). Since on the date of sale the amount of additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole (\$32,000), is equal to the sum of the additional depreciation in respect of each element having such additional depreciation and is less than the gain realized, the gain recognized for each element is determined under subparagraph (3)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(1) is \$28,500, as determined in the following table in accordance with the additional facts assumed:

Element	Additional depreciation after Dec. 31, 1969 ^x	Applicable percentage= (1250(a)(1))	Gain for element
W	\$14,000 ^x	80=	\$11,200
X	6,000 ^x	90=	5,400
Y	2,000 ^x	95=	1,900
Z	10,000 ^x	100=	10,000
Total	32,000		28,500

Example 2. Assume the same facts as in example (1), except that the property was acquired by the taxpayer before January 1, 1970. Since the gain realized (\$60,000) exceeds the additional depreciation attributable to periods after December 31, 1969 (\$32,000), section 1250(a)(2) applies to the remaining gain of \$28,000. Since the additional depreciation in respect of the property as a whole attributable to periods before January 1, 1970 (\$21,000), is equal to the sum of the additional depreciation in respect of each element having such additional depreciation and is less than the remaining gain (\$28,000), the amount of gain recognized for each element under section 1250(a)(2) is determined under subparagraph (5)(i) of this paragraph. The amount of gain taken into account under section 1250(a)(1) is \$28,500 the same as in example (1). The amount of gain taken into account under section 1250(a)(2) is \$3,900, as determined in the following table in accordance with the additional facts assumed:

Element	Additional depreciation before Jan. 1, 1970 ^x	Applicable percentage= (1250(a)(2))	Gain for element (1250(a)(2))
W	\$8,000 ^x	0=	\$0
X	6,000 ^x	10=	600
Y	2,000 ^x	15=	300
Z	5,000 ^x	60=	3,000
Total	21,000		3,900

Example 3. (i) The facts are the same as in example (2) except that element Y has a deficit in additional depreciation attributable to periods after December 31, 1969, of \$6,000 and thus the additional depreciation attributable to periods after December 31, 1969, in respect of the property as a whole is \$24,000. The sum of the additional depreciation for each element having additional depreciation is \$30,000, or \$6,000 more than the additional depreciation in respect of the property as a whole. Thus, the gain recognized for each element under section 1250(a)(1) is determined under subparagraph (3)(ii) of this paragraph. The ratio referred to in subparagraph (3)(ii) (c) of this paragraph is 24:30, that is, the lower of the additional depreciation in respect of the property as a whole attributable to periods after December 31, 1969 (\$24,000), or the gain realized (\$60,000), divided by the sum of the additional depreciation in

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respect of each element having such additional depreciation (\$30,000). The amount of gain taken into account under section 1250(a)(1) is \$21,280, as determined in the following table:

Element	Additional depreciation ^x	Applicable percentage ^x (1250(a)(1))	Ratio=	Gain for element
W	\$14,000 ^x	80 ^x	24:30=	\$8,960
X	6,000 ^x	90 ^x	24:30=	4,320
Y	(6,000) ^x	95 ^x	24:30=	0
Z	10,000 ^x	100 ^x	24:30=	8,000
Total.	24,000			21,280

(ii) In addition, gain is recognized under section 1250(a)(2) since there is a remaining potential gain of \$36,000, that is, gain realized (\$60,000) minus the additional depreciation attributable to periods after December 31, 1969 (\$24,000). The gain recognized in respect of each element and the gain recognized under section 1250(a)(2) (\$3,900) are the same as in example (2), since the additional depreciation attributable to periods before January 1, 1970 (\$21,000) is less than the remaining gain (\$36,000).

(c) *Element*—(1) *General*. For purposes of this section, in the case of section 1250 property there shall be treated as separate elements the separate improvements, units, remaining property, special elements, and low-income housing elements which are respectively referred to in paragraphs (c) (2), (3), (4), (5), and (6) of this section.

(2) *Separate improvements*. There shall be treated as an element each *separate improvement* (as defined in paragraph (d)(1) of this section) to the property.

(3) *Units*. If before completion of section 1250 property one or more units thereof are placed in service, each such unit of the section 1250 property shall be treated as an element.

(4) *Remaining property*. The remaining property which is not taken into account under subparagraph (2) or (3) of this paragraph shall be treated as an element.

(5) *Special elements*. (i) If the basis of section 1250 property is reduced in the manner described in paragraph (b)(2)(ii) of §1.1250-3 (relating to property acquired from a decedent prior to his death) or in paragraph (e)(3)(iii) of §1.1250-3 (relating to basis reduction under section 1071 or 1082(a)(2)), then such property shall be considered as having a special element with additional depreciation equal to the

amount of additional depreciation included in the depreciation adjustments (referred to in paragraph (d)(1) of §1.1250-2) to which the basis reduction is attributable. For purposes of computing applicable percentage, the holding period of a special element under this subdivision shall be determined under paragraph (b)(2)(ii) or (e)(3)(iii) (whichever is applicable) of §1.1250-3.

(ii) If a disposition described in section 1250(d)(4)(A) (relating to like kind exchanges and involuntary conversions) of a portion of an item of property gives rise to an addition to capital account (described in the last sentence of paragraph (d)(2)(i) of this section) which is not a separate improvement, then such property shall be considered as having a special element with additional depreciation and, for purposes of computing applicable percentage, a holding period determined under paragraph (d)(7) of §1.1250-3.

(6) *Low-income housing elements*. If, in an approved disposition of a qualified housing project, a replacement qualified housing project is treated as consisting of more than one element of section 1250 property by reason of section 1250(d)(8)(E) (see paragraph (h)(2) of §1.1250-3), the elements determined under such section shall be treated as elements for purposes of this section. For definition of the terms *qualified housing project* and *approved disposition*, see section 1039(b) and the regulations thereunder.

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

Example 1. A taxpayer constructs an apartment house which he places in service in three stages. The total cost is \$1 million, of which \$350,000 is allocable to the first stage, \$500,000 to the second stage, and \$150,000 to the third stage. The first stage, which is placed in service on January 1, 1965, consists of 300 apartments and certain facilities including a central heating system and a common lobby. The second stage, which is placed in service on July 15, 1965, consists of 550 apartments and certain facilities including the motor for a central air-conditioning system. The third stage, which is placed in service on January 19, 1966, consists of the residue of the apartment house. On December 31, 1968, the taxpayer disposes of the apartment house. On such date, the apartment house has three elements which are described in the table below:

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Stage	Kind of element	Cost	Full months in holding period	Applicable percentage
1	Unit	\$350,000	48	72
2	Unit	500,000	42	78
3	Remaining property.	150,000	36	84

Example 2. Assume the same facts as in example (1) except that on January 1, 1969, two new floors, which were added after the apartment house was completed, are placed in service and that on July 1, 1972, the taxpayer disposes of the building. Assume further that the two new floors are one separate improvement (within the meaning of paragraph (d) of this section). On the date disposed of, the property consists of four elements, that is, the three elements described in example (1) and the separate improvement.

(d) *Separate improvement*—(1) *Definition.* For purposes of this section, with respect to any section 1250 property, the term *separate improvement* means an *addition to capital account* described in subparagraph (2) of this paragraph which qualifies as an *improvement* under the 1-year test prescribed in subparagraph (3) of this paragraph and which satisfies the 36-month test prescribed in subparagraph (4) of this paragraph.

(2) *Addition to capital account.* (i) In the case of any section 1250 property, an addition to capital account described in this subparagraph is any addition to capital account in respect of such property after its initial acquisition or completion by the taxpayer or by any person who held the property during a period included in the taxpayer's holding period (see §1.1250-4) for the property. An addition to the capital account of section 1250 property may arise, for example, if there is an expenditure for section 1250 property which is an improvement, replacement, addition, or alteration to such property (regardless of whether the cost thereof is capitalized or charged against the depreciation reserve). In such a case, the *addition to capital account* is the gross addition, unreduced by amounts attributable to replaced property, to the net capital account and not the net addition to such account. Thus, if a roof has an adjusted basis of \$20,000, and is replaced by constructing a new roof at a cost of \$50,000, the gross addition of \$50,000 is an addition to capital account. (The adjusted basis of the old

roof is no longer included in the capital account for the property.) For purposes of this section, the status of an addition to capital account is not affected by whether or not it is treated as a separate property for purposes of determining depreciation adjustments. In case of an addition to the capital account of property arising after December 31, 1963, upon a disposition referred to in section 1250(d)(4) (relating to like kind exchanges and involuntary conversions) of a portion of an item of such property, the amount of such addition (and its basis for all purposes of the Code) shall be the basis thereof determined under paragraph (d) (2), (3), or (4) (whichever is applicable) of §1.1250-3, applied by treating such portion and such addition as separate properties.

(ii) An addition to capital account may be attributable to an excess of the adjusted basis of section 1250 property in the hands of a transferee immediately after a transaction referred to in section 1250(e)(2) (relating to holding period of property with transferred basis) over its adjusted basis in the hands of the transferor immediately before the transaction. Thus, for example, such excess may arise from a gift which is in part a sale or exchange (see paragraph (a)(2) of §1.1250-3), from an increase in basis due to gift tax paid (see section 1015(d)), from a transfer referred to in paragraph (c)(2) of §1.1250-3 (relating to certain tax-free transactions) in which gain is partially recognized, or from a distribution by a partnership to a partner in which no gain is recognized by reason of the application of section 731. Similarly, an addition to capital account may be attributable to an excess of the adjusted basis of a principal residence acquired in a transaction referred to in section 1250(e)(3) over the adjusted basis of the principal residence disposed of, as well as to any increase in the adjusted basis of section 1250 property of a partnership by reason of an optional basis adjustment under section 734(b) or 743(b).

(iii) Whether or not an expenditure shall be treated as an addition to capital account described in this subparagraph, as distinguished from a separate item of property, may depend on how the property or properties are disposed of. Thus, for example, if a taxpayer,

who owns a motel consisting of 10 buildings with common heating and plumbing systems, adds to the motel three new buildings which are connected to the common systems, and if the taxpayer sells the motel to one person in one transaction, then for purposes of this subparagraph the cost of the three new buildings shall be treated as an addition to the capital account of the motel and, if the 1-year and 36-month tests of subparagraphs (3) and (4) of this paragraph are satisfied, the motel consists of at least two elements. If, however, the 10-building group and the three-building group were individually sold in separate transactions to two different people each of whom would operate his group as a separate business, the motel would consist of two items of property.

(3) *One-year test for improvement.* (i) An addition to capital account of section 1250 property for any taxable year (including a short taxable year and the entire taxable year in which the disposition occurs) shall be treated as an improvement only if the sum of all additions to the capital account of such property for such taxable year exceeds the greater of:

(a) \$2,000, or

(b) One percent of the unadjusted basis of the property, determined as of the beginning (1) of such taxable year, or (2) of the holding period (within the meaning of § 1.1250-4) of the property, whichever is the later.

(ii) For purposes of this section, the term *unadjusted basis* means the adjusted basis of the property, determined without regard to the adjustments provided in section 1016(a) (2) and (3) (relating to adjustments for depreciation, amortization, and depletion). For purposes of this paragraph, as of any particular date the unadjusted basis of section 1250 property (a) includes the cost of any addition to capital account for the property which arises prior to such date (regardless of whether such addition qualified under this subparagraph as an improvement), and (b) does not include the cost of a component retired before such date.

(iii) In respect of a particular disposition of section 1250 property by a person:

(a) There shall not be taken into account under the 1-year test for improvements in this subparagraph any addition to capital account which arises by reason of (or after) such disposition or which arises before the beginning of the holding period under § 1.1250-4 of such person for the property, and

(b) Such test shall be made in respect of each taxable year of such person (and of any prior transferor) any day of which is included under § 1.1250-4 in such person's holding period for the property, except that (1) such test shall be made for a taxable year of such person only if such person actually owned the property on at least 1 day of such taxable year, and (2) such test shall be made for a taxable year of such prior transferor only if such prior transferor actually owned the property on at least 1 day of such taxable year.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. The unadjusted basis of section 1250 property as of the beginning of January 1, 1960, is \$300,000. During the taxable year ending on December 31, 1960, the only additions to the capital account for the property are addition A on January 1, 1960, costing \$1,000, and addition B on July 1, 1960, costing \$600. Since the sum of the amounts added to capital account for such taxable year is less than \$2,000, A and B are not treated as improvements. This result would not be changed if addition C, costing \$600, were added on December 15, 1960, since although the sum of the additions (\$1,000 plus \$600 plus \$600, or \$2,200) exceeds \$2,000, such sum is less than 1 percent of the unadjusted basis of the property as of the beginning of 1960 (\$3,000, that is, 1 percent of \$300,000). If however, C cost \$1,500, then A, B, and C would each be considered an improvement since the sum of the amounts added to capital account (\$3,100) would exceed \$3,000.

Example 2. Green and his son both use the calendar year as the taxable year. On February 1, 1965, Green makes addition A to a piece of section 1250 property. On June 15, 1965, Green transfers such property to his son as a gift which is in part a sale (see paragraph (a) of § 1.1250-3). Addition B arises by reason of the transfer. On August 1, 1965, the son makes addition C to the property. For purposes of determining the amount of gain recognized under section 1250(a) to Green upon the transfer, the determination of whether addition A is an improvement is made without taking into account additions B and C. For purposes of determining the

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amount of gain recognized under section 1250(a) upon a subsequent disposition of the property by the son, additions B and C would be taken into account in the determination of whether A is an improvement, and A would be taken into account in the determination of whether B and C are improvements.

Example 3. Assume the same facts as in example (2). Assume further that on September 15, 1965, the son transfers the property to a corporation in exchange for cash and stock in the corporation in a transaction qualifying under section 351 (see paragraph (c) of § 1.1250-3), and that the corporation uses a fiscal year ending November 30. For purposes of determining the amount of gain recognized under section 1250(a) upon a subsequent disposition by the corporation, the one-year test under subdivision (i) of this subparagraph is made for the entire taxable year of Green and of the son ending on December 31, 1965, and in respect of the corporation's taxable year ending November 30, 1965. Accordingly, if on December 7, 1965, addition D is made by the corporation, then, upon a subsequent disposition by the corporation, D is taken into account for purposes of the determination in respect of the entire taxable year of Green and of the son ending on December 31, 1965, and for the corporation's taxable year ending November 30, 1966, but not for purposes of the corporation's taxable year ending November 30, 1965. If D were made on January 3, 1966, D would still be taken into account for purposes of the determination in respect of the corporation's taxable year ending November 30, 1966. However, since neither Green nor his son actually owned the property on any day of the taxable year ending December 31, 1966, no determination is made in respect of such taxable year of Green or of the son.

(4) *36-month test for separate improvement.* (i) If, during the 36-month period ending on the last day of any taxable year (including a short taxable year and the entire taxable year in which the disposition occurs), the sum of the amounts treated under subparagraph (3) of this paragraph as improvements for such period exceeds the greatest of:

(a) 25 percent of the adjusted basis of the property,

(b) 10 percent of the unadjusted basis (determined under subparagraph (3)(ii) of this paragraph) of the property, or

(c) \$5,000,

Then each such improvement during such period shall be treated as a separate improvement, and thus as an element. For purposes of (a) and (b) of this subdivision, the adjusted basis (or

unadjusted basis) of section 1250 property shall be determined as of the beginning of the 36-month period, or as of the beginning of the holding period of the property (within the meaning of § 1.1250-4), whichever is the later.

(ii) In respect of a particular disposition of section 1250 property by a person:

(a) There shall not be taken into account under the 36-month test for separate improvements in this subparagraph any amount treated under subparagraph (3) of this paragraph as an improvement which arises by reason of (or after) the disposition or which arises before the beginning of the holding period under § 1.1250-4 of such person for the property, and

(b) Such test shall be made in respect of each 36-month period ending on the last day of each taxable year of such person (and of any prior transferor) if at least 1 day of such period is included under § 1.1250-4 in such person's holding period for the property, except that (1) such test shall be made for a 36-month period ending on the last day of a taxable year of such person only if such person actually owned the property on at least 1 day of such period, and (2) such test shall be made for a 36-month period ending on the last day of a taxable year of such prior transferor only if such prior transferor actually owned the property on at least 1 day of such period.

(iii) For illustration of the principles of subdivision (ii) of this subparagraph, see examples (2) and (3) in subparagraph (3)(iv) of this paragraph.

(5) *Example.* The application of this paragraph may be illustrated by the following example:

Example: (i) On December 31, 1967, X, a calendar year taxpayer, purchases an item of section 1250 property at a cost of \$100,000. In the table below, the adjusted basis and unadjusted basis of the property are shown for the beginning of January 1 of each taxable year and it is assumed that each addition to capital was added on January 1 of the year shown.

Year	Adjusted basis	Unadjusted basis	1 percent of unadjusted basis	Addition
1969	\$94,000	\$100,000	\$1,000	A-\$10,000
1970	97,030	110,000	1,100	B-4,000

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Year	Adjusted basis	Unadjusted basis	1 percent of unadjusted basis	Addition
1971	94,041	114,000	1,140	C-6,000
1972	92,799	120,000	1,200
1973	86,158	120,000	1,200	D-18,000

(ii) Since each addition to capital account for the property exceeds the greater of \$2,000 or one percent of unadjusted basis, determined as of the beginning of the taxable year in which made, each addition to capital account qualifies as an improvement under subparagraph (2) of this paragraph.

(iii) Since the beginning of the holding period of the property under § 1.1250-4 (Jan. 1, 1968) is later than the beginning of the 36-month period ending on December 31, 1969, the determination as to whether there are any separate improvements on the property as of December 31, 1969, is made by examining the adjusted basis (or unadjusted basis) of the property as of the beginning of January 1, 1968. As of December 31, 1969, there were no separate improvements on the property since the only amount treated as an improvement for the period beginning on January 1, 1968, and ending on December 31, 1969, in addition A (costing \$10,000), which is less than \$25,000, that is, 25 percent of the adjusted basis (\$100,000) of the property as of the beginning of January 1, 1968.

(iv) As of December 31, 1970, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1970, is \$14,000 (that is, \$10,000 for A, plus \$4,000 for B), and this sum is less than \$25,000, that is, 25 percent of the adjusted basis (\$100,000) of the property as of the beginning of January 1, 1968.

(v) As of December 31, 1971, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1971, is \$20,000 (that is, \$10,000 for A, plus \$4,000 for B, plus \$6,000 for C), and this sum is less than \$23,500, that is, 25 percent of the adjusted basis (\$94,000) of the property as of the beginning of January 1, 1969.

(vi) As of December 31, 1972, there were no separate improvements on the property since the sum of the amounts treated as improvements for the 36-month period ending on December 31, 1972, is \$10,000 (that is, \$4,000 for B plus \$6,000 for C), and this sum is less than \$24,258 that is, 25 percent of the adjusted basis (\$97,030) of the property as of the beginning of January 1, 1970.

(vii) As of December 31, 1973, C and D are separate improvements (notwithstanding that as of December 31, 1971 and 1972, C was not a separate improvement) since the sum of the amounts added for the 36-month pe-

riod ending December 31, 1973, is \$24,000 (that is, \$6,000 for C plus \$18,000 for D), and this sum exceeds the greatest of:

- (a) \$23,510, that is, 25 percent of the adjusted basis (\$94,041) of the section 1250 property as of the beginning of January 1, 1971,
- (b) \$11,400, that is, 10 percent of the unadjusted basis (\$114,000) of the property as of the beginning of such first day, or
- (c) \$5,000.

(e) *Additional depreciation and holding period of property acquired in certain transactions*—(1) *Transferred basis*. If property consisting of two or more elements is disposed of, and if the holding period of the property in the hands of the transferee for purposes of computing applicable percentage includes the holding period of the transferor by reason of the application of paragraph (c) (other than subparagraph (2) thereof) of § 1.1250-4, then the additional depreciation for each element of the property in the hands of the transferee immediately after the transfer shall be computed in the manner set forth in this subparagraph. First, any element having a deficit in additional depreciation in the hands of the transferor immediately before such transfer shall be considered to have the same deficit in the hands of the transferee. Second, elements having additional depreciation in the hands of the transferor immediately before the transfer shall be considered to have additional depreciation in the hands of the transferee. The sum of the transferee's additional depreciation for all elements of the property having additional depreciation in the hands of the transferor shall be an amount equal to the additional depreciation in respect of the property as a whole immediately after the transfer increased by the sum of the deficits in addition depreciation for all elements having such deficits. In case there is more than one element having additional depreciation, the additional depreciation for any such element in the hands of the transferee shall be computed by multiplying (i) the amount computed under the preceding sentence by (ii) the additional depreciation for such element in the hands of the transferor divided by the sum of the additional depreciation for all such elements having additional depreciation

in the hands of the transferor. For purposes of computing applicable percentage, the holding period for an element of such property in the hands of the transferee shall include the holding period of such element in the hands of the transferor.

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

Example: Section 1250 property has additional depreciation of \$16,000 of which \$12,000 is additional depreciation for element X and \$4,000 for element Y. The property is transferred to a corporation in exchange for cash of \$6,000 and for stock in the corporation. Assume that recognition of gain under section 1250(a) is limited to \$6,000 (the amount of cash received) by reason of the application of section 351(b) (relating to transfer to corporation controlled by transferor) and section 1250(d)(3) (relating to limitation on application of section 1250 in certain tax-free transactions). Under paragraph (c)(3)(i) of § 1.1250-3, the additional depreciation for the property in the hands of the corporation immediately after the transfer is \$10,000, that is, the additional depreciation for the property in the hands of the transferor immediately before the transfer (\$16,000) minus the gain under section 1250(a) recognized upon the transfer (\$6,000). Under subparagraph (1) of this paragraph, in the hands of the corporation immediately after the transfer element X has additional depreciation of \$7,500 ($\frac{12}{16}$ of \$10,000) and element Y as additional depreciation of \$2,500 ($\frac{4}{16}$ of \$10,000). Under paragraph (d)(2)(ii) of this section there is an addition of \$6,000 to the capital account for the property.

(3) *Principal residence.* If a principal residence consisting of two or more elements is disposed of, and if for purposes of computing applicable percentage the holding period of the principal residence acquired includes the holding period of the principal residence disposed of by reason of the application of paragraph (d) of § 1.1250-4, then the additional depreciation (or a deficit in additional depreciation) for an element of the principal residence acquired immediately after the transaction shall be determined in a manner consistent with the principles of subparagraph (1) of this paragraph. For purposes of computing applicable percentage, the holding period for an element of the principal residence acquired includes the holding period of such element of the principal residence disposed of, but not the period beginning on the day after

the date of the disposition and ending on the date of the acquisition.

(f) *Holding period for small separate improvements—(1) General.* This paragraph prescribes a special holding period solely for the purpose of computing the applicable percentage of a separate improvement (as defined in paragraph (d) of this section) which is treated as an element. See paragraph (a)(2)(ii) of this section for determination of holding period under section 1223 for purposes of computing additional depreciation. In respect of section 1250 property, if the amount of a separate improvement does not exceed the greater of:

- (i) \$2,000, or
- (ii) One percent of the unadjusted basis (within the meaning of paragraph (d)(3)(ii) of this section) of such property, determined as of the beginning of the taxable year in which such separate improvement was made,

Then such separate improvement shall be treated for purposes of computing applicable percentage as placed in service on the first day, of a calendar month, which is the closest such first day to the middle of the taxable year. See the last sentence of section 1250(f)(4)(B). If two such first days are equally close to the middle of the taxable year, the earliest of such days is the applicable day.

(2) *Example.* The application of this paragraph may be illustrated by the following example:

Example: (i) The unadjusted basis of section 1250 property as of the beginning of January 1, 1960, is \$100,000. During the taxable year ending on December 31, 1960, the only additions to the capital account for the property are addition A on March 10, 1960, costing \$1,200 and addition B on September 16, 1960, costing \$1,400. Since the sum of the additions (\$2,600) exceeds the greater of \$2,000 and 1 percent of unadjusted basis (\$1,000, that is, 1 percent of \$100,000), each addition is an improvement under the 1-year test of paragraph (d)(3) of this section. Assume that the 36-month test of paragraph (d)(4) of this section is satisfied and, therefore, each addition is a separate improvement treated as an element.

(ii) Since each element is less than \$2,000, the provisions of this paragraph apply. Since there are 366 days in 1960, the middle of the year is at the end of 183 days, or July 1. Thus, that first day of a calendar month in

1960, which is the closest first day (of a calendar month) to the middle of the taxable year, is July 1, 1960. Accordingly, for purposes of computing applicable percentage, elements A and B are each treated as placed in service on July 1, 1960.

[T.D. 7084, 36 FR 275, Jan. 8, 1971, as amended by T.D. 7193, 37 FR 12957, June 30, 1972; T.D. 7400, 41 FR 5103, Feb. 4, 1976]

§ 1.1251-1 General rule for treatment of gain from disposition of property used in farming where farm losses offset nonfarm income.

(a) *Applicability.* The provisions of section 1251, this section, and §§ 1.1251-2 through 1.1251-4 shall apply with respect to any taxable year beginning after December 31, 1969, but only if (1) there is a farm net loss (as defined in section 1251(e)(2) and paragraph (b) of § 1.1251-3) for the taxable year, or (2) there is a balance in the excess deductions account (as described in § 1251-2) as of the close of the taxable year before subtracting any amount under paragraph (c)(1)(i) of § 1251-2. See section 1251(a). In general, a taxpayer who has a farm net loss and certain other taxpayers are required to establish and maintain an excess deductions account as provided in section 1251(b). Certain additions and subtractions are made to the excess deductions account, and upon the disposition of *farm recapture property* any gain to the extent of the balance in the excess deductions account is recognized as ordinary income under section 1251(c)(1). See paragraph (b)(1) of this section. *Farm recapture property* is, in general, certain farming property (other than section 1250 property) described in paragraph (1), (3), or (4) of section 1231(b). See paragraph (a) of § 1.1251-3.

(b) *Ordinary income—(1) General rule.* In general, subject to the provisions of subparagraphs (2), (3), (4), and (5) of this paragraph, upon a disposition of an item of farm recapture property during a taxable year beginning after December 31, 1969, the amount of which:

(i) In the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) In the case of any other disposition, the fair market value of such property

exceeds the adjusted basis of such property shall be recognized under section 1251(c)(1) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). The amount of gain recognized as ordinary income under section 1251(c)(1) shall be determined separately for each item of farm recapture property in a manner consistent with the principles of subparagraphs (4) and (5) of § 1.1245-1(a) (relating to gain from dispositions of certain depreciable property). Generally, such ordinary income treatment applies even though in the absence of section 1251(c)(1) no gain would be recognized under the Code. For example, if a corporation distributes farm recapture property as a dividend gain may be recognized as ordinary income to the corporation even though, in the absence of section 1251(c)(1), section 311(a) would preclude any recognition of gain to the corporation. For purposes of section 1251, the term *disposition* shall have the same meaning as in paragraph (a)(3) of § 1.1245-1. For the relation of section 1251 to other provisions of the Code, see paragraph (e) of this section.

(2) *Limitation as to dispositions of land—(i) In general.* In the case of a disposition of land, gain shall be recognized as ordinary income under section 1251(c)(1) only to the extent of the land's *potential gain*. See section 1251(c)(2)(C).

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

(iii) *Cross reference.* For additional recapture of certain deductions allowed under sections 175 and 182 in respect of farm land, see section 1252.