

ALASKA LEGISLATURE COMMITTEE FILES, 1989-1990  
6424 SENATE LABOR & COMMERCE 8672

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containing costs in all bargaining sessions, with some success.

Risk pooling is already allowed under the Federal Risk Retention Act, whereby small businesses can form risk purchasing or risk retention groups for most types of liability insurance. Senator Jim Duncan has a health risk pool bill (SB 254) in the works which may also help address this problem. Uncompensated care and mandated benefits were discussed earlier.

Tort reform is a complex subject, to say the least. Any legislation will be hard-fought. My administration, primarily through the DCED, Division of Insurance, is assisting the Liability Insurance and Tort Reform Task Force in identifying appropriate measures to ease the crisis. I look forward to the task force's report.

Increasing bond requirements for a general contractor's license would make life more difficult for small contractors, unless the increase were adopted hand-in-hand with the suggested written competency test. With no basic competency exams, surety insurers require high collateralization of all types of contractors' bonds. Exams would help reduce required collateral and assist small contractors in securing bonding. Construction trades have traditionally opposed such exams. They've been concerned with the ability of examiners to produce a fair, valid test. The DCED's Division of Occupational Licensing would be the entity to develop competency requirements; I encourage interested parties to share their views. Contact Director Randall Burns, Division of Occupational Licensing, at 465-2534.

Licensure should be a matter of technical competence, not whether a person is able to secure a bond. I support the concept of eliminating unnecessary bonding requirements. The business/contractor community should help the State identify appropriate situations for such action.

Because of changes I initiated several years ago, State statutes and regulations do not require bonds for projects of \$100,000 or less, except as provided in the procurement code. Contract alterations that boost costs past the \$100,000 limit are problems; sometimes agencies may require bonds on projects starting below \$100,000 that are likely to exceed that limit later.

Streamlining processes and dividing up large projects to benefit smaller contractors are worthy goals. I've asked DOT&PF, the Alaska Industrial Development and Export Authority (AIDEA), the Alaska Energy Authority (AEA) and others to present specific ideas on how we might pursue this.

#### 14. Business Information Dissemination

As discussed earlier, the DCED/DBD Business Development Information Network (BDIN) should help greatly in spreading accurate information on Alaska business. Establishing a small business-oriented data base is feasible. The DBD has an extensive data base on file, but it is inadequate for small businesses at this time because 1) it is organized at the state, not local or regional, level and 2) it does not include several items directly relevant to small business. The Division's regional economist plans to identify and collect the relevant data and then compile those data into a consistent form. This will take about six months. For more information, contact Jamie Parsons at 465-2017.

#### 15. Business Education

Employer/employee/entrepreneurial training was the subject of a special effort of my administration, a conference called "Alaska Youth: Ready for Work." Schools, private industry councils, the Alaska State Job Training Coordinating Council and others, under the direction of the Institute for Social and Economic Research at the University of Alaska Anchorage, focused attention on the issues you've identified. An additional conference is desirable, but may be difficult to fund in Alaska's current austere climate. I see tremendous value in such gatherings, however, and will be alert for opportunities to promote this idea.

In the meantime, the State will continue its work via Small Business Development Centers and the State plan for vocational education. The FY 91-93 plan is now in draft form; the State Board of Education will review and approve the final plan by May. The plan provides for continued support of teacher inservice and additional model programs in school-based enterprises. A videotape to promote economic development through school-based enterprises and entrepreneurship education should be complete in March.

Federal funds have been the prime source of funding for training school district personnel in entrepreneurship education, school-based enterprises and public information.

The State provides additional money as part of foundation formula funding for vocational education. We expect the State will take responsibility for more and more such programs as federal funding dwindles. Stable State funding for education is essential to Alaska's future social and economic health. My Education Fund amendment will provide that stability. I encourage you to contact your State Senator and urge him or her to support my proposal. Their approval would put the idea on a statewide ballot, and Alaskans could then decide the issue. It's an important concept; I hope you'll support it.

#### 16. Marketing Alaska

The ongoing success of the Alaska Grown and Buy Alaska/Alaska Product Preference programs and the Alaska Seafood Marketing Institute demonstrates my commitment to marketing Alaska's resources and products. Budget constraints have prevented us from doing all we wanted in the past as far as promoting Alaska, but we've accomplished a lot with available resources. The DNR, charged with management and disposition of Alaska's State-owned natural resources, works regularly with the DCED in planning resource marketing to ensure that 1) prospective purchasers are fully informed about sale procedures and requirements and 2) the State receives the greatest possible return.

Favorable southbound freight rates would probably help sales of Alaskan goods, but there's not much the State is able to do to affect them. If you have specific suggestions, please share them.

The legislative prohibition of finfish mariculture persists, but invertebrate and sea vegetable farming is expanding in Alaska. Mariculture holds great economic potential for the State, and I look forward to acting on the reports of the finfish farming task force and the mariculture interagency working group. I support the economically and ecologically sound application of mariculture techniques. State-owned tidelands in southeast Alaska were recently opened to shellfish mariculture; DNR is now reviewing applications for other sites.

Despite the wreck of the EXXON VALDEZ, Alaska's tourism industry experienced its biggest year ever. Research conducted as a part of the emergency tourism marketing campaign in response to the oil spill has revealed two important facts: 1) Potential visitors changed their plans to visit Alaska in 1989 and 2) concern of potential visitors

was affected positively by the campaign. In other words, we brought some of them back. We'll be ready as the first anniversary of the spill approaches. The DCED's Division of Tourism and the Alaska Tourism Marketing Council (ATMC) will help the various media spread accurate information about Alaska as a tourist destination.

It's important to remember that Alaska's capacity to house and feed visitors is barely adequate during the peak summer season. To me, that means we should devote our efforts to developing a year-round tourist industry, starting with promotion of the so-called "shoulder seasons." Since our capacity to provide tourists with a high-quality experience is limited by available facilities, any expansion of infrastructure should follow in a coordinated manner with increased promotion. Promotion without infrastructure expansion may well be counter-productive.

The Buy Alaska and Alaska Grown campaigns are successful because they were developed with the help of knowledgeable people, often at a local or regional level. The DCED/DBD is continuing this successful pattern with the establishment of the Alaska Regional Development Organizations (ARDOR) program. Through ARDOR, the State assists regional entities in developing their respective areas. The resultant expanding network of State, municipal and private entities strengthens and diversifies the economy.

Expanded State contact with tour, charter and transport operators will encourage both tourism businesses to serve Alaskan food and beverage products and visitors to buy Alaskan products. The Division of Tourism will also pursue a campaign to acquaint visitors with available Alaskan gifts and art by regions of the State. Gift shops aboard the vessels of the Alaska Marine Highway System are vendor-operated. We'll encourage those vendors once again to expand their inventories of Alaskan products.

Availability of sorted address labels is a complex issue. The Department of Law recently ruled that the labels, as public information, are available to anyone who asks for them. The ATMC, Alaska Visitors Association (AVA) and DCED, Division of Tourism, have reviewed the present partnership framework that governs distribution of labels. Legislation addressing this matter was recently introduced (HB 442); I encourage you to share your views with your legislators.

The Anchorage Convention and Visitors Bureau (ACVB) operates brochure racks at both Anchorage terminals under an

agreement with the Alaska International Airport System (AIAS). The ACVE absorbs virtually all costs in maintaining its visitor centers and requires membership in its bureau to place brochures in those centers. Opening the racks to all businesses would require a change in the current agreement or perhaps assumption of center operation by the State--at a considerable cost.

Alaska's resource development project review system, in place for six years now, has a successful, documented record. Brochures describing the system are available to any interested party; pre-application conferences with permitting agencies are arranged on request. Depending on the complexity of the application, reviews take either 30 or 50 days. The program has an excellent on-time record. Conference concerns may well indicate that a new round of education of the small business sector is in order. Division of Governmental Coordination (DGC) and DBD officials will work together to arrange orientation sessions; DGC brochures on the permit review process will be distributed through DBD's small business advisory network.

State dollars are indeed spent to attract film companies that use non-Alaskans. In fact, a small expenditure outside has again resulted in a big boost to local and regional economies--as a major film project proceeds in Haines this winter. Some expertise and capacity simply doesn't exist within the Alaska business community. We are occasionally faced with little choice but to contract outside.

#### 17. International Trade

I'm particularly proud of my administration's promotion of international trade. From \$987 million in 1980, Alaska exports have grown to about \$2.5 billion in 1989. On a per capita basis, Alaska's export record leads the nation. Obviously, we're doing something right, but that doesn't mean we can't do even better.

My Office of International Trade (OIT) publishes an extensive newsletter containing trade lead bulletins that goes to over 3,500 business people, as well as a weekly fisheries report that reaches nearly 100 contacts across the State. Also, upon learning of or receiving notice of trade leads, OIT contacts Alaskan businesses potentially able to provide goods or services. OIT makes use of an extensive network of foreign contacts; they also coordinate with the Alaska Center for International Business and the Alaska World Trade Center, making use of their international trade

data bases. Business people wishing placement on OIT's mailing list should call Bob Poe at 561-5585.

OIT regularly sponsors seminars and public information events, providing how-to-do-business hints on protocol, import/export requirements, etc. These events are advertised in a number of ways and have been well-attended. OIT staff continue their strong efforts to cooperate and participate in a wide range of speaking engagements throughout the state to provide assistance to Alaskan businesses and organizations.

Clearly, the commitment of personnel and pursuit of the Conference's well-reasoned recommendations depend to a large extent upon the budget. With increased personnel, OIT could take a more active role in a larger variety of events and markets. This is certainly true of OIT's overseas offices, but it is important to remember to proceed not just with a bigger budget, but within a carefully-laid plan. Due to budget limitations, OIT has focused on the Pacific Rim, historically Alaska's largest trading partner. Europe is important and deserves increased attention.

We regularly promote export of natural resources and the use of Foreign Trade Zones (now in Anchorage, Valdez and St. Paul). Recent successes include working with Konkor to export round logs to Taiwan and bringing Federal Express to Anchorage to establish an international cargo hub. Our overseas offices are actively promoting Foreign Trade Zone use, ranging from manufacturing to "just-in-time" inventory systems.

We also regularly include the private sector in the international trade development process. An excellent example of this cooperation is the annual Korea-Alaska Trade Fair, involving the Alaska State Chamber of Commerce and the Alaska-Korea Business Council.

High seas fish interception and the 200-mile limit are largely federal issues, but we continue to convey our concerns to both U.S. and foreign governments.

#### 18. Tourism Infrastructure and Marketing

The quality and carrying capacity of our tourism infrastructure are of continuing concern. As we succeed in attracting more visitors to Alaska, our parks, campgrounds, turnouts and stream banks become more congested. To maintain the quality of life of Alaskans and to avoid

degradation of visitors' experiences here, the Tourism Coordinating Committee has evaluated and is pursuing a list of interagency recommendations with appropriate State entities. The State, as a significant holder of lands with potential for development of accommodations, attractions and recreation, is in a good position to stimulate private investment in Alaska and promote growth in the visitor industry. Efforts to develop Hatcher Pass and South Denali projects exemplify my interest in improving Alaska's visitor industry.

Cooperative ventures are essential to the continued vitality of the tourism industry; the State will continue to look for every opportunity to encourage these relationships.

Marketing Alaska as a year-round destination must proceed with development of attractions and accommodations that will fulfill the wishes of "shoulder season" visitors. To broaden the mostly seasonal nature of Alaska tourism, the State will actively support sound infrastructure development while continuing to promote statewide events and marketing programs to stimulate visits by friends and relatives. The State will continue to support programs designed to dispel weather stereotypes and increase awareness of "off season" Alaska.

At present funding levels, Alaska is losing its share of voice in the marketplace due to increasing media costs and competitive clutter. If we are to sustain visitor numbers and seek growth, we'll need increased promotional funding. Of course, we'll continue to make every attempt to keep that marketing money in Alaskan hands.

#### 19. Government Wages and Benefits

Public employees are important to the State, and they work hard. They are also well-compensated for their efforts. Recent studies indicate that Alaska's public employees are paid considerably better than their counterparts outside, even after removing geographic cost-of-living differentials. That's why I've resisted the political pressures to grant substantial raises in pay. Private sector businesses have only maintained or even reduced wages and benefits in the past few years. Reliable data on private sector employee turnover caused by public sector competition would be useful to the State's bargaining team. I encourage private business to work with the Department of Administration in accumulating that information.

Voter approval of wage and benefit increases is unrealistically cumbersome. Budgeting would be difficult, contracts would have to contain complex retroactive clauses and this idea would require a statutory change that has little support. State employee wage and benefit increases are already subject to legislative approval and appropriation.

Overtime compensation requirements are set in Alaska statute (AS 21; Alaska Wage and Hour Act) and federal law (Fair Labor Standards Act). Neither permits use of "compensatory time" for private sector employees. Support to modify either is not presently apparent.

An exemption from overtime exists, however; AS 23.10.055(i) exempts employers with fewer than three employees from overtime requirements. They must pay straight time for all hours worked.

State wages and benefits should reflect competitive variances by geographic area. Geographic differentials attempt this, but really are more reflective of cost-of-living variances. We're working on a salary survey to compare public and private sectors. No wage increase since 1985 has served to bring public and private rates closer. When funding permits, we ought to conduct more research.

Any modification of retirement systems requires statutory change. Proposed changes will no doubt meet strong resistance. I doubt that change is likely.

## 20. Davis-Bacon Wages

One specific goal of the Little Davis-Bacon Act is to protect construction workers from exploitation by requiring that prevailing wages be paid employees working on public construction projects. To deny these employees, who are especially susceptible to wage-cutting competition, the remedies available through the Little Davis-Bacon Act would undermine its very essence. The DOL requires uniform interpretation of the Little Davis-Bacon Act and associated rules and regulations in all regions of the state.

The Department of Labor (DOL) continuously updates its lists of job classifications and associated prevailing rates of minimum pay and presently lists 595 job classifications with a published prevailing minimum rate of pay. State law

contains a provision for obtaining special wage rates on public construction for job classifications not listed.

### Resolutions

With regard to the Governor's Conference on Small Business Resolutions, let me state generally that I feel the exercise has been very valuable. I suggest the delegates form working groups to pursue the courses of action we've identified, with a follow-up statewide meeting perhaps one to two years into the next administration. I'll work with you to develop an appropriate Administrative Order to demonstrate Executive Branch support for this ongoing effort. Keep in mind that money for commissions and councils is increasingly tight. The future clearly belongs to those who don't wait around for funding but get right to work and make things happen through available means.

We have indeed already appointed a small business person as Director of the DCED, Division of Business Development. Jamie Parsons has been on the job since last year; I trust the Conference approves of this appointment.

The concept of including small business people in Alaska's boards and commissions is attractive. I call on the state's business community to help identify appropriate applicants for vacancies on these bodies. Contact Penny Forsmo in my Juneau office at 465-3500 for more information.

**S J R**

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SENATE COMMITTEE REPORT

FIRST COMMITTEE OF REFERRAL

Date of 5-DAY NOTICE 2/16/89  
IN ACCORDANCE WITH UNIFORM RULE 23

FURTHER

\*\*FISCAL NOTE(S) MUST BE ATTACHED  
IN ACCORDANCE WITH AS 24.08.035

DATE TURNED INTO OFFICE 2/23/89

1/9/89

Mr. President:

L&C Committee considered SJR 8

Urging a change under the Internal Revenue Code in the tax treatment of the transfer of real property subject to a mortgage that is a recourse loan when the indebtedness on the property is discharged through foreclosure, repossession, or surrender of the property

and recommended:

- replace with CS \_\_\_\_\_  same title
- attached amendment(s) and  new title
- \_\_\_\_\_ letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to \_\_\_\_\_

FISCAL NOTE(S) attached  zero  
 appropriation no FN attached

fiscal impact  
 Gov. FN introduced w/ bill

MEMBERS SIGNING DO PASS

*[Handwritten signatures]*

OTHER RECOMMENDATIONS

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

*[Handwritten signature]*  
Chairman signature and recommendation

Committee backup attached

FISCAL NOTE

REQUEST: \_\_\_\_\_

Revision Date: \_\_\_\_\_  
Title: Transfer of real property

Agency Affected: Revenue  
BRU: Income & Excise Audit

Sponsor: Halford and Pearce  
Requestor: Labor and Commerce

Components: Operating

EXPENDITURES/REVENUES: (Thousands of Dollars)

	FY 90	FY 91	FY 92	FY 93	FY 94	FY 95
<b>OPERATING</b>						
PERSONAL SERVICES	0	0	0	0	0	0
TRAVEL	0	0	0	0	0	0
CONTRACTUAL	0	0	0	0	0	0
SUPPLIES	0	0	0	0	0	0
EQUIPMENT	0	0	0	0	0	0
LANDS & STRUCTURES	0	0	0	0	0	0
GRANTS, CLAIMS	0	0	0	0	0	0
MISCELLANEOUS	0	0	0	0	0	0
<b>TOTAL OPERATING</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>CAPITAL</b>						
	0	0	0	0	0	0
<b>REVENUE</b>						
	0	0	0	0	0	0

FUNDING: (Thousands of Dollars)

GENERAL FUND	0	0	0	0	0	0
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
<b>TOTAL</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME	0	0	0	0	0	0
TEMPORARY	0	0	0	0	0	0

ANALYSIS: (Attach a separate page if necessary)

Prepared By: Steven E. Kettel *Steven E. Kettel* Phone: (907) 465-2320  
Division: Income and Excise Audit Date: February 21, 1989

Approved by Commissioner: Hugh Malone *Hugh Malone* Date: February 21, 1989  
Agency: Department of Revenue *2/21/89*

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Impacted Agency(ies)

# ALASKA STATE LEGISLATURE

Anchorage Office:  
3111 C St., Suite 530  
Anchorage, AK 99503  
907-561-7616



White in Juneau:  
P.O. Box V  
Juneau, AK 99811  
907-465-4958

**Senator Rick Halford**

## MEMORANDUM

To: Senator Dick Eliason, Chairman  
Labor and Commerce

From: Senator Rick Halford *Rick*

Subject: SJR 8, regarding the tax treatment of real property when the property is transferred through foreclosure, repossession, or surrender.

Date: February 20, 1989

It has come to my attention that in certain cases individuals are being taxed on their losses. Senate Joint Resolution 8 is an effort to correct this problem that is occurring in our State as a result of Alaska's struggling economy.

When an individual has a recourse loan, they are held personally liable for their debt beyond simply giving up the rights to the property. According to the Internal Revenue Code when an owner is personally liable for repayment of a debt which is secured by real property that has been transferred to satisfy the debt and the fair market value of that property is less than the amount of the outstanding debt, the resulting difference is taxable as ordinary income if any portion of the debt is forgiven by the lending institution.

In essence, what is occurring is that individuals who have lost their homes because they can no longer make monthly mortgage payments in our declining economy are held liable for taxes on the amount of their loan over and above fair market value and are thus being taxed on their losses.

I hope you will join me in this attempt to correct this terrible inequity.

INFORMATION FOR THE BORROWER ON FORECLOSURES AND REPOSSESSIONS OF REAL PROPERTY

The following information will apply only if:

1. The property is real property (including mobile homes) and
2. The property is residential and is either held for personal use or for the production of rental income and
3. The borrower purchased the property and
4. The debt was secured by the property and
5. The borrower relinquished possession and rights to the property through voluntary foreclosure or repossession and
6. The property was acquired by the seller or by a financial institution through voluntary foreclosure or repossession and
7. The borrower received a correctly prepared Form 1099A and
8. The borrower is a natural person, not a partnership, corporation or other entity.

In general, if real property is voluntarily foreclosed or repossessed by the seller or lender, the borrower may realize as income:

1. Capital gain income
2. Ordinary income from recapture of additional depreciation
3. Ordinary income from discharge of indebtedness

Voluntary foreclosures and repossessions of real property are treated as dispositions similar to the sale of the property. The amount realized is the greater of amount of debt satisfied (box 3 Form 1099A) or the fair market value of the property (box 4 Form 1099A).

Recourse loan referred to in this information is a loan that, by the governing instrument and/or state law, requires the borrower to be personally liable for the debt beyond relinquishing possession and rights to the property.

Non-recourse loan referred to in this information is a loan that, by the governing instrument and/or state law, requires that the property be taken in full satisfaction of the debt without further recourse by the lender.

To determine whether or not the borrower has capital gain on voluntary foreclosure / repossession of real property held for personal use:

1. Determine the borrower's adjusted basis in the property.
2. Compare the basis to amount realized.
3. If the adjusted basis is less than the amount realized and the loan is a non-recourse loan, the difference is capital gain.
4. If the adjusted basis is more than the amount realized, the difference is a non-deductible loss.
5. If the property is the principal residence of the borrower, the gain on disposition should generally be reported on Form 2119.
6. All other gains on disposition of property held for personal use should be reported on schedule D.

Foreclosures and repossessions of property held for personal use - recourse loan

If the adjusted basis is less than the amount of debt satisfied, the difference is discharge of indebtedness income. Report this income on line 21, Form 1040. If the fair market value of the property is greater than the amount of debt satisfied and the adjusted basis is less than or equal to the amount of debt satisfied, the remaining difference is capital gain.

Property held for the production of residential rental income

The same rules apply in determining amount realized and discharge of indebtedness income. The disposition should be reported on Form 4797 and gain or loss determined accordingly. Losses are deductible as supplemental losses from Form 4797.

Department of the Treasury  
Internal Revenue Service

Publication 544  
(Rev. Nov. 87)

# Sales and Other Dispositions of Assets

For use in preparing  
1987 Returns



## Highlights

**Capital gains and losses.** For tax years beginning after 1986, the 60% deduction for net capital gains is repealed. The full amount of the net capital gain must be included in income. The income tax rate for individuals on net capital gains that occur in tax years beginning in 1987 will not exceed 28%.

Capital losses are first allowed in full against capital gains and then, secondly, against up to \$3,000 of ordinary income. In addition, long-term capital losses are no longer reduced by 50% before applying them against ordinary income. See Part III, *Tax Treatment of Gains and Losses*, of this publication.

**Disposition of real property.** Additional depreciation is no longer treated as ordinary income on the disposition of residential rental property or nonresidential real property placed in service after 1986 (or after July 1986 if the election was made to use the modified accelerated cost recovery system) since these properties are now depreciated using the straight line method. See Part IV, *Dispositions of Depreciable Property*.

**Passive activities.** For tax years beginning after 1986, gain on the sale of an interest in a passive activity may represent income from a passive activity. For information on the new rules discussing passive activities, see Publication 925, *Passive Activity and At-Risk Rules*.

**Real estate transactions.** For real estate transactions closing in 1987, the real estate broker must report the sale or exchange of certain real estate by filing Form 1099-B with the Internal Revenue Service. See *Reporting Gains and Losses* in Part V of this publication.

## Introduction

If you trade or sell one of your assets, you may have a gain on the transaction or you may have a loss. In general, gains increase your taxable income, and losses decrease it. However, not all transactions result in taxable gains or deductible losses, and not all gains are taxed in the same way. This publication explains how to figure gain and loss on various types of transactions, and the tax results of different types of gains and losses. The publication is divided into the following parts.

- Part I—Transfers of Property
- Part II—Ordinary or Capital Gain or Loss
- Part III—Tax Treatment of Gains and Losses
- Part IV—Dispositions of Depreciable Property
- Part V—Reporting Gains and Losses

You may find other publications such as those listed below particularly helpful. These publications offer additional information related to sales, exchanges, and other dispositions of assets.

Publication 523, *Tax Information on Selling Your Home*,

Publication 541, *Tax Information on Partnerships*,

Publication 550, *Investment Income and Expenses* (includes information on capital assets not used in a trade or business or for the production of income), and

Publication 537, *Installment Sales* (under Part IV of this publication, the *Installment Sales* discussion explains how to figure and report gain that includes recapture of depreciation).

This publication provides information on the most common tax situations. It explains the tax law in plain language so that it will be easier to understand. However, the information provided does not cover every situation and is not intended to replace the law or change its meaning.

## Part I Transfers of Property

When you transfer ownership of an asset to someone else, you may have a gain or loss on the transaction. However, not all transfers of ownership will affect your income tax. In general, only sales and exchanges, including involuntary exchanges, can result in taxable gains or deductible losses.

A sale is a transfer of property for money or for a mortgage, note, or some other promise to pay money. An exchange is a transfer of property for other property or for services. The rules for figuring a taxable gain or a deductible loss apply to both sales and exchanges. However, some exchanges are not taxable.

Part I discusses how transactions that result in gains and losses differ from transactions that do not.

## Sales and Exchanges

A transaction must be a sale or exchange for any gain on it to be taxable or any loss to be deductible. While it might seem easy to tell the difference between what is and what is not a sale or exchange, there are a number of transactions for which it might be difficult. This section discusses these areas and points out how to tell those transactions that are from those that are not sales or exchanges.

**Sale or lease.** You should know the difference between a lease agreement and a conditional sales contract. Some agreements that seem to be leases may really be conditional sales contracts. To know which one it is, you must know what the parties to the agreement had intended when it was made.

There is no test or group of tests that may be used to absolutely prove what the parties intended when they made the agreement. You should consider each agreement based on its own facts and circumstances. For more information on leases, see Publication 535, *Business Expenses*.

**Easements.** Granting or selling an easement usually is not a taxable sale of property. Instead, the amount received for the easement is subtracted from the basis of the property. If only a part of the entire tract of property is permanently affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separately determine the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received.

Any amount received that is more than the basis that is to be reduced is a taxable gain. The transaction is reported as if it were a sale of property.

If you transfer a perpetual easement for consideration, the transaction will be treated as a sale of property. However, if you freely give an open space or scenic easement in perpetuity to a government or charity, it is treated as a charitable contribution and not a sale or exchange. See Publication 561, *Determining the Value of Donated Property*, for additional information.

A transfer of property to satisfy a debt is a taxable exchange.

**Cancelled debt.** A person's debt that is cancelled or paid by another person is not a sale or exchange. The cancelled or paid debt, however, is generally income to the debtor unless the cancellation or payment is intended as a gift. For information on a cancelled debt that is secured by property relating to a foreclosure, repossession or abandonment, see *Foreclosure, Repossession or Abandonment* in Part II. For information on cancelled debts generally see Publication 525, *Taxable and Nontaxable Income*, and Publication 908, *Bankruptcy*.

The mere extension of the maturity date of a note under an agreement that states that some of

the noteholders will not redeem their notes during the extension period but will keep them until all other notes are retired or their retirement is provided for, is not treated as an exchange of outstanding notes for new and different notes. It is not a closed and completed transaction upon which a gain or a loss is figured.

**The transfer of property to an executor or administrator, or to the heirs or beneficiaries, upon the death of an individual generally is not a sale or exchange. No gain or loss is recognized on the transfer.**

**Bankruptcy.** A transfer of property to a trustee in bankruptcy is a nontaxable transfer. For information on this kind of transfer, see Publication 908.

**Foreclosure and repossession.** A transfer of property to a mortgagee or creditor through foreclosure or repossession is a sale or exchange even if the owner voluntarily conveys the property to the mortgagee or creditor. For more information, see *Foreclosure, Repossession, or Abandonment* in Part II.

## Involuntary Exchanges

An involuntary exchange occurs when your property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and you receive other property or money in payment, such as insurance or a condemnation award. Involuntary exchanges are also called *involuntary conversions*.

You do not report the gain if your property is involuntarily converted and you receive property that is similar or related in service or use to it. Your basis for the new property is the same as your basis for the converted property. Thus, the gain on the current transaction is deferred until a taxable sale or exchange occurs.

You must ordinarily report the gain on your converted property if you receive dissimilar property or money for your property. You can choose to postpone reporting the gain if you acquire replacement property or the controlling interest in a corporation owning property that is similar or related in service or use to your converted property within a specified replacement period. To postpone all of the gain, the cost of your replacement property must be equal to or more than the net proceeds from your converted property.

**Replacement period.** To postpone reporting your gain from property disposed of under an involuntary conversion, you must buy replacement property within the replacement period.

**The replacement period begins.** If you choose to postpone reporting your gain from a casualty or theft, your replacement period begins on the date your property was damaged, destroyed, or stolen.

If you choose to postpone reporting your gain from a condemnation, or other disposition of property, because of a threat of condemnation, the replacement period begins on the earlier of the following dates: the date of disposition of the converted property, or the date condemnation was first threatened.

**The replacement period ends.** For most involuntary conversions your replacement period ends 2 years after the close of the first tax year in which any part of your gain on the conversion is realized. The only exception is for condemned business or investment real estate.

For the condemnation of your real property held for use in a trade or business or for investment, your replacement period ends 3 years after the close of the first tax year in which any part of your gain from the conversion is realized.

**Additional information.** For more information on involuntary exchanges, see *Like-Kind Exchanges and Involuntary Conversion*, under Part IV. Also see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts*, and Publication 549, *Condemnations and Business Casualties and Thefts*.

## Figuring Gain or Loss

Gain or loss is usually realized when property is sold or exchanged. A *gain* is the excess of the amount you realize from a sale or exchange over the adjusted basis of the property you transfer. A *loss* is the excess of the adjusted basis of the property over the amount you realize.

**Basis.** The cost or purchase price of property is usually its basis for figuring the gain or loss from its sale or other disposition. However, if you got the property by gift, inheritance, or in some way other than by buying it, you must use a basis other than its cost. **The adjusted basis** of property is your original cost or other basis plus certain additions, and minus certain deductions such as depreciation and casualty losses. See Publication 551, *Basis of Assets*. In determining gain or loss, the cost of transferring property to a new owner, such as selling expenses, is added to the adjusted basis of the property.

**Amount realized.** The amount you realize from a sale or exchange is the total of all money you receive plus the *fair market value* of all property or services you receive. The amount you realize includes any of your liabilities that were assumed by the buyer and liabilities to which the property you traded is subject, such as real estate taxes or a mortgage.

**Fair market value** is the price at which the property would change hands between a buyer and a seller when both have reasonable knowledge of all the necessary facts and neither is required to buy or sell. If parties with adverse interests place a value on property in a certain length transaction, that is strong evidence of fair market value. If there is a stated price for services, this price is treated as their fair market value, unless there is evidence to the contrary.

**Example.** In your business you used a building that cost you \$70,000. You made certain permanent improvements at a cost of \$20,000 and deducted depreciation totaling \$10,000. You sold the building for \$100,000 cash, plus property having a fair market value of \$20,000. The buyer assumed the current real estate taxes of \$3,000 and a mortgage of \$17,000. The selling expenses were \$4,000. Your gain on the sale is figured as follows:

Amount realized:		
Cash.....	\$100,000	
Property received (fair market value).....	20,000	
Real estate taxes (assumed by buyer).....	3,000	
Mortgage (assumed by buyer).....	17,000	
Amount realized.....		\$140,000
Adjusted basis:		
Cost of building.....	\$ 70,000	
Improvements.....	20,000	
Total.....	\$ 90,000	
Minus: Depreciation.....	10,000	
Adjusted basis.....	\$ 80,000	
Plus: Selling expenses.....	4,000	84,000
Gain.....		<u>\$ 56,000</u>

**Amount recognized.** For tax purposes, the amount you realize from a sale or exchange may not be recognized. Generally, gains from the sale, exchange, or other disposition of property must be included in gross income and losses from these transactions are deductible. However, there are exceptions to this rule, as discussed later under *Nontaxable Exchanges*.

**Life estates, etc.** The entire amount you realize from the disposition of a life interest in property, an interest for a set number of years, or an income interest in a trust is a taxable gain if you first got the interest as a gift, inheritance, or transfer in trust. Your basis in the property is considered to be zero. This rule does not apply if all interests in the property are disposed of at the same time.

**Example 1.** Your father dies, leaving his farm to you for life, with a remainder interest to your

younger brother. You decide to sell your life interest in the farm. The entire amount you receive is a taxable gain. Your basis in the farm is disregarded.

**Example 2.** The facts are the same as in Example 1, except that your younger brother joins you in selling the farm. Because the entire interest in the property is sold, your basis in the farm is not disregarded. Your taxable gain is an amount equal to your share of the sales price minus your adjusted basis in the farm.

## Nontaxable Exchanges

Certain exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even if you realize a gain or loss on the exchange, it will not be recognized for tax purposes. The property you get is treated as a continuation of your old investment.

**Caution:** When this publication went to print, Congress was considering legislation that would limit to \$100,000 per year the amount of gain that can be deferred in a like-kind exchange of real estate. The rule, generally to be effective for exchanges after October 13, 1987, would apply to business or investment property.

### Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must meet all six of the following conditions:

**One.** It must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither may be used for personal purposes, such as your home or family car.

**Two.** It must not be property held for sale. Neither the property you trade nor the property you receive may be property you sell to customers, such as merchandise. It must be property held for investment or property held for productive use in your trade or business. Machinery, buildings, land, trucks, and rental houses are examples of property that might qualify. Inventories, raw materials, accounts receivable, and real estate that dealers hold for sale to customers are examples of property that would not qualify.

**Three.** It must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. For example, the trade of an apartment house for a store building, or a panel truck for a pickup truck is a like-kind exchange.

In an exchange of real estate for real estate, it does not matter if city property is exchanged for farm property, or if improved property is exchanged for unimproved property. These differences are not enough to make the exchange taxable.

The exchange of real estate you own for a real estate lease that runs 30 years or more also qualifies as a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

An exchange of personal property for real property does not qualify as a like-kind exchange. For example, an exchange of a piece of machinery for a store building would not qualify. The exchange of livestock of different sexes also does not qualify.

If the like-kind exchange includes the receipt of money or unlike property, you may have a taxable gain (see *Partially nontaxable exchange*, later).

**Four.** It must be tangible property. The rules for like-kind, nontaxable exchanges do not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or

other securities or evidences of indebtedness or interest, or the exchange of partnership interests. However, you may have a nontaxable exchange of corporate stock. See *Exchanges of Corporate Stocks*, later in this publication.

**Five.** It must meet the identification requirement. A transfer of exchanged property can be considered a like-kind exchange if the property to be received is identified in 45 days after you transfer the property given up in the exchange. The identification requirement may be met by designating the property to be received in the contract between the parties. Also, the identification requirement will be satisfied if the contract specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties.

For example, if the executed contract for transfer of property provides that you will transfer real estate to Mary Brown in exchange for property A if zoning changes are approved and property B if the zoning changes are not obtained, the identification requirement is satisfied.

**Six.** It must meet the completed transaction requirement. The transfer of the property to be received will meet the completed transaction requirement if the property is received on or before the earlier of:

- The 180th day after the date on which you transfer the property given up in the exchange, or
- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

**Binding contract.** If the property to be received in the exchange is identified in a binding contract in effect on June 13, 1984, and at all times thereafter before the transfer, rules five and six above apply to transfers made after July 18, 1984, and to transfers before July 19, 1984, if the property to be received in the exchange is not received before 1989. For any transfers before July 19, 1984, which you treat as part of a like-kind exchange, the period for assessing any tax attributable to that exchange will not expire before 1990.

**Effective dates for rules five and six above.** The identification requirement and the completed transaction requirement apply to transfers made after July 18, 1984, and to transfers before July 19, 1984, if the property to be received in the exchange is not received before 1987. For any transfers before July 19, 1984, which you treat as part of a like-kind exchange, the period for assessing any tax attributable to that exchange will not expire before 1988.

**Partially nontaxable exchange.** If, in addition to like property, you receive money or unlike property in a like-kind exchange, you may have a taxable gain. However, you are taxed on the gain only to the extent of the money and unlike property you receive.

To figure the amount of taxable gain, first determine the fair market value of any unlike property you receive and add it to the amount of any money you receive. The total is the maximum amount of gain that can be taxed. Next, figure the amount of gain on the whole exchange, as discussed earlier under *Figuring Gain or Loss*. Your taxable gain is the lesser of these two amounts. A loss is never deductible in a nontaxable exchange, even though you receive unlike property or cash.

**Example.** You exchange real estate held for investment that has an adjusted basis of \$8,000 for other real estate that you want to hold for investment. The real estate you receive has a fair market value of \$10,000, and you also receive \$1,000 in cash. Although the total gain realized on the transaction is \$3,000, only \$1,000 (cash) is recognized and included in your income.

**Assumption of liabilities.** If the other party to a nontaxable exchange assumes any of your liabilities, or you transfer property subject to a liability, you will be treated as if you received cash in the amount of the liability. If, in the previous example, the property you give up is subject to a \$3,000 mortgage, the gain realized and the amount of gain to be taxed is figured as follows:

Fair market value of like property received.....	\$10,000
Cash.....	1,000
Mortgage assumed.....	3,000
Total received.....	\$14,000
Minus: Adjusted basis of property you transferred.....	8,000
Gain realized.....	\$ 6,000

The realized gain is taxed only up to \$4,000, the sum of the money (\$1,000) and the mortgage (\$3,000). For information on figuring the basis of the new property, see Publication 551.

**If you pay money.** If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible loss.

**Example.** Bill Smith trades an old cab for a new one. The new cab costs \$10,800. He is allowed \$2,000 for the old cab, and pays \$8,800 cash. He has no taxable gain or deductible loss on the transaction, regardless of the adjusted basis of his old cab. If Bill had sold the old cab to a third party for \$2,000, and then had purchased a new cab, he would have had a recognized gain or loss on the sale of his old cab equal to the difference between the amount realized and the adjusted basis of the old cab.

**If you give up unlike property.** If, in addition to like property, you give up unlike property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is equal to the difference between the fair market value of the unlike property and the property's adjusted basis.

**Example.** You exchange stock and real estate that you held for investment for real estate that you also intend to hold for investment. The stock you transfer has a fair market value of \$1,000 and an adjusted basis of \$4,000. The real estate you exchange has a fair market value of \$19,000 and an adjusted basis of \$15,000. The real estate you receive has a fair market value of \$20,000. You do not have a taxable gain or a deductible loss on the exchange of the real estate because it qualifies as a nontaxable exchange. However, you must recognize a \$3,000 loss on the stock because the stock is unlike property.

**Sale and purchase.** If you sell property and buy similar property in two mutually dependent transactions, you may be required to treat the sale and purchase as a single nontaxable exchange.

**Example.** You used your car in your business for 2 years. Its adjusted basis is \$3,500 and its trade-in value is \$4,500. You are interested in a new car that costs \$10,500. Ordinarily, you would trade your old car for the new one and pay the dealer \$6,000. Your basis for depreciation of the new car would then be \$9,500 (\$6,000 plus \$3,500 basis for the old car).

Because you want your new car to have a larger basis for depreciation, you arrange to sell your old car to the dealer for \$4,500. You then buy the new car for \$10,500 from the same dealer. However, you will be treated as having exchanged your old car for the new one because the sale and purchase are reciprocal and mutually dependent. Your basis for depreciation for the new car will be \$9,500, the same as it would have been if you had traded the old car.

**Partnership interests.** The like-kind nontaxable exchange rules do not apply to any exchange of interest in different partnerships. The exchange of interests in the same partnership may qualify as a

like-kind exchange. For information on partnerships, see Publication 541, *Tax Information on Partnerships*.

**U.S. Treasury notes or bonds.** Certain issues of U.S. Treasury obligations may be exchanged for certain other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the exchange. For information on the notes or bonds involved, write to the Bureau of the Public Debt, U.S. Treasury Department, Washington, DC 20239-1000.

**Insurance policies and annuities.** No gain or loss is recognized if you exchange:

- 1) A life insurance contract for another or for an endowment or an annuity contract,
- 2) An endowment contract for an annuity contract or for another endowment contract providing for regular payments beginning at a date not later than the beginning date under the old contract, or
- 3) An annuity contract for another if the insured or annuitant remains the same. However, gain on the sale of an annuity contract before its maturity date attributable solely to interest accumulated on the contract is ordinary income.

### Transfers Between Spouses

No gain or loss is recognized on a transfer of property after July 18, 1984, from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. This rule does not apply if the recipient-spouse is a nonresident alien. The rule also does not apply to a transfer in trust if the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the transferee as acquired by gift and is not considered a sale or exchange. The transferee's basis in the property is the same as the adjusted basis of the transferor immediately before the transfer. Any gain recognized on a transfer in trust increases the basis. For more information, see Publication 504, *Tax Information for Divorced or Separated Individuals*.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the marriage ends, or the transfer is related to the end of the marriage.

For a discussion on transfers of property prior to July 19, 1984, see *Sales and Exchanges Between Related Parties* under Part II.

### Exchanges of Corporate Stocks

In certain cases, exchanges of corporate stock are nontaxable. The rules for these nontaxable exchanges are given below.

**A corporation's own stock.** A corporation may dispose of its own stock, including treasury stock, without having a recognized gain or loss.

**Stock for stock of the same corporation.** You may exchange common stock for common stock in the same corporation, or preferred stock for preferred stock in the same corporation, without having a recognized gain or loss.

**Convertible stocks and bonds.** If you convert bonds into stock, or preferred stock into common stock, there is no recognized gain or loss. For this rule to apply, the stock you receive must be in the same corporation as the bond or preferred stock you convert. The conversion must also be made according to the terms of the bond or preferred stock certificate.

**Corporate reorganizations.** When a corporation reorganizes, the exchange of securities in the old organization for securities in the new organization may be nontaxable.

**Property for stock.** If you transfer property to a corporation in exchange for stock or securities in

that corporation, and immediately afterwards you are in control of the corporation, the exchange is usually nontaxable. This rule applies both to individual investors and to groups of investors who transfer property to a corporation.

However, if the property exchanged includes depreciable property, you may be taxed on ordinary gain because of depreciation. See Part IV of this publication for more information on the disposition of depreciable property.

**Control of a corporation.** To be in control of a corporation, you or your group of investors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

**Example 1.** You and Bill Jones purchased property for \$100,000. Together, you organize a corporation at a time when the property has a fair market value of \$300,000, and transfer the property to the corporation for all of its authorized capital stock, which has a par value of \$300,000. No gain is recognized by you, Bill, or the corporation.

**Example 2.** You and Bill transfer the property having a basis of \$100,000 to a corporation in exchange for stock having a fair market value of \$300,000. However, this represents only 75% of each class of stock of the corporation. The other 25% already has been issued to someone else. You and Bill recognize a taxable gain of \$200,000 on the transaction.

**Services rendered.** The term *property* does not include services rendered or to be rendered to the issuing corporation. Therefore, stock received for services is income to the recipient.

**Example.** You transfer property worth \$35,000 and render services valued at \$3,000 to a corporation in exchange for stock valued at \$38,000. Right after the exchange you own 85% of the outstanding stock. No gain is recognized on the exchange of property; however, you will recognize ordinary income of \$3,000 as payment for the services you rendered to the corporation.

**Property of relatively small value.** The term *property* does not include property that is of a relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor, if the main purpose of the transfer is the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if the fair market value of the property transferred is at least 10% of the fair market value of the stock and securities already owned or to be received for services by such person.

**Stock received in disproportion to property transferred.** If a group of investors exchange property for corporate stock, each investor does not have to receive stock in proportion to his or her interest in the property transferred. However, if a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock had been received in proportion first and then some of it had been used to make gifts, to pay compensation for services, or to satisfy obligations of the transferor.

**Money or other property.** If, in an otherwise nontaxable exchange of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. However, you are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring gain in this situation generally follow those for a *Partially nontaxable exchange* discussed earlier under *Like-Kind Exchanges*. No loss is recognized.

**Liabilities.** If the corporation assumes your liabilities, or the property is taken subject to a liability, the transfer generally will not be treated as if you

received money or other property. There are two exceptions to this treatment:

- 1) If the liabilities the corporation assumes are more than your adjusted basis in the property you exchange, gain is recognized up to the amount of the excess. However, if the liabilities assumed would give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
- 2) If there is no good business reason for the corporation to assume your liabilities, or if your main purpose in the exchange is to avoid federal income tax, the assumption will be treated as if you received money in the amount of the liabilities.

**Example.** You transfer property to a corporation for stock. You also receive cash of \$10,000 in the exchange. Your adjusted basis in the property you transfer is \$20,000. The stock you receive has a fair market value of \$16,000, and the corporation also assumes a mortgage of \$5,000 on the property. The gain realized is as follows:

Stock received, fair market value .....	\$16,000
Cash received .....	10,000
Liability assumed by corporation .....	5,000
Total received .....	\$31,000
Minus: Adjusted basis of property transferred .....	20,000
Gain realized .....	\$11,000

The recognized gain is limited to \$10,000, the amount of cash received.

**Installment obligation exchanged for stock of the debtor.** If an installment obligation is exchanged only for stock having a value that is more than the creditor's basis in the installment obligation, the exchange is a satisfaction of the installment obligation at other than its face value. Gain is recognized on the exchange even though right after the exchange the former creditor is in control of the corporation. The difference between the fair market value of the stock and the creditor's basis in the installment obligation is the gain recognized on the exchange. The creditor's basis in the installment obligation is the excess of the face value of the obligation over the income returnable if the obligation were satisfied in full.

## Part II Ordinary or Capital Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be a capital gain or loss or it may be an ordinary gain or loss, depending on the circumstances. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss.

When you sell or exchange a capital asset, your gain or loss is a capital gain or loss. It will be a long-term gain or loss if you owned the capital asset for more than 6 months. It will be a short-term gain or loss if you owned the asset or the property 6 months or less.

For tax years beginning after 1986, the 60% capital gains deduction is no longer allowed. The full amount of the net capital gain is included in income. However, for tax years beginning in 1987, the highest tax rate that can be imposed on the gain is generally 28%.

You must still distinguish gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions need to be made to arrive at net capital gains for figuring the 1987 28% rate limit, and for figuring the limit on capital losses. See Part III, *Tax Treatment of Gains and Losses*, later.

The tax treatment of gains and losses from several types of transactions is discussed in this part.

It is important that you properly classify everything you sell or exchange as:

- 1) A capital asset,
- 2) A noncapital asset, or
- 3) An asset that may be treated as either capital or noncapital, depending on the circumstances. This category includes some assets used in your trade or business, and involuntarily converted assets held in connection with a trade business or a transaction entered into for profit. These assets are referred to as "section 1221 property." See the definition of capital asset below, and the later discussions of *Property used in your business* and *Section 1231 Property* in Part IV.

## Capital Assets

For the most part, everything you own and use for personal purposes or investment is a capital asset. Some examples are: stocks or bonds held in your personal account; a home owned and occupied by you and your family; household furnishings; a car used for pleasure or commuting; coin or stamp collections; gems and jewelry; gold, silver, or any other metal.

**Capital asset defined.** Everything you own is a capital asset *except*:

- 1) **Property held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers
- 2) **Accounts or notes receivable** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1),
- 3) **Depreciable property** used in your trade or business (even though fully depreciated),
- 4) **Real property** used in your trade or business
- 5) **A copyright, literary, musical, or artistic composition, letter or memorandum, or similar property—**
  - a) Created by your personal efforts,
  - b) A letter, memorandum, or similar property prepared or produced for you, or
  - c) Acquired from a person who created the property, or for whom the property was prepared, under circumstances entitling you to the basis of the person who created the property, or for whom it was prepared or produced (for example, by gift), and
- 6) **U.S. Government publications** that you got from the government for free or for less than the normal sales price or that you acquired under circumstances entitling you to the basis of someone who got the publications for free or for less than normal sales price, if you sell, exchange, or contribute the publication.

**Property held for personal use** is a capital asset. Gain from a sale or exchange of such property is a capital gain. However, losses from sales and exchanges of such property are not deductible unless they result from personal casualty losses.

**Personal casualty gains and losses.** To figure your personal casualty (or theft) loss, reduce each loss by \$100. If your personal casualty gains for the tax year exceed your personal casualty losses all of your gains and losses are treated as sales and exchanges of capital assets. However, if your personal casualty losses for the tax year exceed your personal casualty gains, losses to the extent of gains can be deducted in full. Losses in excess of gains are deductible on Schedule A to the extent they exceed 10% of your adjusted gross income. Use Section A of Form 4684, *Casualties and Thefts*, to report all personal casualty gains and losses. For more information, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts*.

Investment property is a capital asset and a gain or loss from its sale or exchange may be a capital gain or loss.

Business bad debts except those evidenced by corporate securities are short-term capital assets.

Release of restriction on land. Amounts you get by the release of a restrictive covenant in a deed on land are treated as proceeds from the sale of a capital asset.

## Noncapital Assets

This discussion gives examples of some of the items listed previously as exceptions to capital assets.

Property held mainly for sale to customers is a noncapital asset. Whether property is held mainly for sale to customers in the ordinary course of business is a question of fact to be judged in each case. Among the factors to be considered are:

- 1) The purpose for which the property is acquired,
- 2) The development of the property between the time it was acquired and sold,
- 3) The number and frequency of sales, and
- 4) The time the property is held before it is sold.

**Example 1.** You are in the business of developing and selling luncheonette businesses. You are constantly acquiring new sites, developing and selling the businesses. Upon completion of the construction of a luncheonette and prior to its operation, you sell it. Because the businesses are property that you hold mainly for sale to customers in the ordinary course of your business, the businesses are not capital assets. Gain or loss from the sales of the businesses is ordinary gain or loss. The result would be the same if you had incorporated the luncheonettes and sold the stock of the corporations.

**Example 2.** You manufacture and sell to customers steel reels which you deliver on returnable reels that have a useful life of 8 years. The customers make deposits on the reels, which you will refund if the reels are returned within a year. If they are not returned, you keep the deposits as the agreed-upon sales price of the reels; however, most of the reels are returned within the one-year period. You keep adequate records showing depreciation and other charges to the capitalized cost of the reels. Under these conditions, the reels are not property held for sale to customers in the ordinary course of your business. Any gain or loss resulting from their nonreturn may be capital or ordinary, depending on your section 1231 transactions. See Section 1231 Property, later, in Part IV. Business assets classified as real property or depreciable property used in your trade or business are not capital assets, but may be treated as such under certain circumstances. See Section 1231 Property, later.

Rental property is treated as a business asset.

## Sales and Exchanges Between Related Parties

Special rules apply to the sale or exchange of property between related parties.

**Gain on the sale or exchange.** If a gain is recognized on the sale or exchange of property, including a leasehold or a patent application that is depreciable property in the hands of the party who receives it, the gain is ordinary income if the transaction is either between:

- 1) A person and that person's controlled entity or entities (discussed below),
- 2) A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary, unless the beneficiary's interest in the trust is a remote contingent interest, that is, the value of the interest computed actuarially is 5% or less of the value of the trust property,

3) An employer and any person related to the employer under the rules (1) and (2),

- 4) A welfare benefit fund (within the meaning of section 419(e)) that is controlled directly or indirectly by persons referred to in rule (3), and
- 5) Husband and wife (only applicable to transfers before July 19, 1984, see *Transfers Between Spouses* under Part 1).

For sales and exchanges between related parties before October 23, 1986, a controlled entity is:

- 1) A corporation in which 80% or more of the value of all outstanding stock is owned, directly or indirectly, by or for one person, and
- 2) A partnership in which 80% or more of the capital interest or profits interest is owned, directly or indirectly, by or for one person.

**Determining control.** For purposes of the above rules, use the following discussion to determine if you control an entity.

- 1) Stock or an interest owned directly or indirectly by or for your spouse is considered as constructively owned by you.
- 2) Stock or an interest owned directly or indirectly by or for a partnership or estate in which you are a partner or beneficiary, or by a trust of which you are treated as owner or are a beneficiary is considered owned by you in proportion to your ownership interest in the partnership, estate, or trust.
- 3) Stock or an interest owned directly or indirectly by or for a corporation in which you own stock is considered as constructively owned by you in proportion to your ownership interest in the corporation.
- 4) Options to acquire stock or options to acquire options to acquire such stock make you the constructive owner of the stock on which you hold the option.
- 5) For purposes of applying rules (1), (2), (3), and (4), stock or an interest owned by an individual is treated as actually owned by that individual. Stock or an interest constructively owned by an individual under rule (1) is not considered owned by that individual for again applying rule (1) to make another the constructive owner of the stock or an interest. Stock that may be considered owned by an individual under either rule (1) or rule (4) is considered owned under rule (4).

**Transitional rule.** Sales after October 22, 1986, made under a binding contract in effect on August 14, 1986, are treated as sales before October 23, 1986.

For sales and exchanges between related parties after October 22, 1986, a controlled entity is:

- 1) A corporation in which more than 50% of the value of all outstanding stock, or a partnership, in which more than 50% of the capital interest or profits interest, is owned, directly or indirectly, by or for one person.
- 2) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.
- 3) Two corporations that are members of the same controlled group.
- 4) Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 5) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

**Determining control.** For purposes of the above rules, use the following discussion to determine if you control an entity.

- 1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
- 2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family, including only brothers and sisters (either whole or half), spouse, ancestors, and lineal descendants, or
- 3) Stock constructively owned by a person under rule (1), for applying rules (1) and (2), is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) will not be treated as owned by the individual for applying rule (2) to make another person the constructive owner of that stock.

A loss on the sale or exchange of property is not deductible if the transaction is directly or indirectly between the following related parties:

- 1) Members of the same immediate family, including brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) An individual and a corporation when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
- 3) Two corporations that are members of the same controlled group as defined in section 1563(a) except that "more than 50%" is substituted for "at least 80%" in that definition. For this purpose a controlled group does not include an IC-DISC.
- 4) A trust fiduciary and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
- 5) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- 6) Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 7) A tax-exempt educational or charitable organization and a person who, directly or indirectly, controls such an organization, or a member of that person's family.
- 8) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
- 9) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 10) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

If a sale or exchange is between any of these related parties and it involves the lump-sum sale of a number of blocks of stock or pieces of property, the gain or loss must be computed separately for each block of stock or piece of property. The gain on each item is taxable; however, the loss on any item is nondeductible. Also, gains from the sales of any of those items may not be reduced by losses on the sales of any of the other items.

**Special rules applicable to controlled groups.** Losses on transactions between members of the same controlled group are deferred rather than denied. The losses are deferred until the property is transferred outside the controlled group and the

loss recognized under consolidated return principles or as may be prescribed by regulations. These loss deferral rules do not apply to sales of inventory in the ordinary course of business between two corporations if one or both of them are foreign corporations. These loss deferral rules also do not apply to a loss on the repayment of a loan to another member of the controlled group if the loan is payable in a foreign currency and the loss is due to a reduction in value of the foreign currency.

**Indirect transactions** include sales through a stock exchange. You may not deduct your loss on the sale of stock through your broker if, for example, under a prearranged plan a related person or entity buys the same stock that you had owned.

**Property received from a related party.** If you sell or exchange at a gain property you received from a related party, you recognize the gain only to the extent that it is more than the loss previously disallowed to the transferor. This rule applies only to the original transferee.

**Example 1.** You sell stock with a cost basis of \$10,000 to your brother for \$7,600. Your loss of \$2,400 is not deductible. Later he sells the same stock to an unrelated party for \$10,500, thus realizing a gain of \$2,900. His reportable gain is only \$500, the excess over the \$2,400 loss not allowed to you.

**Example 2.** Assume the same facts as in Example 1, except that your brother sells the stock for \$6,900 instead of \$10,500. His recognized loss is only \$700. He cannot deduct the loss that was not allowed to you.

**Ownership of stock.** In determining whether an individual directly or indirectly owns any of the outstanding stock of a corporation for purposes of a loss on a sale or exchange, the following rules apply.

**Rule 1.** Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.

**Rule 2.** An individual is considered as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

**Rule 3.** An individual owning (other than by applying rule 2) any stock in a corporation is considered to own the stock owned directly or indirectly by or for his or her partner.

**Rule 4.** For purposes of applying rules 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rules 2 or 3 is not treated as owned by the individual for again applying either rule 2 or 3 to make another person the constructive owner of the stock.

If you transfer a patent for value, see *Inventions*, as discussed later in this Part, for transfers to certain related persons that will not qualify for capital gain treatment.

## Cancellation or Sale of a Lease

Payments for the cancellation or sale of a lease received by a tenant may result in a gain or loss from the sale or exchange of a capital asset. If the lease was used in the tenant's trade or business, the gain or loss is a section 1231 gain or loss, see *Section 1231 Property*, later. If the lease was for the tenant's home, a gain would be taxed as a capital gain but any loss would not be deductible.

Payments received by a landlord (lessor) for cancellation of a lease are ordinary income and not capital gains.

## Cancelling a Sale of Real Property

If you sell real property to an individual and the sales contract gives the buyer the right to return the property to you for the amount paid, you may not have to recognize gain or loss on the sale. You will not recognize gain or loss if the property is returned to you within the same tax year as the sale. However, if the property is returned to you in a future tax year, you must recognize gain or loss in the year of the sale. In the year the property is returned to you, your new basis in the property will be equal to the amount you give back to the buyer.

## Foreclosure, Repossession, or Abandonment

If the owner (borrower) does not make payments due on a loan secured by property, the lender (mortgagee or creditor) may foreclose on the mortgage or repossess the property. The foreclosure or repossession is treated as a sale or exchange (even if voluntarily conveyed to the lender) from which the owner may realize gain or loss (discussed below). In another situation, the owner may abandon the property. The abandonment is treated as a disposition from which the owner may realize ordinary income or loss (see *Income or loss on abandonment*, later).

If the owner is personally liable for repayment of the loan, then the above sale or exchange, or the abandonment of the property, may give rise to discharge of indebtedness income to the owner (see *Owner personally liable for debt and Income or loss on abandonment*, later).

Further, if investment credit property is transferred or abandoned, the owner may owe additional tax from recapture of the investment credit. See Publication 572, *General Business Credit*.

**Gain or loss on foreclosure or repossession.** The owner's gain or loss from the sale or exchange described above is figured in the same way as a gain or loss from sales or exchanges generally. The gain or loss is the difference between the owner's adjusted basis of the property transferred and the amount realized. See *Figuring Gain or Loss* in Part I, earlier.

**Amount realized.** If the owner is not personally liable for repayment of the debt secured by the property transferred, the amount realized by the owner includes the full amount of the debt discharged by the transfer, or, if greater, the sales proceeds. The full amount of the debt discharged is included even if the property's fair market value is less than the amount of the debt discharged.

If the owner is personally liable for the debt, and the fair market value of the property transferred is less than the amount of the debt discharged, the amount realized by the owner does not include the amount of the debt discharged that is more than the fair market value of the property. In this case, the owner may realize ordinary income from discharge of indebtedness for that part of the discharged debt not included in the amount realized. See *Owner personally liable for debt*, later.

**Capital or noncapital asset.** If the property transferred is a capital asset, the owner's gain or loss is a capital gain or loss. If the property is not a capital asset, the gain or loss is an ordinary gain or loss, unless the property is the kind that can be treated as a capital asset. See *Ordinary or Capital Gain or Loss*, earlier.

**Loss.** A loss realized by the owner of property transferred through foreclosure or repossession is figured in the same way as a loss from sales or exchanges generally. See *Figuring Gain or Loss* in Part I.

No deduction is allowed for loss on *personal residence or other property held for personal use*, unless the loss is from a personal casualty or

theft. Also, no deduction is allowed for loss on *transfer of any property between related parties*. See *Capital Assets and Sales and Exchanges Between Related Parties*, earlier.

The owner will have a deductible loss if the adjusted basis of business or investment property transferred through foreclosure or repossession more than the amount realized (discussed earlier). Depending on whether the property is a capital asset, the loss may be an ordinary loss or a capital loss. See *Ordinary or Capital Gain or Loss*, earlier. For information on how ordinary losses are deducted, see Part III. For information on ordinary losses (normally from dispositions of section 1231 property), see Part IV and *Form 4797*, in Part V.

**Example.** In 1985, Harold Boggs purchased improved real property as an investment at a cost of \$77,000. He paid \$12,000 cash and obtained \$65,000 note secured by a mortgage on the property. Harold repaid \$5,000 of the principal before he encountered financial difficulties and defaulted. At a foreclosure sale, the property was sold for \$60,000, the unpaid balance of Harold's mortgage loan. His loss on the transaction is \$17,000 (\$77,000 basis minus \$60,000 realized from the foreclosure and used to pay off the mortgage). Since Harold's foreclosed property was held for investment and is a capital asset held for more than 6 months, Harold's loss is treated as a long-term capital loss.

**Gain.** If the amount realized by the owner of property transferred through foreclosure or repossession is greater than the adjusted basis of the property, the excess is a gain, taxed in the same way as a gain from sales or exchanges generally. Gain from property held for personal use is taxed as a capital gain. Property used in a trade or business and held for more than 6 months is section 1231 property. Gain on sale or exchange of section 1231 property, whether by foreclosure or repossession, may qualify as long-term capital gain. See *Section 1231 Property*, later.

**Example.** John purchased property for \$34,000. He paid cash of \$7,500 and assumed a \$26,500 mortgage. During the year John had financial problems and the mortgage was subsequently foreclosed. The net proceeds from the foreclosure sale are \$35,000, representing an increase in the value of the property. Of this amount, John received \$8,500. His gain is \$1,000 (\$35,000 proceeds less \$34,000 basis).

**Owner personally liable for debt.** If property transferred through foreclosure or repossession to satisfy a debt secured by the property, the owner may realize ordinary income from discharge of indebtedness. However, the income may not be recognized in certain cases, such as a debt cancellation intended as a gift, an insolvent debtor, or bankruptcy. See Publication 908.

The income from discharge of indebtedness is in addition to the gain or loss from the sale or exchange (transfer of property). This ordinary income from the discharge of indebtedness may be realized if:

- 1) The owner is personally liable for repayment of the debt secured by the property transferred to satisfy the debt, and
- 2) The fair market value (FMV) of the property transferred is less than the amount of debt discharged.

In this case, the amount realized by the owner does not include the amount of debt discharged that is more than the FMV of the property transferred. However, the owner may have ordinary income from discharge of indebtedness for that part of the discharged debt not included in the amount realized.

**Example.** Frank is personally liable for repaying a mortgage on his investment property. After Frank stopped making payments on the mortgage the lender foreclosed on it. The balance due was

500. When the property was transferred to the lender, its FMV was \$6,000 and Frank's adjusted basis in it was \$8,000. Frank realized a capital gain of \$2,000 (\$8,000 basis minus \$6,000 amount realized) and ordinary income from discharge of indebtedness of \$1,500 (\$7,500 mortgage debt discharged minus \$6,000 FMV of property transferred to satisfy the debt).

**Income or loss on abandonment.** If the owner is personally liable for a debt secured by property that has been abandoned, and the debt is cancelled, the owner may realize ordinary income from discharge of indebtedness to the extent of an unpaid debt. However, the income may not be recognized in certain cases, such as a debt cancellation intended as a gift, an insolvent debtor, or bankruptcy. See Publication 908.

**Loss from abandonment of business or investment property** is deductible as an ordinary loss up to the amount of the property's adjusted basis when abandoned. However, if the property is later foreclosed on or repossessed, there may be a gain or loss, figured as discussed earlier under **Gain or loss on foreclosure or repossession**. The abandonment loss is taken in the tax year in which the loss is sustained. The owner, however, may not deduct any loss on his or her personal residence or other property held for personal use, unless the loss is from personal casualty or theft.

**Reporting income or loss.** The owner of property transferred through foreclosure or repossession to satisfy a debt reports gain or loss on the transfer in the same way as for a gain or loss on sales or exchanges generally. See Part V.

**Reporting Gains and Losses.** If the owner who transfers or abandons property realizes taxable income from discharge of indebtedness, that income is reported on line 21 of Form 1040.

**Abandonment loss.** The owner who abandons business or investment property may have an ordinary loss up to the amount of the property's adjusted basis when abandoned. This loss is reported on Form 4797, Part II, line 10.

**Form 1099-A.** If a lender (including a governmental unit) has acquired an interest in property that was security for a loan, or knows that such property has been abandoned, the lender must provide the owner with a copy of Form 1099-A, *Information Return for Acquisition or Abandonment* or with an equivalent statement. For acquisitions or abandonments in 1987, the lender must furnish the owner with the statement or copy of the form by February 1, 1988.

Form 1099-A gives the information needed to determine whether or not the owner has income or loss on the acquisition or abandonment of his or her property. If the owner believes any of the information on the form is inaccurate, he or she should contact the issuer of the form immediately. Otherwise, the owner should figure income or loss and report it as discussed in this publication.

**Seller's (lender) gain or loss on repossession.** If you finance a buyer's purchase of property and later acquire an interest in the property through foreclosure or abandonment, you may have a gain or loss on the acquisition. For more information, see Publication 537, *Installment Sales*.

If you acquire an interest in property that was security for a loan, or have reason to know that the property has been abandoned, you must file an information return with the Internal Revenue Service and also report the information to the borrower. See Form 1099-A, above.

## Sale of a Business

The sale of a business is not usually a sale of one asset.

**Sole proprietorships.** A sole proprietorship usually has many assets. When sold, the assets of the business must be classified as capital assets, depreciable property used in the business, real property used in the business, or property held for

sale to customers, such as inventory or stock in trade. The gain or loss on each asset is figured separately. The sale of capital assets results in capital gain or loss; the sale of real property or depreciable property used in the business results in gain or loss from a section 1231 transaction (explained later); and the sale of inventory results in ordinary income or loss. See *Goodwill* for information on the allocation of the sales price when goodwill exists.

**Partnerships.** An interest in a partnership or joint venture is treated as a capital asset when it is sold, except that the part of any gain or loss that is from unrealized receivables or inventory items that have appreciated substantially in value will be treated as ordinary gain or loss. Unrealized receivables include the ordinary income potential in certain depreciable property (see Part IV of this publication) owned by the partnership, to the extent of the gain that would have been realized if the partnership had sold the depreciable property at its fair market value when the partnership interest was sold. The amount realized on the sale of a partner's interest includes partnership liabilities for which a partner is relieved. For information on partnerships, see Publication 541, *Tax Information on Partnerships*. Also see *Goodwill*, later.

**Corporations.** Your interest in a corporation is represented by stock certificates. When you sell the certificates, you usually realize capital gain or loss. For information on the sale of stock, see Publication 550, *Investment Income and Expenses*.

In general, corporate liquidations of property are treated as a sale or exchange. Gain or loss is generally recognized by the corporation on the liquidating sale of its assets. Gain or loss is also generally recognized on a liquidating distribution of assets as if the corporation had sold the assets to the distributee at fair market value. This rule generally applies to distributions after July 31, 1986, unless the corporation is completely liquidated before 1987, and to distributions not in complete liquidation made after 1986. For more information, get Publication 542, *Tax Information on Corporations*.

## Inventions

An invention is usually a capital asset if the hands of the inventor whether or not a patent or patent application has been obtained. The inventor is the individual whose efforts created the property and who qualifies as the original and first inventor or joint inventor.

**Substantial rights.** If you acquire all the substantial rights to patent property before the invention is reduced to practice (tested and operated successfully under operating conditions) for a consideration paid to the inventor, when you dispose of your interest you may obtain the special tax treatment (discussed later) if you are not the employer of, or related to, the inventor. However, if you purchase patent property after it is reduced to practice, the property may be treated as either a capital or noncapital asset, depending on the circumstances.

All substantial rights to patent property means all rights that are of value when they are transferred. The right to prohibit sublicensing or subassignment of rights, or the keeping of a security interest (such as a lien), or a reservation calling for forfeiture for nonperformance, are not treated as substantial rights for these rules and may be kept by the holder.

In the following situations, all substantial rights were not transferred, and the transferor is not entitled to the special tax treatment described later:

- 1) The rights are limited geographically within a country (limiting the rights to one or more whole countries could be a transfer of all substantial rights).

- 2) The rights are limited in time to a period that is less than the remaining life of the patent.
- 3) The rights are limited to fields of use within trades or industries that are less than all the rights that exist and have value at the time of the grant.
- 4) The rights are less than all the claims or inventions covered by the patent that exist and have value at the time of the grant.

**Special tax treatment.** If you are the inventor or an individual who acquired all the substantial rights to the patent property and you transfer all the substantial rights or an undivided interest in all such rights, the transfer will be treated as a sale or exchange of a long-term capital asset. This treatment applies even if you have not held the patent property for more than 6 months and the payments received are made:

- 1) Periodically during the transferee's use of the property, or
- 2) Contingent on the productivity, use, or disposition of the transferee's rights in the property.

**Related persons.** The special tax treatment does not apply if the transfer is either directly or indirectly between you and your employer or related person as defined earlier under *Sales and Exchanges Between Related Parties* with the following changes:

- 1) Members of your immediate family include your spouse, ancestors, and lineal descendants, but not your brothers or sisters or half-brothers or half-sisters.
- 2) An individual and a corporation are considered related parties if the individual owns, directly or indirectly, 25% or more in value of the outstanding stock of the corporation.
- 3) A partnership and a partner, if the partner owns, directly or indirectly, more than 50% of the capital or profits of the partnership (other than an interest in the partnership).
- 4) Two partnerships, if the same persons directly or indirectly own more than 50% of the capital or profits of each.

If you come within the definition of a related taxpayer independent of family status, the brother-sister exception does not apply. Thus, a transfer between a brother and sister, one of whom is the beneficiary and the other the fiduciary of a trust, is a transfer between related parties. The brother-sister exception does not apply because the trust relationship is independent of the family status.

**Trade secrets (technical "know-how")** are generally eligible for capital gain treatment on their sale or exchange. A transfer of a trade secret is a sale or exchange, if the transfer includes all substantial rights to the trade secret. The substantial rights that must be transferred are the right to use the trade secret in perpetuity or until it becomes public knowledge and no longer protectable under the laws of the country where the transferee operates, and the exclusive right to prevent further disclosure.

## Copyrights

Literary, musical, or artistic compositions, or similar property are not treated as capital assets if your personal efforts created them, or if you got the property in such a way that all or part of your basis in the property is determined by reference to a person whose personal efforts created it (for example, if you get the property as a gift). The sale of such property, whether or not it is copyrighted, results in ordinary income and is generally reported on Form 4797, *Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions*.

However, if you get such property or a copyright to it in any other way, the amounts you get for granting the exclusive use or right to exploit the

work throughout the life of the copyright are treated as being received from the sale of property. It does not matter if the payment is a fixed amount or a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or an amount based on the number of copies sold, performances given, or exhibitions made. It also does not matter if it is paid over the same period as that covering the grantee's use of the copyrighted work.

If the property is used in your trade or business, the gain or loss is a section 1231 gain or loss.

**Letters, memorandums, and similar property** (such as a draft of a speech, recordings, transcripts, manuscripts, drawings, or photographs) are not treated as capital assets if your personal efforts created them or if they were prepared or produced for you. Also, this property is not a capital asset if your basis in the property is determined by reference to the person who created the property or the person for whom it was prepared. For this purpose, letters and memorandums addressed to you are considered prepared for you. If letters or memorandums are prepared by persons under your administrative control, they are considered prepared for you whether or not you review them.

## Goodwill

Goodwill is a capital asset that may or may not exist within a business.

Goodwill includes every positive advantage that a firm gets in doing its business. It is the total of all those undefinable qualities that bring customers to a business, such as the right to have the business at a particular location under a trade name or trademark, any special knowledge or know-how, the number and quality of customers, or any other similar elements of value in the business as a going concern.

Because of the many facts and circumstances in each business situation, there are a number of methods for figuring the value of goodwill. One of these methods views the cost of goodwill to be that part of the total purchase price of a business that is more than its book value, fair market value, or assigned value of the separate tangible and other intangible net assets acquired. The seller receives capital gain treatment on the amount of the sale price that is for the sale of goodwill and the buyer cannot deduct any of this amount because goodwill is a capital asset with an unknown useful life and is not subject to depreciation or amortization for income tax purposes. The amount the buyer pays for goodwill becomes its asset value (basis) to the business.

**Agreement not to compete** accompanying sale of goodwill. When an agreement not to compete for a set number of years can be separated from goodwill, the agreement is not a capital asset and the amount received is ordinary income. However, if an agreement not to compete goes along with the transfer of goodwill in the sale of a going concern and it serves to assure the purchaser of the beneficial enjoyment of the goodwill acquired, the agreement may not be separated from goodwill and is a capital asset. You must establish from the facts and circumstances in your particular case whether you have sold goodwill or have entered into an agreement not to compete.

**Professional skill or other characteristics of an owner.** Whether the amount you got for the sale of a professional practice is for goodwill depends on the facts in each case. The dependency of the business solely upon the professional skill or other personal characteristics of the owner is not the main factor.

If the seller keeps a right to fees collected after the sale for services performed before the sale, or gets a payment for giving up all or part of the right to these fees, the amount received is for services performed before the sale rather than from the sale of goodwill, and is ordinary income.

If the seller keeps a right to any fees or revenue collected for services performed after the sale, or if the buyer agrees to pay an amount equal to any part of these fees or revenue, these amounts are ordinary income from the business, and not amounts from the sale of goodwill.

Amounts received by a professional person when admitting partners to that person's practice may be payment for a partial transfer of goodwill (rather than for an assignment of anticipated future earnings), provided that the goodwill in fact exists and that the amount allocated to it actually is a payment for it.

### Allocation of sales price of business assets.

The sale of a trade or business for a lump-sum amount is considered a sale of each individual asset rather than a single asset. Both the buyer and seller of a business are now required to use the residual method to allocate the sales price of the business to the various business assets bought or sold. This method determines the amount of gain or loss from the transfer of each asset and how much of the sales price is considered received for **goodwill and going concern value**. It also determines the buyer's basis in the assets of the business.

The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business, or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid. A group of assets is adjusted for the amount paid. A group of assets constitutes a trade or business if goodwill or going concern value could, under any circumstances, attach to the assets.

This rule applies to any qualifying transfer after May 6, 1986, unless the transfer was made under a binding contract in effect on May 6, 1986, and at all times after that date.

**Residual method.** The residual method provides for the sales price to be allocated first among the business's various assets in a specified order, and then for the remainder of the sales price to be allocated to goodwill or going concern value.

The allocation must be made among the following assets in proportion to (but not in excess of) their fair market value in the order specified.

- 1) Cash and demand deposits and similar accounts;
- 2) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency;
- 3) All other assets, both tangible and intangible, except goodwill or going concern value.

After making this allocation, the remainder of the purchase price is considered paid for goodwill or going concern value.

**Example.** The total amount paid in the sale of Company SKB is \$21,000. No cash or demand deposits were sold. The company's U.S. government securities had a fair market value of \$3,200 and other business assets had a fair market value of \$15,000. Of the \$21,000 paid for Company SKB, \$3,200 is allocated to U.S. government securities, \$15,000 to other business assets, and the remaining \$2,800 to goodwill or going concern value.

**Reporting requirement.** Both the buyer and the seller involved in the sale of business assets must report to the IRS the allocation of the sales price among goodwill and the other business assets. Form 8594, *Asset Acquisition Statement*, should be used to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax returns for the year in which the sale occurred.

## Transfer of a Franchise, Trademark, or Trade Name

A franchise is an agreement that gives one of the parties the right to distribute, sell, or produce goods, services, or facilities within a specific area.

The transfer of a franchise, trademark, or name will not receive capital gain or loss treatment if the transferor keeps any significant power, right, or continuing interest in the franchise, trademark, or trade name. A transfer includes the renewal of a franchise, trademark, or trade name.

A **significant power, right, or continuing interest** in a franchise, trademark, or trade name includes, but is not limited to, the following in the transferred interest:

- 1) A right to disapprove any assignment of interest, or any part of it.
- 2) A right to end the agreement at will.
- 3) A right to set standards of quality for products used or sold, or for services provided, and the equipment and facilities used to promote such products or services.
- 4) A right to make the recipient sell or advertise only the products or services of the transferor.
- 5) A right to make the recipient buy most supplies and equipment from the transferor.
- 6) A right to get payments based on the productivity, use, or disposition of the item of interest transferred if those payments are a substantial part of the transfer agreement.

## Subdivision of Land

If you own a tract of land, and, in order to exchange it, you subdivide the land into individual lots or parcels, you may receive capital gains treatment on at least a part of the proceeds if show that:

- 1) You are not a dealer in real estate;
- 2) You have made no substantial improvement that substantially enhances the value of the tract or parcel sold while you have held the tract and no such improvement will be made as of the contract of sale;
- 3) You have held the land for at least 5 years unless you got it by inheritance or devise;
- 4) You did not previously hold the tract or any parcel on the tract mainly for sale to customers in the ordinary course of your trade or business (unless the tract previously would have qualified for this treatment), and during the year in which the sale occurred you were not holding any other land for sale to customers in the ordinary course of trade or business.

**A substantial improvement** must be substantial in character and also must significantly increase the value of the lot or parcel sold. An improvement may substantially increase the value of lots in a tract and not others. A 10% increase in the value of a lot is not a substantial increase. The increase is more than 10%, you must show that when all relevant factors are considered, the increase is not substantial. Shopping centers, other commercial or residential buildings, hard surface roads, or utility services (such as sewer, water, gas, or electricity) are some improvements that are considered substantial.

**Minimum all-weather access roads** are not substantial in character. This includes gravel roads where they are required by the climate.

**Clearing operations**, including surveying, fill, draining, and leveling, are not substantial improvements. Neither are temporary structures used in field offices.

If you hold property for 10 years, an improvement you made will not be considered substantial if all of the following conditions are met:

The improvement consists of the installation of water, sewage or drainage facilities, roads (including hard surface roads), curbs, and gutters.

The district director for your area is satisfied that without the improvement the lot sold would not have brought the current local price for similar sites, and

A statement is filed with your tax return stating that you choose not to adjust the basis of the lots sold, or any other property you own, to reflect the cost of the improvement attributable to the lots, and not to deduct the costs as an expense.

You must have actually held the property for 10 years or more. If you inherited it, you must have inherited it 10 years or more before the sale. If the holding period of a prior owner is included in your holding period, improvements made by a previous owner are considered to have been made by you.

**Making the choice.** You make this choice by sending the following information with your income tax return for the tax year in which the lots that are subject to the choice were sold:

- 1) A plat showing the subdivision and all improvements you made,
- 2) A list of all the improvements made to the tract, showing—
  - a) The cost of the improvements,
  - b) Which of the improvements, without regard to this choice, you consider substantial and which you consider not substantial,
  - c) For those improvements that you consider to be substantial and to which the choice is to apply, you must make a fair allocation of their cost to each lot that they affect, and state the amount by which they have increased the values of these lots,
  - d) The date each lot was acquired and its basis for figuring gain or loss, exclusive of the cost of any improvements listed in item (c), and

3) A statement that you will neither deduct as an expense nor add to the basis of any lot or other property that you sold any part of the cost of any substantial improvement, which substantially increased the value of any lot in the tract and which either you listed in item (c) or the district director determined to be substantial.

An improvement is made by you if it is made by:

- 1) Members of your family, including only your whole or half-brothers and sisters, your spouse, your ancestors, and your lineal descendants,
- 2) A corporation in which you directly or indirectly own more than 50% of voting stock (see *Indirect ownership of stock*, discussed earlier),
- 3) A partnership of which you were a member at the time the improvements were made,
- 4) A lessee, if the improvements are rental income to you, or
- 5) A federal, state, or local government, or political subdivision thereof, but only if it results in an increase in your basis in the property, such as a special assessment for street paving.

A tract is a single piece of land. Two or more adjoining pieces of land are considered a single tract for this purpose. They may have been acquired over a period of time, and may be owned separately, jointly, in partnership, or under any combination of such forms of ownership. Two or more pieces of land are adjoining even though they may be divided by a road, street, stream, etc. Gain on sale of lots. If your holding of the land meets the four requirements listed at the beginning of this discussion, any gain realized on its sale or exchange is treated in the following manner.

**If you sell less than six lots or parcels from the same tract,** the entire gain is a capital gain. In figuring the number of lots or parcels sold, two or more adjoining lots sold to a single buyer in a single sale are counted as only one parcel.

**When you sell or exchange the sixth lot or parcel from the same tract,** the amount by which 5% of the selling price exceeds the expenses of the sale is treated as ordinary income and the rest of any gain is a capital gain. Five percent of the selling price of all lots sold or exchanged from the tract in the tax year the sixth lot is sold or exchanged and in subsequent years is treated as ordinary income.

If you sell the first six lots of a single tract in one year, and realize gain, the lesser of 5% of the selling price of each lot sold or the gain is treated as ordinary income. However, if you had sold the first three lots in a single tract in one year and the next three lots in the following year, the 5% rule would apply only to the gains realized in the second year.

The selling expenses of the sale must first be deducted from the part of the gain treated as ordinary income, and any remaining expenses are deducted from the part treated as a capital gain. You may not deduct the selling expenses from other income as ordinary business expenses.

**Example 1.** You sell five lots from a single tract in a certain year. In the following year, you sell the sixth lot for \$20,000. Your basis for this lot is \$10,000 and your selling expenses are \$1,500. Your gain is \$8,500, all of which is capital gain, figured as follows:

Selling price.....	\$20,000	
Minus: Basis.....	\$10,000	
Expense of sale.....	1,500	11,500
Gain from sale of lot.....		\$ 8,500
5% of selling price.....	\$ 1,000	
Minus: Expense of sale.....	1,500	
Gain reported as ordinary income.....		0
Gain reported as capital gain.....		\$ 8,500

Because the selling expenses exceed 5% of the selling price, none of the gain is treated as ordinary income.

**Example 2.** Assume in Example 1 that the selling expenses are \$800. The gain is \$9,200, of which \$200 is ordinary income and \$9,000 is capital gain, figured as follows:

Selling price.....	\$20,000	
Minus: Basis.....	\$10,000	
Expense of sale.....	800	10,800
Gain from sale of lot.....		\$ 9,200
5% of selling price.....	\$ 1,000	
Minus: Expense of sale.....	800	
Gain reported as ordinary income.....		200
Gain reported as capital gain.....		\$ 9,000

**Exchange treated as a sale.** If the lots are exchanged for other property, the selling price is the fair market value of the property received plus any money received. If you exchanged a lot for other property in a transaction of the type discussed earlier under *Nontaxable Exchanges*, the gain is not taxed. However, in counting the number of lots sold, you must count all lots disposed of whether or not the gain or loss is recognized.

**If you make no sales for 5 years,** the rest of the tract is treated as though you had acquired it new on the day after the day of the last sale.

**Loss on sale of lots.** The 5% rule does not apply to losses. If you sell a lot at a loss, it is treated as a capital loss if you held it for investment. If the lot was used in your trade or business, the loss is a section 1231 loss. See *Section 1231 Property*, later.

## Timber

If you sell standing timber you held as investment property, it is a capital asset and is treated as a sale of a capital asset. Gain or loss is reported on Schedule D. If you held the timber primarily for sale to customers, it is not a capital asset and gain or loss on the sale is ordinary income or loss reported in the gross receipts/sales and cost of goods sold items of your return. Special rules apply, however, if you owned the timber more than 6 months and you either choose to:

- 1) Treat timber cutting as a sale or exchange, or
- 2) Enter into a cutting contract discussed below.

Under these rules, discussed below, disposition of the timber is treated as a sale or exchange of section 1231 property. Gain or loss is reported on Form 4797.

Ordinarily, farmers who cut timber on their land and sell it in the form of logs, firewood, or pulpwood have no cost or other basis for that timber, and the sales constitute a very minor part of their farm business. In these cases, amounts realized from such sales, and the expenses incurred in cutting, hauling, etc., may be entered as ordinary farm income and expenses on Schedule F.

**Christmas trees.** Evergreen trees, such as those used as Christmas trees, that are more than 6 years old at the time severed from their roots and sold for ornamental purposes, are included in the term "timber" and qualify for both rules, discussed below.

**Caution:** When this publication went to print, Congress was considering legislation that would reduce the growing period for these trees from 6 years to 4 years. This change, if enacted, would apply to tax years beginning after 1986.

**Timber cutting as a sale or exchange.** Under the general rule, the cutting of timber results in no gain or loss, and it is not until the sale or exchange that gain or loss is realized. But if you owned, or had a contractual right to cut timber, you may choose to treat the cutting of timber as a sale or exchange in the year the timber is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary income or loss (see *Example*, later).

**Qualifying for treatment under this rule.** To have your timber qualify for this treatment, you must:

- a) Have owned, or held a contractual right to cut, the timber on the first day of the tax year in which you cut it and for a period of more than 6 months before the timber is cut,
- b) Cut the timber for sale or for use in your trade or business, and
- c) Elect to treat the cutting of the timber as a sale or exchange of property used in a trade or business (regardless of whether the timber is includible in inventory or held primarily for sale to customers).

**Election.** You make your election on your return for the year in which the cutting takes place by including in income the gain or loss on the cutting, and including a computation of your gain or loss. You do not have to make the election in the first year you cut timber. You may choose to make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect for all later years, unless you revoke it. Except for the special rule noted below, you may revoke an election only if you can show undue hardship and get the consent of the Internal Revenue Service (IRS). Thereafter, you may not make any new election unless you have the consent of IRS.

**Revocation of election.** A special rule for any election you made for a tax year beginning before 1987 allows you to revoke it for any tax year ending after 1986 without the consent of IRS. If you make this special revocation, which can be made only once, you can still make a new revocation without the consent of IRS. However, any further revocation or later election will require the consent of IRS.

**Gain or loss.** You figure your gain or loss on the cutting of standing timber by subtracting its adjusted basis for depletion from the fair market value on the first day of your tax year in which it is cut. Depletion on timber is discussed in Publication 535, *Business Expenses*.

**Example.** In April of 1987, you have owned for more than 6 months 4,000 MBF (1,000 board feet) of standing timber having an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 1987, the timber had a fair market value of \$120 per MBF, and the timber was cut in April for sale. On your 1987 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report as a gain the difference between the fair market value and your adjusted basis for depletion. This amount is reported on Form 4797, along with your other section 1231 gains and losses to figure whether it is treated as long-term capital gain or as an ordinary gain. You figure your gain as follows:

Fair market value of timber January 1, 1987...	\$480,000
Minus: Adjusted basis for depletion.....	160,000
	<hr/>
Section 1231 gain.....	<u>\$320,000</u>

**Cutting contract.** If you own standing timber and dispose of it under a cutting contract, you must treat the disposal as a sale or exchange provided you held the timber for more than 6 months before its disposal and you retain an economic interest in it.

The difference between the amount realized from the disposal of the timber and the timber's adjusted basis for depletion is treated as gain or loss on its sale. This amount must be included on Form 4797 along with your other section 1231 gains or losses to figure whether it is treated as capital or ordinary gain or loss.

**Date of disposal** is the date the timber is cut; however, if you receive payment under the contract before the timber is cut, you may choose to treat the date of payment as the date of disposal.

**Owner** is any person who owns an interest in timber, including a sublessor and the holder of a contract to cut timber.

**Economic interest** means that you have acquired an interest in standing timber by investment and get, by any form of legal relationship, income from cutting that timber, to get a return of your capital investment.

**Example.** You own standing timber that you have held for more than 6 months and that has an adjusted basis for depletion of \$20 per MBF. You had no other gains or losses during the year. If you enter into a contract with a buyer under which that person has a right to cut and remove the timber for \$40 per MBF, you will have a section 1231 gain of \$20 per MBF on its disposal.

**Tree stumps** are a capital asset if they are on land held by an investor who is not in the timber or stump business as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators, after the merchantable standing timber has been cut and removed from the land are considered byproducts. Gain from the sale of stumps by lot or on a tonnage basis by such operators is taxed as ordinary income.

## Precious Metals and Stones, Stamps, and Coins

Gold, silver, stamps, coins, gems, etc., are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or exchange generally is a capital gain or loss. If you are a dealer, the amount received from the sale is ordinary income reportable on Schedule C (Form 1040).

## Coal and Iron Ore

If you own coal (including lignite), or iron ore mined in the United States, for more than 6 months and dispose of it under a contract in which you keep an economic interest in the coal or iron ore, the resulting gain or loss is figured as the difference between the amount realized from disposal of the coal or iron ore and its adjusted basis for depletion (increased by certain expenditures not allowed as deductions for the tax year). This amount is included on Form 4797 along with your other section 1231 gains and losses.

You are considered an **owner** if you own or sublet an economic interest in the coal or iron ore in place. In this instance you are not entitled to the allowance for percentage depletion for the coal or iron ore. If you own only an option to buy the coal in place, you do not qualify as an owner. In addition, this special gain or loss treatment, does not apply to income realized by an owner who is a co-adventurer, partner, or principal in the mining of coal or iron ore.

The expenses of making and administering the contract under which the coal or iron ore was disposed and the expenses of preserving the economic interest kept under the contract are added to the adjusted basis of the coal or iron ore. The date of disposal is treated as the date the coal or iron ore is mined.

**Special rule for iron ore and coal.** The above treatment does not apply if you dispose of the iron ore or coal directly or indirectly to:

- 1) A related taxpayer (see *A loss on the sale or exchange, under Sales and Exchanges Between Related Parties*, earlier in this part), whose relationship to you would result in the disallowance of a loss,
- 2) A partnership if you are a partner who owns directly or indirectly more than 50% of the capital or profit interests in the partnership or between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profit interests, or
- 3) An individual, a trust, estate, partnership, association, company, or corporation owned or controlled directly or indirectly by the same interests that own or control the party disposing of the iron ore or coal.

## Part III Tax Treatment of Gains and Losses

If you have a gain or loss from the disposition of a capital asset, it is a capital gain or loss. Likewise, you may have a capital gain from the disposition of a noncapital asset, if it is section 1231 property. However, a net section 1231 loss is an ordinary loss, and not a capital loss. Gain or loss on the disposition of a capital asset that is treated as if it were a noncapital asset is ordinary gain or loss. See Part II of this publication for a discussion of how various types of assets are treated.

This part discusses the way capital gains are taxed and capital losses are deducted.

## Long- and Short-Term

The tax treatment of capital gains and losses depends on how long you own the asset before

you sell or exchange it. The length of time you own an asset before disposing of it is known as the holding period.

If you hold a capital asset 6 months or less, the gain or loss from its disposition is short-term. If you hold a capital asset longer than 6 months, the gain or loss from its disposition is long-term.

**Note.** For property acquired after 1987, if you hold a capital asset for one year or less, the gain or loss from its disposition is short-term. If you hold a capital asset longer than one year, the gain or loss is long-term.

These differences are still important despite the repeal of the 60% capital gains deduction by the Tax Reform Act of 1986. For tax years beginning in 1987, net capital gain (not long-term capital gain over net short-term capital loss) are taxed at a maximum rate of 28%. However, short-term capital gains are still fully taxable. In addition, capital losses are allowed in full against capital gains plus up to \$3,000 of ordinary income.

**Inventions.** Generally, any gain or loss from the disposition of your own invention is long-term, no matter how long you actually owned it. See the section on *Inventions* in Part II.

**Inheritance.** You do not have to figure a holding period for property you inherit. Any gain or loss from its disposition is long-term, no matter how long you or the person you inherited it from actually owned it. However, this rule only applies if you figure your basis in the property using its fair market value at the time the person you inherited it from died or at the alternate valuation date. It also does not apply if the property was acquired by the estate after the decedent's death and was distributed to the heirs.

**Holding period.** To figure if you held property more than 6 months, start counting on the day following the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you dispose of the property is part of your holding period.

**Example.** If you bought an asset on June 19, 1987, you should start counting on June 20, 1987. The 20th of December is the start of a new 6-month holding period. If you sell the asset on December 19, 1987, your holding period is not more than 6 months, but if you sell it on December 20, 1987, your holding period is more than 6 months.

**Installment sale.** The gain from an installment sale of an asset qualifying for long-term capital gain treatment in the year of sale will continue to be long term in later tax years. If it is short term in the year of the sale it will continue to be short term when payments are received in later tax years.

**Nontaxable exchanges.** If you acquire an asset in exchange for another asset and your basis for the new asset is figured, in whole or in part by your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

**Example.** You bought machinery on December 2, 1986. On June 2, 1987, you traded this machinery for some other machinery in a nontaxable exchange. You sold the machinery you got in the exchange on December 3, 1987. The holding period is one year and a day.

**Corporate liquidation.** The holding period for property you receive in a liquidation generally starts on the day after you receive it if gain or loss is recognized. However, in a one-calendar-month liquidation in which your basis in the property is figured in whole or in part using the basis of the stock you gave up in the transaction, the holding period of the property includes the holding period of the stock.

**Profit-sharing plan.** The holding period of common stock withdrawn from a qualified contributory profit-sharing plan begins on the day following the day the plan trustee delivered the stock to the transfer agent with instructions to reissue the stock in the taxpayer's name.

**Gifts.** If you receive a gift of property and your basis in it is figured using the donor's basis, your holding period includes the donor's holding period. See *Property Received as a Gift* in Publication 591.

**Real property.** To figure how long you have held real property, start counting on the day after you received title to it or, if earlier, the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

**Repossession.** If you sell real property but keep a security interest in it and then later repossess it, your holding period for a later sale includes the period you hold the property before the original sale, as well as the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

## Net Gain or Loss

Long-term capital gains and losses are treated differently than short-term capital gains and losses. The totals for short-term items and the totals for long-term items must be figured separately.

**Net short-term capital gain or loss.** Merge together your short-term capital gains and losses. Do this by adding up all your short-term capital gains. Then add up all your short-term capital losses. Subtract one total from the other. The result is your net short-term capital gain or loss.

**Net long-term capital gain or loss.** Follow the same steps to merge together your long-term capital gains and losses. The result is your net long-term capital gain or loss.

**Net capital gain or loss.** To figure your total net capital gain or loss, merge your net short-term capital gain or loss with your net long-term capital gain or loss.

**Example.** During the 1987 tax year, you have the following transactions:

Long-term capital gains .....	\$5,400	
Long-term capital losses.....	(1,750)	
Net long-term capital gain .....		\$3,650
Short-term capital gains.....	\$2,600	
Short-term capital losses.....	(3,790)	
Net short-term capital loss .....		(1,190)
Total net capital gain.....		<u>\$2,460</u>

If you have a total net capital gain, the gain is taxable. But if any part of the gain comes from a net long-term capital gain, it may be given special tax treatment, discussed next.

If you have a total net capital loss, the loss is deductible. But there are limits on how much of the loss you may deduct, and when you may deduct it. See *Treatment of Capital Losses*, later.

## Taxing Capital Gains

Before 1987, individuals were allowed to deduct 60% of their net capital gains (excess of net long-term capital gains over net short-term capital losses). Since the top individual tax rate was 50%, the deduction resulted in a maximum tax rate on the gain of 20% (40% of the gain reported, times 50% maximum rate).

For tax years beginning after 1986, the 60% capital gains deduction is no longer allowed. The full amount of the net capital gain must be included in income. However, for tax years beginning in 1987, the highest tax rate that can be imposed on the gain is generally 28%.

**Example 1.** In 1986, Bill Smith had a net long-term capital gain of \$5,000 and a net short-term capital loss of \$1,000. The net capital gain was \$4,000 (\$5,000 - \$1,000). Bill deducted 60% of the net capital gain, or \$2,400. The balance of the gain, \$1,600, was added to his other income. If Bill were in the 50% tax bracket in 1986, he would have paid \$800 tax on the \$1,600 gain (50% x \$1,600). This would have resulted in an effective tax rate on the net capital gain of 20% (\$800 ÷ \$4,000 = 20%).

**Example 2.** Assume the same facts as Example 1, except that it is 1987. Bill figures his net capital gain, \$4,000, in the same manner. He does not, however, reduce his gain by the 60% deduction. Instead, the entire \$4,000 is added to his other income. The top tax rate for 1987 is 38.5%. However, the maximum tax rate that can be applied to the gain is 28%.

**Maximum tax on 1987 capital gain.** For 1987 the highest tax rate on a net capital gain is 28%. Following is a worksheet, which may be useful in figuring this tax. If an individual's taxable income is not more than the amount shown for his or her filing status in the following table, the worksheet does not have to be completed because the individual's income would not be taxed at more than 28%. This tax is figured on Schedule D (Form 1040).

Filing Status	Amount
Married filing joint return or qualifying widow(er).....	\$ 45,000
Single.....	\$ 27,000
Head of household.....	\$ 38,000
Married filing separate return.....	\$ 22,500

If the taxable income is more than the amount shown for the individual's filing status, the individual should complete the worksheet to figure his or her tax.

### 1987 Tax Figured If There Is Net Capital Gain Income

- A) Enter taxable income. (A) \_\_\_\_\_
- B) Enter the smaller of the long-term capital gain or the net capital gain. (B) \_\_\_\_\_
- C) Subtract the amount on line B from the amount on line A. (C) \_\_\_\_\_
- D) Enter the amount shown for your filing status. (D) \_\_\_\_\_

Filing Status	Amount
Married filing joint return or qualifying widow(er).....	\$ 28,000
Single.....	16,800
Head of household.....	23,000
Married filing separate return.....	14,000

- E) Enter the greater of line C or line D. (E) \_\_\_\_\_
- F) Subtract line E from line A. (F) \_\_\_\_\_
- G) Tax on the amount on line E. (Figured using 1987 Tax Tables or Tax Rate Schedules, whichever applies.) (G) \_\_\_\_\_
- H) Multiply the amount on line F by .28. (H) \_\_\_\_\_
- I) Add the amounts on lines G and H. This is the tax. (I) \_\_\_\_\_

**Example 1.** Bill Beach, a single taxpayer, has 1987 taxable income of \$50,000, including a long-term capital gain of \$10,000. Since Bill's taxable income is more than \$27,000, his maximum tax rate is higher than 28%. To figure his 1987 tax, Bill completes the worksheet as follows:

### 1987 Tax Figured If There Is Net Capital Gain Income

- A) Enter taxable income. (A) 50,000
- B) Enter the smaller of the long-term capital gain or the net capital gain. (B) 10,000
- C) Subtract the amount on line B from the amount on line A. (C) 40,000
- D) Enter the amount shown for your filing status. (D) 16,800

Filing Status	Amount
Married filing joint return or qualifying widow(er).....	\$28,000
Single.....	16,800
Head of household.....	23,000
Married filing separate return.....	14,000
E) Enter the greater of line C or line D. (E) <u>40,000</u>	
F) Subtract line E from line A. (F) <u>10,000</u>	
G) Tax on the amount on line E. (Figured using 1987 Tax Tables.) (G) <u>9,863</u>	
H) Multiply the amount on line F by .28. (H) <u>2,800</u>	
I) Add the amounts on lines G and H. This is the tax. (I) <u>12,663</u>	

**Example 2.** Elena Palm, an unmarried head of a household, has 1987 taxable income of \$42,000, including a long-term capital gain of \$10,000. Since Elena's taxable income is more than \$38,000, her maximum tax rate is higher than 28%. To figure her 1987 tax, Elena completes the worksheet as follows:

### 1987 Tax Figured If There Is Net Capital Gain Income

- A) Enter taxable income. (A) 42,000
- B) Enter the smaller of the long-term capital gain or the net capital gain. (B) 10,000
- C) Subtract the amount on line B from the amount on line A. (C) 32,000
- D) Enter the amount shown for your filing status. (D) 23,000

Filing Status	Amount
Married filing joint return or qualifying widow(er).....	\$28,000
Single.....	16,800
Head of household.....	23,000
Married filing separate return.....	14,000
E) Enter the greater of line C or line D. (E) <u>32,000</u>	
F) Subtract line E from line A. (F) <u>10,000</u>	

- G) Tax on the amount on line E. (Figured using 1987 Tax Tables.) (G) 5,877
- H) Multiply the amount on line F by .28. (H) 2,800
- K) Add the amounts on lines G and H. This is the tax. (K) 8,677

**Alternative minimum tax.** The repeal of the capital gains deduction means that after 1986 the deduction is no longer treated as a tax preference item for purposes of the alternative minimum tax. See Publication 909, *Alternative Minimum Tax for Individuals*.

**S corporations.** The capital gains and losses of an S corporation are taxed to the shareholders in proportion to their ownership of stock in the corporation. The corporation may also be subject to tax on its net capital gains. For more information, get Publication 589, *Tax Information on S Corporations*.

## Treatment of Capital Losses

This discussion relates only to individuals who have capital losses. For information on capital losses of corporations, see Publication 542.

If you have a total net capital loss, you must first figure how much of the loss is deductible. Then you must figure how much of the loss you may deduct in the year of the loss and how much of it you may carry over and use in future tax years.

Capital losses are allowed in full against capital gains, and then against up to \$3,000 of ordinary income. However, for tax years beginning after 1986, long-term capital losses no longer have to

be reduced by 60% before applying them against ordinary income. Capital losses not fully used in one year may still be carried forward and used in later years.

**Your deductible capital loss.** Yearly limits (discussed later) apply to a capital loss that may be deducted. Subject to such limits, if you only have short-term gains and losses, your deductible loss is the same as your net short-term capital loss. If you only have long-term gains and losses, your deductible loss, in 1987, is also the same as your net long-term capital loss. If you have both short-term and long-term items, figure your deductible loss as follows:

- 1) If you have a net short-term capital loss and a net long-term capital gain, your deductible loss is the excess of the loss over the gain.
- 2) If you have a net long-term capital loss and a net short-term capital gain, your deductible loss is the excess of the loss over the gain.
- 3) If you have both a net short-term capital loss and a net long-term capital loss, your deductible loss is the total of the short-term loss plus the total of the long-term loss.

**Example 1.** You have capital gains and losses for the year as follows:

	Short-term	Long-term
Gains.....	\$700	\$400
Losses.....	\$800	\$2,000

Your deductible capital loss is \$1,700, which you figure as follows:

Short-term capital losses.....	\$800	
Minus: Short-term capital gains.....	700	
Net short-term capital loss.....		\$100
Long-term capital losses.....	\$2,000	
Minus: Long-term capital gains.....	400	
Net long-term capital loss.....		\$1,600
Deductible capital loss.....		\$1,700

**Example 2.** You have a net long-term capital loss of \$1,600 and a net short-term capital gain of \$450. Your net capital loss is \$1,150 (\$1,600 minus \$450). All of this loss is from a net long-term capital loss, and the entire \$1,150 is deductible.

**Yearly limit.** The amount of capital loss that you may deduct in any tax year is limited to the smaller of:

- 1) \$3,000 (\$1,500 if you are married and file a separate return), or
- 2) Your deductible capital loss.

**Capital loss carryover.** If your deductible capital loss is more than the yearly limit, you may carry over the unused part to the next tax year and treat it as if it occurred in that year. When a loss is carried over, it retains its original character as long term or short term. A short-term loss that is carried over to the next tax year is added to short-term losses that occur in that year. A long-term loss that is carried over to the next tax year is added to long-term losses that occur in that year.

If the loss you carry over cannot all be used up in the year it is carried to, you may continue to carry the unused part of your loss forward from year to year. In this way your deductible capital losses will eventually be fully used up.

**Figuring the carryover.** When figuring how much of your capital loss you may carry over as short term and how much as long term, short-term losses are deducted before long-term losses. Use the following steps to figure your short-term and/or long-term loss carryover(s).

#### Computation of Yearly Limit:

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- A) Combine short-term capital gain (or loss) with long-term capital gain (or loss). (A) \_\_\_\_\_
- B) If line A is a loss, enter the smaller of: (1) the amount on line A; or (2) \$3,000 (\$1,500 if married filing a separate return). Note: In determining the smaller amount, think of both as being positive. (B) \_\_\_\_\_

#### Short-term Capital Loss Carryover:

- C) Enter short-term capital loss. (C) \_\_\_\_\_
- D) Enter long-term capital gain. (D) \_\_\_\_\_
- E) Subtract the amount on line D from the amount on line C. (E) \_\_\_\_\_
- F) Enter the smaller of line B or line E. (Consider both amounts as being positive.) (F) \_\_\_\_\_
- G) Subtract the amount on line F from the amount on line E. This is your short-term capital loss carryover. (G) \_\_\_\_\_

#### Long-term Capital Loss Carryover:

- H) Enter long-term capital loss. (H) \_\_\_\_\_
- I) Enter short-term capital gain. (I) \_\_\_\_\_
- J) Subtract the amount on line I from the amount on line H. (J) \_\_\_\_\_
- K) Subtract the amount on line F from the amount on line B. (Note: If there are no entries on line D through line G, enter the amount from line B.) (K) \_\_\_\_\_
- L) Subtract the amount on line K from the amount on line J. This is your long-term capital loss carryover. (L) \_\_\_\_\_

**Example.** Willa and Mark Allen have a 1987 short-term capital loss of \$6,000 and a \$10,000 long-term capital loss. They have no other capital transactions for that year. Willa and Mark compute the amounts of their capital loss carryovers by completing the following worksheet.

#### Computation of Yearly Limit:

- A) Combine short-term capital gain (or loss) with long-term capital gain (or loss). (A) (16,000)
- B) If line A is a loss, enter the smaller of: (1) the amount on line A; or (2) \$3,000. Note: In determining the smaller amount, think of both as being positive. (B) 3,000

#### Short-term Capital Loss Carryover:

- C) Enter short-term capital loss. (C) (6,000)
- D) Enter long-term capital gain. (D) —
- E) Subtract the amount on line D from the amount on line C. (E) (6,000)
- F) Enter the smaller of line B or line E. (Consider both amounts as being positive.) (F) 3,000
- G) Subtract the amount on line F from the amount on line E. This is your short-term capital loss carryover. (G) (3,000)

#### Long-term Capital Loss Carryover:

- H) Enter long-term capital loss. (H) (10,000)
- I) Enter short-term capital gain. (I) —
- J) Subtract the amount on line I from the amount on line H. (J) (10,000)
- K) Subtract the amount on line F from the amount on line B. (Note: If there are no entries on line D through line G, enter the amount from line B.) (K) 0
- L) Subtract the amount on line K from the amount on line J. This is your long-term capital loss carryover. (L) (10,000)

**Carryovers of pre-1970 losses.** In 1987, a short- or long-term capital loss carryover from pre-1970 years is first used to reduce net capital gain and then to offset 1987 income dollar for dollar. 1986 was the last year you could use Form 4798, *Carryover of Pre-1970 Capital Losses*, to figure your carryover from pre-1970. If you used Form 4798 in 1986 and had an entry on line 44

and/or line 50, you should enter the carryover(s) on line 6 and/or line 15 of the 1987 Schedule C **Joint and separate returns.** On a joint return, capital gains and losses of a husband and wife figured as though they are the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to \$1,500 (one-half of the \$3,000 limit allowed on a joint return). Neither you nor your spouse may deduct any part of the other's loss.

If you once filed separate returns and are now filing a joint return, you must combine each of your capital loss carryovers. However, if you once file jointly and are now filing separately, any capital loss carryover is deducted only on the return of the person who actually had the loss.

**Death of taxpayer.** Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed for the decedent's behalf. The capital loss limits discussed earlier still apply in this situation. Even if the loss is greater than the limit, the excess cannot be deducted by the decedent's estate nor can it be carried over to following years.

**Corporations.** A corporation, other than an S corporation, may deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has a total net capital loss, the loss cannot be deducted in the current tax year. It must be carried to other tax years and deducted from capital gains that occur in those years. For more information see Publication 542.

## Part IV Dispositions of Depreciable Property

If you dispose of depreciable property at a gain you may have to treat all or part of the gain as ordinary income. The amount of gain that is ordinary income depends on the amount of the depreciation deductions you took and on certain section 1231 losses. (See *Net section 1231 gain*, later).

This Part discusses the rules for figuring the part that is ordinary income from dispositions of depreciable property. Generally, any remaining gain is treated as described later in Part V, *Reporting Gains and Losses*. Losses are not subject to the rules discussed in this Part.

Different rules apply to section 1245 property and to section 1250 property in figuring what part of the gain on disposition is ordinary income. See *Section 1245 Property* and *Section 1250 Property* later.

**Records.** You must keep permanent records of the facts necessary to figure the amount of depreciation allowed or allowable on your depreciable property to calculate any gain that must be reported as ordinary income. This includes the date and manner of acquisition, cost or other basis, depreciation, and all other adjustments that affect basis.

If you have property that has an adjusted basis that was reduced by depreciation or amortization you claimed on other property (such as a machine you got in a nontaxable exchange) or by another person on the same or other property (such as for property you received as a gift), your records must contain this information.

**Property used in your business.** Property used in your trade or business includes real property and depreciable personal property, but it does not include property you hold for sale to customers.

**Depreciable property used to carry on your trade or business** includes most assets for which you expect to get back nearly all of your investment through depreciation deductions.

**Property that is mainly for sale to customers** or property that is includable in your inventory is not depreciable property. If you believe that you will get back all, or nearly all, of your investment in it, by selling it rather than by using it up in your

business, it is property that is mainly for sale to customers. Thus, all cars acquired by a car dealer are treated as a part of the dealer's stock in trade unless the dealer can clearly show that a vehicle was bought only for use in the dealer's business (other than as a demonstrator), and it is believed that its cost will be recovered through depreciation rather than resale.

**Example.** A car dealer operates a car rental service as a part of the business. A car may be rented for periods ranging from 6 months to 2 years, with the renter having the option to buy it at any time. If the renter does not buy it before the end of the rental period, the auto is turned over to the used car division of the car dealer's business and such cars are not property used in a trade business, but are held mainly for sale to customers. Gain on these sales must be reported as ordinary income.

## Section 1231 Property

Property used in a trade or business or held for the production of rents or royalties and held more than 6 months and any other property (including capital assets held in connection with a trade or business or a transaction entered into for profit) held more than 6 months that is subjected to an involuntary conversion, is known as section 1231 property. In a disposition of depreciable property, any ordinary gain that is from the deduction of depreciation is figured first by using the rules discussed in Part IV of this publication. Any remaining gain is included in the section 1231 computation in Part I of Form 4797.

Sales or exchanges of the following types of property may result in gain or loss subject to section 1231 treatment—

**Real property or depreciable personal property** used in a trade or business and held for more than 6 months.

**Property held for the production of rents or royalties** if held for more than 6 months.

**Leaseholds** used in a trade or business and held for more than 6 months.

**Cattle and horses** held for draft, breeding, dairy, or sporting purposes and held for 2 years or more from acquisition date.

**Livestock** (other than cattle, horses, and poultry) held for draft, breeding, dairy, or sporting purposes and held 1 year or more from acquisition date.

**Unharvested crops.** The sale, exchange, or involuntary conversion of an unharvested crop on land used in farming if the crop and land are sold, exchanged, or involuntarily converted at the same time and to the same person, and the land has been held for more than 6 months.

Growing crops sold with a lease on the land, even though to the same person in the same transaction, are not included. Nor is a sale, exchange, or involuntary conversion of an unharvested crop with land included if the taxpayer keeps any right or option to reacquire the land, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction).

**The cutting of timber,** and the disposal of timber, coal, or domestic iron ore as described earlier in this publication.

**Condemnations** (property condemned for public use), if the property was held for more than 6 months. This includes business property, and capital assets held in connection with a trade or business or a transaction entered into for profit, such as investment property. However, because losses from the condemnation of property held for personal use are not deductible, they are not included.

**Casualty and theft gains and losses** on property held for more than 6 months. These include casualty or theft to business property, property held for the production of rents and royalties, and

investment property (such as notes and bonds). Insurance payments or other reimbursements must be taken into account in arriving at the net gain or loss. See later discussion, *Net section 1231 gain*, concerning effect of casualty and theft gains and losses in figuring section 1231 gain that may have to be treated as ordinary income.

For more information on casualties and thefts, see Publication 547, *Nonbusiness Disasters, Casualties, and Theft*, and Publication 549, *Condemnations and Business Casualties and Theft*.

## Treatment of Gains and Losses

You combine all gains and losses from the sales and dispositions of section 1231 property for the tax year. If your section 1231 gains exceed your section 1231 losses, you have a net section 1231 gain. An excess of section 1231 losses over section 1231 gains results in a net section 1231 loss. If the section 1231 losses equal or exceed the section 1231 gains, then you treat each item as an ordinary gain or loss.

**Net section 1231 gain.** Net section 1231 gains are treated as ordinary income to the extent the gain does not exceed nonrecaptured losses from tax years beginning after 1981. **Nonrecaptured net section 1231 losses** are net section 1231 losses deducted in tax years beginning after 1981 that have not yet been applied against any net section 1231 gains for tax years beginning after 1984. Your losses, or the losses of your predecessor, are considered recaptured in the chronological order in which they arose.

**Example.** Ashley, Inc., a graphic arts company, is a calendar-year corporation. In 1984 Ashley had a net section 1231 loss of \$8,000. Ashley had no net section 1231 losses in 1982, 1983, or 1985. For tax years 1986 and 1987, the company has net section 1231 gains of \$5,250 and \$4,600, respectively. In figuring taxable income for 1986, Ashley treated its net section 1231 gain of \$5,250 as ordinary income by recapturing \$5,250 of their \$8,000 net section 1231 loss. Then in 1987, Ashley applies the remaining net section 1231 loss, \$2,750 (\$8,000 minus \$5,250) against its net section 1231 gain of \$4,600. The company reports \$2,750 as ordinary income and also reports \$1,850 (\$4,600 minus \$2,750) as long-term capital gain.

**Involuntary conversion.** If your recognized losses from involuntary conversions arising from fire, storm, shipwreck, or other casualty or from theft exceed your recognized gain, they do not have to be included in figuring your nonrecaptured net section 1231 losses. However, gain from an involuntary conversion is included in figuring net section 1231 gain.

**The amount of your net section 1231 gain** for 1987 that is not treated as ordinary income is long-term capital gain. A net section 1231 loss for 1987 is treated as an ordinary loss.

## Section 1245 Property

A gain on the disposition of section 1245 property is taxed as ordinary income to the extent of depreciation or ACRS deductions claimed on the property if the property is recovery property or property subject to the depreciation allowance under modified ACRS. See *Treatment of Gain*, later.

Section 1245 property includes any property that is or has been subject to an allowance for depreciation and that is:

- 1) Personal property (both tangible and intangible),
- 2) An elevator or an escalator (placed in service before 1987),
- 3) Real property (not included in (4)) to the extent its adjusted basis has been reduced by certain amortization deductions including those for certified pollution control facilities, on-the-job

training and child-care facilities, removal of architectural barriers to the handicapped and elderly, reforestation expenditures, or with respect to which a section 179 deduction was taken, or

- 4) A special purpose structure or storage facility. This includes single purpose agricultural and horticultural structures and storage facilities used in connection with the distribution of petroleum or any primary product of petroleum. It is also any other depreciable tangible property, except a building or its structural components, that is or has been an integral part of certain business activities, a research facility used in connection with these activities, or a storage facility used in connection with these activities. These activities are manufacturing, production, extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services.

**Buildings and structural components.** This does not include a structure that is essentially an item of machinery or equipment. Also, it does not include a structure that houses property used as an integral part of an activity, if the use of the structure is so closely related to the use of the property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. The fact that the structure is specially designed to withstand the stress and other demands of the property and the fact that the structure cannot be used economically for other purposes indicates that it is closely related to the use of the property it housed. Thus, such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples are not treated as buildings.

**Storage facility.** This is a facility used mainly for the bulk storage of fungible commodities. To be fungible, a commodity must be such that one part may be used in place of another. Bulk storage means the storage of a commodity in a large mass before it is used. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage.

## Treatment of Gain

The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is limited to the lower of the amounts listed below.

- 1) The recomputed basis of the property minus the adjusted basis of the property, or
- 2) The amount realized from the sale minus the adjusted basis of the property.

For any other disposition of section 1245 property, ordinary income is measured by the amount the fair market value exceeds the adjusted basis of the property. See *Other Dispositions*, later.

**Recomputed basis.** The recomputed basis of section 1245 property is the adjusted basis of the property (described earlier under *Figuring Gain or Loss*) plus all adjustments reflected in the adjusted basis on account of deductions (whether for the same or other property) allowed or allowable for depreciation or amortization.

**Depreciation** includes the amount allowed or allowable for section 1245 property based on useful life for depreciable property. Also included is the regular or alternate ACRS deductions claimed if the property is section 1245 recovery property. Amortization, for this purpose, includes the section 179 deduction claimed (discussed later), and the deductions for removal of certain barriers for the handicapped and elderly, child-care facilities or on-the-job training facilities, pollution control facilities, reforestation expenditures, and certain expenditures for certified historic structures. In figuring these deductions, you should also include any basis adjustment that must be made for

investment credit claimed on the property. See *Investment credit*, later.

**Example 1.** In February 1985 you purchased and placed in service for 100% use in your business a light-duty truck (3-year property) with an adjusted basis of \$10,000. You file your return on a calendar year. Your ACRS deductions for this truck were \$2,500 in 1985 and \$3,800 in 1986. There is no ACRS deduction in 1987, the year of sale. You sell the truck in May 1987 for \$7,000. Your adjusted basis is \$3,700 (\$10,000 minus \$6,300). Your recomputed basis is \$10,000 (\$3,700 plus \$6,300). The amount you treat as ordinary income is the lower of the following:

- 1) Recomputed basis (\$10,000) minus adjusted basis (\$3,700) or \$6,300, or
- 2) Amount realized (\$7,000) minus adjusted basis (\$3,700) or \$3,300.

The lower of these two amounts, \$3,300, is the amount of gain treated as ordinary income.

**Example 2.** On January 3, 1978, you bought a machine for \$9,000. You claimed \$600 depreciation on it each year and sold it for \$8,000 on July 2, 1987. Your adjusted basis on the date of sale was \$3,300 (\$9,000 less \$5,700 (the \$600 depreciation for each of the years 1978 through 1986 and \$300 for 1987)). Your recomputed basis is \$9,000 (your total depreciation deductions plus your adjusted basis). The amount you treat as ordinary income is the lower of the following:

- 1) Recomputed basis (\$9,000) minus adjusted basis (\$3,300) or \$5,700, or
- 2) Amount realized (\$8,000) minus adjusted basis (\$3,300) or \$4,700.

The lower of these two amounts, \$4,700, is the amount of gain treated as ordinary income. Because the gain (\$4,700) is less than the total depreciation (\$5,700), the entire gain is included as ordinary income.

**Section 1231 gain.** Any gain that is more than the ordinary income part is a section 1231 gain, which is subject to the rule on nonrecaptured net section 1231 losses. See *Treatment of Gains and Losses under Section 1231 Property*, earlier.

**Tax-free exchange or involuntary conversion.** If you receive property for like property in a tax-free exchange or in an involuntary conversion, depreciation includes all the depreciation that you took on the property you exchange to the extent it is reflected in your adjusted basis of the property you receive. If you receive property as a gift, depreciation taken by the transferor is included to the extent that it is reflected in your basis. If you acquired property from a decedent, you do not include depreciation taken by the decedent for that property.

**On property other than personal property,** you must take into account depreciation during periods when the property was not used as an integral part of an activity or did not constitute a research or storage facility, as described earlier.

For example, if depreciation deductions taken on certain storage facilities amount to \$10,000, of which \$6,000 is from the periods before their use in connection with a prescribed business activity, the entire \$10,000 must be taken into account in determining ordinary income because of depreciation.

The greater of the depreciation allowed or allowable to you, or to any other person who held the property if the depreciation was used to figure the adjusted basis of the property in your hands, is generally the amount to use in figuring the part of gain to report as ordinary income. If in prior years you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take a deduction for depreciation for that tax year or any

prior tax year, your adjustments to basis for depreciation allowable are figured by using the straight line method of depreciation. However, if you can prove that the depreciation allowed in any tax year was less than the amount allowable, you may use the amount allowed.

This treatment applies only when figuring what part of gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

**Class Life Asset Depreciation Range (CLADR) system.** For treatment of gains under the CLADR system, including gains recognized in ordinary retirements and extraordinary retirements, see section 1.167(a)-11 of the Income Tax Regulations.

**Section 179 deduction.** Amounts deducted under the section 179 deduction are recovered as ordinary income to the extent of any gain on a sale or disposition. See Publication 534, *Depreciation*.

**Investment credit.** On a disposition of section 1245 property or section 1250 property (discussed later), any reduction in basis by part or all of the investment credit claimed on the property is considered a deduction allowed for depreciation.

If a disposition results in the recapture of investment credit on property whose depreciable basis has been reduced, the basis of the property immediately before the disposition resulting in the recapture is increased by part or all of the recapture amount. This amount is any increase in tax that must be paid plus any adjustment to investment credit carrybacks or carryforwards. For more information on the basis reduction, see Publication 572, *General Business Credit*.

**Section 1245 property and other property.** A sale or other disposition may include several items of section 1245 property, or a combination of section 1245 property and other property. To figure the gain or loss on each item, the total amount realized must be allocated among the section 1245 property and the other property in proportion to each item's fair market value. If a buyer and seller have adverse interests, their arm's length agreement setting values for the items will establish the allocation. Losses cannot be used to offset gains to report a combined gain for section 1245 property.

**Multiple asset accounts.** In figuring ordinary income because of depreciation, you may treat any number of units of section 1245 property in a single depreciation account as one item if the total ordinary income because of depreciation figured by using this method is not less than it would be if depreciation on each unit were figured separately.

**Example.** In one transaction you sold 50 machines, 25 trucks, and certain other property that is not section 1245 property. All of the depreciation was recorded in a single depreciation account. After dividing the total received among the various assets sold, you figured that each unit of section 1245 property was sold at a gain. You may figure the ordinary income because of depreciation as if the 50 machines and 25 trucks were one item.

However, if 5 of the trucks had been sold at a loss, only the 50 machines and 20 of the trucks could be treated as one item in determining the ordinary income because of depreciation.

**The normal retirement of section 1245 property in multiple asset accounts** does not require recognition of ordinary income because of depreciation if your method of accounting for asset retirements does not require recognition of that gain.

## Section 1250 Property

Section 1250 property includes all real property that is subject to an allowance for depreciation and is not or has never been section 1245 property. It also includes leased property (such as a

building) to which the lessee has made improvements that are subject to an allowance for depreciation, and the cost of acquiring a lease. A fee simple interest in land is not included because it is not depreciable.

If, because of a change in use, section 1250 property becomes section 1245 property in the hands of a taxpayer, it may never again be treated as section 1250 property by that taxpayer.

ACRS deductions for recovery property and property subject to the depreciation allowance under modified ACRS are treated as ordinary income under section 1245 except for the follow-up which are treated as section 1250 property:

- 1) 15-year, 18-year, or 19-year real property or low-income housing that is residential rental property,
- 2) 15-year, 18-year, or 19-year real property or low-income housing that is used mostly outside of the United States,
- 3) 15-year, 18-year, or 19-year real property or low-income housing on which the alternate ACRS method of depreciation is taken, and
- 4) Low-income property.

19-year real property is property placed in service after May 8, 1985, and before January 1, 1987, (unless the modified ACRS depreciation system was elected for property placed in service after July 31, 1986, see Publication 534.) 18-year real property is property placed in service after March 15, 1984, and before May 9, 1985. 15-year real property is property placed in service after 1980 and before March 16, 1984.

The rules for section 1250 property do not apply to an item if:

- 1) You figure depreciation on the property using the straight line method or any other method as long as that method does not result in depreciation that is more than the amount that is figured by the straight line method, and you have held the property more than a year,
- 2) You realize a loss on the sale, exchange, or involuntary conversion of the property,
- 3) You dispose of residential low-income rental property that you held for 16½ years or more (for low-income rental housing on which the special 60-month depreciation for rehabilitation expenditures was allowed, the 16½ years started when the rehabilitated property was placed in service), or
- 4) You chose the alternate ACRS method for the types of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- 5) You dispose of residential rental property or nonresidential real property placed in service after December 31, 1986, (or after July 31, 1986, if the election to use the modified ACRS method was made). Additional depreciation is not treated as ordinary income on the disposition of residential rental property and nonresidential real property because these properties are now depreciated using the straight line method.

## Gain Treated as Ordinary Income

To find what part of the gain is treated as ordinary income follow these steps:

- 1) In a sale, exchange, or involuntary conversion of the property, figure the excess of the amount realized over the adjusted basis of the property (in any other disposition of the property, figure the excess of fair market value over adjusted basis),
- 2) Figure the additional depreciation for the periods after 1975, and
- 3) Multiply the smaller of (1) or (2) by the applicable percentage (discussed later).

If any gain is left after following this procedure (that is, if (1) is more than (2)) then:

Figure the additional depreciation for periods after 1969 but before 1976,  
 Multiply the smaller of the remaining gain ( (1) less (2) ) or (4) by the applicable percentage (discussed later), and  
 Add (3) and (5) to arrive at the gain that is to be treated as ordinary income. However, see *Special rule for corporations*, below, for additional income corporations may have to report.  
 Part III, Form 4797, must be completed to figure the ordinary income part of any gain.

**Additional Depreciation**

If you hold section 1250 property longer than one year, the additional depreciation is the excess of actual depreciation adjustments over the depreciation figured for the same period using the straight line method. Any reduction in basis for investment credit is treated as a deduction for depreciation (see *Investment credit*, under *Section 1245 Property*, earlier). If you hold section 1250 property for 1 year or less, all the depreciation is additional depreciation.

The additional depreciation for 15-, 18-, or 19-year real property is the excess of the amount allowed over the amount based on straight line depreciation for the recovery period you actually used for the property. The straight line method is applied without any reduction of the basis for 50% of the investment credit.

You will have additional depreciation if you use the regular ACRS method, the declining balance method, the sum of the years digits method, the units of production method, any other method of rapid depreciation, or if you elect amortization. However, you will not have additional depreciation from the amortization of: certified pollution control facilities; on-the-job training and child-care facilities; expenditures to remove architectural and transportation barriers to the handicapped and elderly; or certain rehabilitation expenditures for certain historic structures.

**Special rule for corporations.** Corporations, other than S corporations, have an additional amount to recognize as ordinary income on the sale or other disposition of section 1250 property. The additional amount treated as ordinary income on the sale of section 1250 property is 20 percent of the excess of the amount that would have been ordinary income if the property was section 1245 property or section 1245 recovery property over the amount treated as ordinary income under section 1250. Report this additional ordinary income on line 26(f) of Form 4797, Part III, in the same property column used for the amount recaptured under section 1250.

**Depreciation taken by other taxpayers or on other property.** To figure the amount of additional depreciation, include all adjustments that were made to the adjusted basis of section 1250 property because of depreciation deductions, whether they were made on this item of property or other property (as in an exchange) and whether the deductions were allowed to the taxpayer or any other person (as in a transfer by gift).

**Example.** Larry Johnson gives his son section 1250 property on which he has taken \$2,000 in depreciation deductions, of which \$500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the \$500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of \$1,000 on the property, of which \$200 is additional depreciation, the son sells the property. At the time of the sale the additional depreciation is \$700 (\$500 allowed the father plus \$200 allowed the son).

**Allowed or allowable.** The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) is generally the amount to use in figuring the part of the gain

to be reported as ordinary income. However, if you can show that the deduction allowed for any tax year was less than the amount allowable, the smaller figure will be the depreciation adjustment for figuring additional depreciation.

**Information to be filed.** If the basis of section 1250 property you have received as a gift, inheritance, or in a tax-free exchange, etc., is reduced by the depreciation that was either allowed or allowable to a former owner, a separate statement containing the information discussed earlier under *Records* must be attached to your return for the year the property was acquired.

**Retired or demolished property.** The adjustments reflected in adjusted basis generally do not include deductions for depreciation on retired or demolished parts of section 1250 property, unless these deductions are reflected in the basis of replacement property that is section 1250 property.

**Example.** If a wing of a building is totally destroyed by fire, the depreciation adjustments figured in the adjusted basis of the building after the wing is destroyed do not include any deductions for depreciation on the destroyed wing unless the wing is replaced and the adjustments for depreciation on the destroyed wing are reflected in the basis of the replacement property.

**The useful life and salvage value** you use to figure the amount that would have been the depreciation if you had used the straight line method are the same as that used under the depreciation method you actually used. If you did not use a useful life under the depreciation method actually used (such as with the units of production method), or if you did not take salvage value into account (such as with the declining balance method), the useful life or salvage value for figuring what would have been the straight line depreciation is the useful life and salvage value you would have used under the straight line method. Salvage value is not used for either the regular, the alternate, or the modified ACRS method.

**Property held by lessee.** If a lessee makes a leasehold improvement, the lease period for figuring what would have been the straight line depreciation adjustments and for figuring the additional depreciation includes all renewal periods, but the period cannot be longer than the useful life of the improvement. This same rule applies to the cost of acquiring a lease.

**Renewal period** means any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee. However, the inclusion of renewal periods cannot extend the lease by more than two-thirds of the period that was the basis upon which the actual depreciation adjustments were allowed.

**Rehabilitation expenditures.** A part of the special 60-month depreciation adjustment allowed for rehabilitation expenditures incurred in connection with low-income rental housing is additional depreciation. After 1986, the special 60-month treatment of expenditures is no longer available, unless the expenditures were incurred under a binding contract, or if rehabilitation began before 1987. See Publication 535, *Business Expenses*.

If the property is held one year or less after the expenses are incurred, the entire special depreciation adjustment is treated as additional depreciation. If the property is held more than one year after the expenses are incurred, the additional depreciation is the excess of the special depreciation adjustments from the rehabilitation expenditures over the adjustments that would have resulted had the straight line method and the normal useful life and salvage value been used.

**Example.** On January 3, 1987, Fred Plums, a calendar-year taxpayer, sells real property, the entire basis of which is from the rehabilitation expenses of \$50,000 incurred in 1975. The property was placed in service on January 2, 1976, and

under the special depreciation provisions for rehabilitation expenses was depreciated under the straight line method using a useful life of 60 months (5 years) and no salvage value. If Fred had used the regular straight line method, he would have used a salvage value of \$5,000 and a useful life of 15 years. Depreciation under the straight line method would be \$3,000 each year ( $1/15 \times \$45,000$  (\$50,000 - \$5,000)). On January 1, 1987, the additional depreciation for the property was \$17,000, figured as follows:

	Depreciation claimed	Straight line depreciation	Additional depreciation
1976	\$10,000	\$ 3,000	\$ 7,000
1977	10,000	3,000	7,000
1978	10,000	3,000	7,000
1979	10,000	3,000	7,000
1980	10,000	3,000	7,000
1981		3,000	(3,000)
1982		3,000	(3,000)
1983		3,000	(3,000)
1984		3,000	(3,000)
1985		3,000	(3,000)
1986		3,000	(3,000)
<b>Total</b>	<b>\$50,000</b>	<b>\$33,000</b>	<b>\$17,000</b>

**Applicable Percentage**

To figure the amount taxable as ordinary income because of additional depreciation, when real property is disposed of, you may have to use one or two applicable percentages depending upon whether the property is nonresidential real property, residential real property, or low-income housing. The applicable percentages that must be applied to these types of real property are as follows.

**Nonresidential real property.** For real property, which is neither residential real property nor low-income housing, the applicable percentage is 100% for periods after 1969. For periods before 1970 the applicable percentage is zero and no ordinary income will result on its disposition because of additional depreciation before 1970.

**Residential real property.** For residential real property (85% or more of the gross income is from dwelling units), other than low-income housing, the applicable percentage is 100% for periods after 1975. For residential rental property (80% or more of the gross rental income is from dwelling units), the applicable percentage for periods after 1969 and before 1976 is 100% minus one percent for each full month the property was held in excess of 100 months. When this property has been held for at least 16 1/2 years, the applicable percentage is zero and no ordinary income because of additional depreciation will result on its disposition. The applicable percentage for periods before 1970 is zero and no ordinary income will result on its disposition because of additional depreciation before 1970.

**Example.** An apartment house that qualifies as residential rental property was acquired on January 1, 1975, is sold on January 2, 1987. The excess of amount realized over adjusted basis is \$50,000. Additional depreciation attributable to the property is \$20,000 of which \$18,000 is additional depreciation after 1975, and \$2,000 for additional depreciation after 1969 and before 1976. For the additional depreciation after 1975, the applicable percentage is 100%, and for after 1969 and before 1976, the percentage is 56%; that is, 100% minus 44% (144 months minus 100 months). Gain treated as ordinary income is figured as follows:

- 1) Excess of amount realized over adjusted basis..... \$50,000
- 2) Additional depreciation after 1975..... \$18,000

Additional steps are necessary because (1) exceeds (2):

3) Lesser of: (1) or (2) times 100%	\$1,000
4) Additional depreciation after 1969 and before 1976	\$2,000
5) Lesser of: (4) or the excess of (1) over (2) times 58%	1,120
Gain treated as ordinary income	<u>\$10,120</u>

The remaining gain of \$30,880 is reported in Part I, Form 4797, and is subject to tax under other provisions of the law relating to sales and exchanges. See the discussion under *Reporting Gains and Losses*.

**Low-income housing.** Low-income housing includes the following types of property:

- 1) Federally assisted housing projects where the mortgage is insured under section 221(d)(3) or 238 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of state or local laws.
- 2) Low-income rental housing for which a depreciation deduction for rehabilitation expenditures was allowed.
- 3) Low-income rental housing held for occupancy by families or individuals who are eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of state or local laws that authorize similar subsidies for low-income families, and
- 4) Housing financed or assisted by direct loan or insured under Title V of the Housing Act of 1949.

The applicable percentage for periods after 1975 for low-income housing is 100% minus one percent for each full month the property was held in excess of 100 full months.

For properties described in (2), (3), and (4) above, the applicable percentage for periods after 1969 and before 1976 is 100% minus one percent for each full month the property was held over 100 full months. However, for property described in (1) the applicable percentage is 100% minus one percent for each full month the property was held over 20 full months.

The applicable percentage for periods before 1970 is zero.

To figure the applicable percentage for low-income housing for which the special depreciation for rehabilitation expenses was allowed, the 100 full months start when the property was placed in service.

**Example.** On July 1, 1987, Bob Brown, a calendar year taxpayer, sold real property that was acquired on September 1, 1975. The excess of amount realized over adjusted basis is \$15,000. The property qualified as low-income residential rental property under item (3) of the listing for each tax year after 1969. For the additional depreciation of \$3,500 after 1975, and for the additional depreciation of \$600, after 1969 but before 1976 the applicable percentage is 58%; that is, 100% minus 42% (142 months less 100 months). Gain treated as ordinary income is figured as follows:

1) Excess of amount realized over adjusted basis	\$15,000
2) Additional depreciation after 1975	\$ 3,500

Additional steps are necessary because (1) exceeds (2):

3) Lesser of: (1) or (2) times 58%	\$2,030
4) Additional depreciation after 1969 and before 1976	\$600
5) Lesser of: (4) or the excess of (1) over (2) times 58%	348
Gain treated as ordinary income	<u>\$2,378</u>

The remaining gain of \$12,622 is reported in Part I, Form 4797. This gain is sometimes treated as capital gain and sometimes treated as ordinary income under rules discussed later under *Reporting Gains and Losses*.

**Foreclosure.** If section 1250 property is disposed of because of foreclosure or similar proceedings, the monthly percentage reduction of the amount of additional depreciation is figured as if you disposed of the property on the starting date of the proceedings.

**Example.** On June 1, 1976, you acquired low-income rental property. On April 1, 1987 (130 months after the property was placed in service), foreclosure proceedings were started on the property and on December 1, 1988 (150 months after the property was placed in service), the property was disposed of as a result of the foreclosure proceedings. The low-income rental property qualified for the special additional depreciation monthly percentage reduction, because it was held in excess of 100 full months (that is, one percent per month reduction after 100 months). The applicable percentage reduction will be 30% (130 months less 100 months) rather than 50% (150 months less 100 months) because the percentage reduction would not apply after March 31, 1987, the starting date of the foreclosure proceedings.

**Holding period.** To figure the applicable percentage, when it is less than 100%, the holding period for property acquired generally starts on the day after it is acquired. Thus, if you bought type (1) low-income housing (defined earlier) on January 1, 1972, the holding period starts on January 2, 1972. If you sold it on January 2, 1987, the holding period is exactly 180 months, and the applicable percentage for additional depreciation for periods after 1969 and before 1976 is 0% (100% reduced by a percentage equal to the number of full months in the holding period in excess of 20 months). The applicable percentage for additional depreciation after 1975 is 20%, that is, 100% minus 80%, one percent for each full month it was held over 100 full months.

**For property you constructed, reconstructed, or erected,** the holding period starts on the first day of the month in which it is placed in service in a trade or business, in the production of income, or in a personal activity.

**For section 1250 property acquired by gift or in a tax-free exchange,** the basis of which is figured by reference to the basis in the hands of the transferor, the holding period, for the purpose of the applicable percentage, includes the holding period of the transferor.

If, however, the adjusted basis of the property in the hands of the transferee just after the transaction is more than its adjusted basis to the transferor just before the transaction, the holding period of the excess is figured as if it were a *separate improvement*. This also applies to the sale of a principal residence and the buying of another principal residence, if the adjusted basis of the residence acquired is more than the adjusted basis of the residence sold.

### Property with Two or More Elements

If section 1250 property has more than one separate element, the gain to be reported as ordinary income is the sum of the ordinary income figured for each element.

Three types of separate elements are:

- 1) A separate improvement (defined later).
- 2) The basic section 1250 property plus improvements not qualifying as separate improvements, and
- 3) The units placed in service at different times before all of the section 1250 property is finished. For example, this happens when a taxpayer builds an apartment house of 100 units, and places 30 units in service (available for

renting) on January 2, 1986, 50 on July 16, 1986, and the remaining 20 on January 19, 1987. As a result, the apartment house consists of three separate elements.

A separate improvement is each improvement added to the capital account of the property if the total of the improvements during the 36-month period ending on the last day of any one tax year is more than the greater of:

- 1) One-fourth of the adjusted basis of the property at the start of the first day of the 36-month period, or the first day of the holding period of the property, whichever is later,
- 2) One-tenth of the unadjusted basis of the property at the start of the first day of the 36-month period, or the first day of the holding period of the property, whichever is later, or
- 3) \$5,000.

Any addition to the capital account made after the initial acquisition or completion of the property by you or by any other person who held the property during a period included in your holding period is to be considered when figuring the total amount of separate improvements.

The addition to the capital account of depreciable real property is the *gross addition*, not reduced by amounts attributable to replaced property. Thus, if a roof with an adjusted basis of \$20,000 is replaced by a new roof costing \$50,000, the improvement is the gross addition to the account, \$50,000, and not the net addition of \$30,000. The \$20,000 adjusted basis of the old roof is no longer reflected in the basis of the property.

Whether an addition to the capital account is to be treated as a separate improvement may depend upon the final disposition of the entire property. If the addition to the property and the original property are sold in two separate transactions, the entire section 1250 property is treated as consisting of two distinct items.

**The adjusted basis** under (1) of the previous listing and the unadjusted basis under (2) include the depreciated cost and the actual cost of all improvements, along with those that do not qualify as separate improvements. However, neither the adjusted nor the unadjusted basis includes the cost of retired components that are no longer part of the section 1250 property, unless the adjusted basis of these is reflected in the basis of the replacement property.

**One-year test.** An addition to the capital account for any tax year is treated as an improvement only if the sum of all additions for the year is more than the larger of \$2,000, or one percent of the unadjusted basis of the property figured as of the start of that tax year or the holding period of the property, whichever is later. Thus, in applying the 36-month period test, improvements in any one of the 3 years are omitted entirely if the total of the improvements in that year does not qualify under the one-year test.

This one-year test is applied to all years following the acquisition of section 1250 property. Therefore, if such property was acquired in 1978 and improved in 1987, it will be necessary to figure if the improvements made in 1987 qualify as a separate element with a separate holding period.

**Example.** Assume that the unadjusted basis of property is \$300,000 on January 1, 1987, for a calendar-year taxpayer. During the year the taxpayer makes improvements A, B, and C which cost \$1,000, \$600, and \$700, respectively. Because the sum of the improvements, \$2,300, is less than one percent of the unadjusted basis (one percent is \$3,000), the improvements in 1987 do not satisfy the one-year test and cannot be treated as separate improvements for the 36-month period test. However, if improvement C cost \$1,500, the sum of the 1987 improvements would be \$3,100 and it would be necessary to apply the 36-month period

least to figure if the improvements must be treated as separate improvements.

**Holding period of property with two or more elements.** The following is used for figuring the applicable percentage:

- 1) The holding period of a separate element placed in service before the entire section 1250 property is finished starts on the first day of the month that the separate element is placed in service.
- 2) The holding period for each separate improvement starts on the day after the property was acquired or, for property constructed, reconstructed, or erected, the first day of the month that the property was placed in service; whereas
- 3) The holding period for each improvement *not* qualifying as a separate element is treated as part of the original property and takes the holding period of the original property for figuring the applicable percentage.

However, if an improvement, considered alone, does not meet the one-year test (greater of \$2,000 or one percent of the unadjusted basis) but does qualify as a *separate improvement constituting a separate element* when grouped with other improvements made during the tax year (which also do not meet this test), the holding period for the improvements starts on the first day of a calendar month that is closest to the middle of the tax year. If there are two dates that are equally close to the middle of the year, the earliest date is used.

**Ordinary Income attributable to each separate element** is figured as follows—

**Step 1.** Figure the ratio of the additional depreciation after 1975 for the element to the sum of the additional depreciation after 1975 for all elements.

**Step 2.** Multiply the ratio figured in Step 1 by the lesser of the additional depreciation after 1975 for the entire property or the gain from disposition of the entire property (the difference between the fair market value, or amount realized, and the adjusted basis).

**Step 3.** Multiply the result in Step 2 by the applicable percentage for the element.

For any gain that is left, you must apply the following steps.

**Step 4.** Figure the ratio of the additional depreciation after 1969 and before 1976 for the element to the sum of the additional depreciation after 1969 and before 1976 for all elements.

**Step 5.** Multiply the ratio figured in Step 4 by the lesser of the additional depreciation after 1969 and before 1976 for the entire property or the remaining gain from disposition of the entire property.

**Step 6.** Multiply the result in Step 5 by the applicable percentage for the element.

**Example.** You acquired type 1 low-income housing on January 2, 1977. On January 2, 1987, you sold it at a gain of \$25,000. But, at the date of sale it consisted of four elements (W, X, Y, and Z). The additional depreciation after 1975 for each element was: W—\$12,000; X—None; Y—\$6,000; and Z—\$6,000. The sum of the additional depreciation for all the elements (Step 1) is \$24,000. The depreciation deducted on element X was \$4,000 less than it would have been under the straight line method and depreciation on the property as a whole was \$20,000 (\$24,000 minus \$4,000). Because \$20,000 is lower than the \$25,000 gain on the sale, the \$20,000 is used in Step 2. The applicable percentages to be used in Step 3 for the elements were: W—68%; X—85%; Y—92%; and Z—100%.

From these facts, the sum of the ordinary income for each element is computed as follows:

	Step 1	Step 2	Step 3	Ordinary Income
W.....	\$12,000 +			
	\$24,000	\$20,000	68%	\$ 6,800
X.....	\$0 +			
	\$24,000	\$20,000	85%	0
Y.....	\$6,000 +			
	\$24,000	\$20,000	92%	4,600
Z.....	\$6,000 +			
	\$24,000	\$20,000	100%	5,000
<b>Sum of the ordinary income of the separate elements</b>				<b>\$16,400</b>

## Installment Sales

A gain from the disposition of depreciable personal property or real property may be reported under the installment method, if you meet the rules for using that method.

Any recapture of depreciation, including the section 179 deduction, is taxable as ordinary income under section 1245 or 1250 in the year of disposition up to the amount of the gain, even if no payments are received in that year. Your adjusted basis of the property disposed of is treated as including the amount of depreciation recapture income. If you do not report all of the gain in the year of sale, you report the remainder of the gain using the rules of the installment method.

If you dispose of *more than one asset* in a single transaction, you must separately figure the gain on each asset so that the gains may be properly reported. The part of the down payment that is income and each installment payment must be allocated between your depreciation recapture income and your other interests that may be entitled to capital gains treatment. The amounts thus allocated can be reported concurrently. The depreciation recapture income must be reported in full for each asset before capital gain treatment is allowed on the rest of the gain.

For a detailed discussion of installment sales, see Publication 537.

## Other Dispositions

If you make a *gift* of depreciable personal property or real property, you are not required to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property and this subsequent disposition is subject to recapture, the depreciation that you deducted must be taken into account by the donee in figuring the gain to be reported as ordinary income.

For depreciable real property on which the applicable percentage is less than 100%, depending on how long the property was held, the donee must take into account the donor's holding period to figure the applicable percentage. See *Holding period under Applicable Percentage*, discussed earlier.

**Disposition part gift and part sale or exchange.** If you transfer depreciable personal property or real property for less than its fair market value, in a transaction considered to be partly a gift and partly a sale or exchange, and the amount realized is more than your adjusted basis, you must report ordinary income because of depreciation. Only the balance of your depreciation is carried over to the transferee, to be taken into account on its later disposition. See *Gift to charitable organization*, later.

**Example.** You transfer depreciable personal property to your son for \$20,000. When transferred, the property had an adjusted basis to you of \$10,000 and a fair market value of \$40,000. Your depreciation taken was \$30,000. You are considered to have made a gift of \$20,000, the difference between the \$40,000 fair market value and the \$20,000 sale price to your son. You have a taxable gain on the transfer of \$10,000 (\$20,000 sale price less \$10,000 adjusted basis) that must

be reported as ordinary income because of depreciation. Because you report \$10,000 of your \$30,000 depreciation as ordinary income on the transfer of the property, only the remaining \$20,000 is carried over to your son, to be taken into account by him on its later disposition.

**Gift to charitable organization.** If your gift is to a charitable organization, the amount of your charitable contribution of property must be reduced by 100% of the ordinary gain and short-term capital gain that would result had you sold the property at its fair market value at the time of the contribution. Also, you may have to reduce the amount of your charitable contribution of property by the long-term capital gain that would result if you sold the property at its fair market value at the time of the contribution. See Publication 526, *Charitable Contributions*. Thus, the fair market value of depreciable real or personal property given to a charitable organization must always be reduced by the potential ordinary gain because of depreciation.

**Bargain sale to charitable organization.** A bargain sale is a sale or exchange of property to a charitable organization for less than its fair market value with the result that the transaction is partly a sale or exchange and partly a charitable contribution. The special bargain sale allocation rules apply only if, without regard to those allocation rules, the sale would result in a charitable contribution for the contributed part of the property.

In figuring whether the sale would result in a charitable contribution, the fair market value of the property must be reduced by the sale proceeds, by 100% of the ordinary gain, and by the long-term capital gain, if such reduction applies, that would be realized if the *entire* property had been sold by the donor at its fair market value at the time of the sale or exchange. If no contribution results or, if because of the percentage limitations on charitable contributions, no deduction is allowable, the bargain sale is treated as a regular sale.

**Allocation to sold and contributed parts.** If a sale results in a charitable contribution that qualifies as a bargain sale, the adjusted basis of the property must be divided between the part of the property sold and the part of the property given to the charity. This division is made on the basis of the fair market value of each part. Gain because of depreciation that would have resulted had the entire property been sold at its fair market value at the time of the contribution is divided the same way. For more information on bargain sales, see Publication 526.

**Example.** You sell depreciable personal property to a charitable organization for its adjusted basis of \$12,000. The property has a fair market value of \$25,000, it originally cost \$22,000, and you have claimed depreciation of \$10,000 for it. Assume that the contributed amount is not required to be reduced by the long-term capital gain that would have resulted from a sale at fair market value. Without regard to the bargain sale allocation rules, the sale results in a charitable contribution of \$3,000 (\$25,000 fair market value minus \$12,000 sales proceeds and \$10,000 depreciation).

Because the sale qualifies as a bargain sale, you must assign 48% (\$12,000 sale proceeds divided by \$25,000 fair market value) of the adjusted basis to the part sold and the remaining 52% to the part given.

### Gain on part sold:

Sales price .....	\$12,000
Basis (48% × \$12,000).....	5,760
Gain on part sold.....	\$ 6,240
Depreciation (52% × \$10,000).....	4,800
Gain on part sold, less depreciation.....	<u>\$ 1,440</u>

Because the depreciation (\$4,800) is less than the gain (\$6,240), you must include \$4,800 as ordinary income. The remaining gain (\$1,440) is

treated as explained later under *Reporting Gains and Losses*.

**Gain on part given:**

Value of contribution .....	\$13,000
Reduction for gain not long-term capital gain as described previously. This is the lesser of:	
Entire gain on part given: (\$13,000 minus 52% of \$12,000), \$6,760, or	
Depreciation (52% of \$10,000), \$5,200 .....	5,200
Amount of contribution.....	<u>\$ 7,800</u>

**Transfers at Death**

When a taxpayer dies, no gain is reported on depreciable personal property or real property that is transferred to his or her estate or beneficiary. For more information see Publication 559, *Tax Information for Survivors, Executors, and Administrators* and Publication 551.

However, if the taxpayer disposed of the property while alive and, because of the method of accounting used or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported the same way the decedent would have been required to report if he or she were alive.

Ordinary income because of depreciation must be reported on a transfer from an executor, administrator, or trustee to an heir, legatee, devisee, or beneficiary if the transfer is a sale or exchange on which a gain is realized.

**Example 1.** Janet Smith owns depreciable property that, upon her death, is inherited by her son. No ordinary income because of depreciation is reportable on the transfer, even though the value used for estate tax purposes is more than the adjusted basis of the property to Janet when she died. However, if she had sold the property before her death and realized a gain, and if because of her method of accounting, the proceeds from the sale were income in respect of a decedent reportable by her son, he would have to report ordinary income because of depreciation.

**Example 2.** The trustee of a trust, which was created by a will, transfers depreciable property to a beneficiary in satisfaction of a specific bequest of \$10,000. If the property had a value of \$9,000 at the date used for estate tax evaluation purposes, the \$1,000 increase in value to the date of distribution is a gain realized by the trust, and ordinary income because of depreciation must be reported by the trust on the transfer.

**Exchange of Property for Stock**

A tax-free exchange of depreciable personal property or real property solely for stock or securities of a controlled corporation will not result in ordinary income because of additional depreciation as described earlier. The transferee corporation's basis is the same as the transferor's adjusted basis on the date of the transfer.

For depreciable real property, the holding period of the transferee corporation includes the holding period of the transferor (but see the special rules explained earlier under *Holding period*). Any additional depreciation at the time of the exchange is carried over to the transferee corporation and must be considered if there is a later sale or other disposition.

However, if, in addition to the stock, money or other property is received by the transferor, gain up to the amount of the money or other property received must be included in income under the rules explained in Part I of this publication. Ordinary income because of additional depreciation must be reported, but it may not be more than the amount of gain that must be included in income.

**Example 1.** You own equipment having a fair market value of \$12,000 on which you have

claimed depreciation of \$10,000. The equipment originally cost you \$18,000 in 1977. In 1987, you transfer it to your controlled corporation for stock worth \$11,000 and \$1,000 in cash. Because the gain that must be included in your income is limited to the cash received (see *Non-taxable Exchanges*, earlier) and it is not more than the \$10,000 of depreciation, the \$1,000 must be reported as ordinary income.

The basis of the property in the hands of the corporation is \$9,000 (your adjusted basis of \$9,000—\$18,000 cost less \$10,000 depreciation—plus the gain of \$1,000 you are required to report). If the corporation sells the equipment for \$12,000 without deducting any more depreciation, its gain is \$3,000, all of which it will report as ordinary income (because your \$10,000 of depreciation less the \$1,000 ordinary income you report on your exchange is more than the \$3,000 gain).

**Example 2.** If, in the previous example, you receive \$11,000 cash and stock worth \$1,000, you would report \$4,000 as ordinary income because of depreciation.

**Transfer to tax-exempt organization.** If you transfer property to a tax-exempt organization for stock or securities of that organization, you usually must report the entire amount of ordinary income from depreciation, as figured under the rules discussed in this publication, for the year the exchange is made. This does not apply if you transfer property to an exempt farmers' cooperative or if the organization receiving the property uses it in an unrelated trade or business.

**Like-Kind Exchanges and Involuntary Conversions**

**Depreciable personal property.** A like-kind exchange of your personal property, or an involuntary conversion of the property because of a casualty, theft, or condemnation for public use (or threat or imminence thereof), will not result in your having to report ordinary income because of depreciation unless property other than depreciable personal property is received in the transaction.

If you receive property other than depreciable personal property and you include gain as ordinary income because of depreciation, the amount is limited to the *smaller* of:

- 1) The gain on the transaction up to the amount of depreciation deducted, or
- 2) The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions, plus the fair market value of property other than depreciable personal property acquired in the transaction.

**Example 1.** On January 3, 1987, you bought a new machine for \$4,300 cash plus your old machine for which you were allowed a \$1,360 trade-in. The old machine cost you \$5,000 on January 2, 1983. For 1983 through 1986, you take ACRS deductions of \$750, \$1,100, \$1,050, and \$1,050. Even though \$3,950 has been deducted under ACRS, the \$310 gain (\$1,360 trade-in allowance less \$1,050 adjusted basis) is not reported because any tax on the gain is postponed and you received only depreciable personal property in the exchange.

**Example 2.** On January 3, 1985, you bought office furniture for \$1,500. You deducted \$225 and \$330 under ACRS on your 1985 and 1986 returns. On January 3, 1987, a fire destroyed the furniture and you received \$1,200 from your fire insurance. However, replacement furniture cost you only \$1,000. (See the discussion of *Replacement property* in Publication 547.) Your taxable gain is limited to the remaining \$200 insurance payment. Because your taxable gain is less than the \$555 ACRS deduction you deducted, the \$200 is reported as ordinary income.

**Example 3.** In 1987 a fire destroyed office machinery you purchased in 1983 for \$116,000. The

ACRS deductions were \$91,640, and the machinery had an adjusted basis of \$24,360. You got \$117,000 insurance payment, realizing a gain of \$92,640.

You immediately spent \$105,000 of the insurance payment for replacement machinery and \$9,000 for stock that qualifies as replacement property, and you chose to postpone the tax on your gain. Because \$114,000 of the \$117,000 insurance payment was used to buy replacement property, the gain that must be included in income under the rules for involuntary conversions is an unexpanded part of \$3,000. Also, the part of the insurance payment (\$9,000) used to buy the nondepreciable property (the stock) also must be included in figuring the gain because of depreciation.

The amount you must report as ordinary income on the transaction on your 1987 return is \$12,000, figured as follows:

1) Gain realized on the transaction (\$92,640) limited to depreciation (\$91,640) .....	\$91,640
2) Gain includible in income .....	\$3,000
Fair market value of property other than depreciable personal property (the stock) .....	9,000
Total .....	<u>\$12,000</u>
Amount reportable as ordinary income (lesser of (1) or (2) ) .....	<u>\$12,000</u>

If, instead of buying \$9,000 in stock you had bought \$9,000 worth of depreciable personal property that was similar or related in use to the destroyed property, you would only report \$3,000 as ordinary income.

**Depreciable real property.** If you have a gain from a like-kind exchange of your real property from an involuntary conversion, the amount to be reported as ordinary income because of additional depreciation is limited to the *larger* of:

- 1) The gain that must be reported under the rules for like-kind exchanges or involuntary conversions, plus the fair market value of stock purchased as replacement property in acquiring control of a corporation, or
- 2) The gain you would have had to report as ordinary income because of additional depreciation had the transaction been a cash sale less the cost (or fair market value of an exchange) of the depreciable real property acquired.

The ordinary income not reported for the year the disposition is carried over to the depreciable real property acquired in the like-kind exchange or involuntary conversion as additional depreciation from the property disposed of. Further, to figure the applicable percentage of additional depreciation to be treated as ordinary income, the holding period starts over for the new property.

**Example.** The state paid you \$116,000 when it condemned your depreciable real property for public use. You bought other real property, similar in use to the property condemned, for \$110,000 (\$15,000 for depreciable real property and \$95,000 for land) and you also bought stock for \$5,000 to get control of a corporation owning property similar in use to the property condemned. You chose to postpone the tax on the gain. If the transaction had been a sale for cash only, under the rules described earlier, \$20,000 would have been reportable as ordinary income because of additional depreciation.

The ordinary income to be reported is \$6,000, which is the larger of:

- 1) The gain that would be required to be reported (\$1,000 (\$116,000 - \$115,000) plus the fair market value of stock bought as qualified replacement property, \$5,000, for a total of \$6,000, or
- 2) The gain you would have had to report as ordinary income because of additional depreciation

(\$20,000) had this transaction been a cash sale, less the cost of the depreciable real property bought (\$15,000), or \$5,000.

**Basis of real property acquired in involuntary conversions.** If only depreciable real property is acquired to replace depreciable real property in an involuntary conversion in which gain is realized, and tax on the gain is postponed under the rules for involuntary conversions, the basis of the replacement property is its cost less the gain on which tax is postponed. If the replacement consists of more than one piece of depreciable real property, the cost of each piece is reduced by an allocable part of the gain.

However, if the replacement property consists of both depreciable real property and other property, the basis must be figured as follows:

- 1) Figure a tentative basis for the depreciable real property by subtracting from its cost the ordinary income because of additional depreciation that is not required to be reported (if more than one piece of depreciable property is acquired, the tentative basis must be allocated to each piece in proportion to its cost),
- 2) Add the tentative basis figured in (1) to the cost of the other property acquired,
- 3) Subtract from the total in (2) the excess of gain on which tax is postponed over the ordinary income because of additional depreciation not required to be reported, and finally
- 4) Allocate the amount obtained in (3) to each asset in proportion to its cost, as listed in (2).

**Example 1.** You receive an insurance payment of \$90,000 because of the destruction by fire of depreciable real property (an office building you acquired in 1980) that had an adjusted basis of \$73,000, with additional depreciation of \$10,000.

Your realized gain from the involuntary conversion is \$17,000, and under the general rules for dispositions of depreciable real property you would report \$10,000 (lesser of \$10,000 additional depreciation or your \$17,000 gain) as ordinary income because of additional depreciation. However, you immediately spend the \$90,000 for depreciable real property similar in use to the property destroyed, choosing to postpone the tax on the gain, and therefore no income from the additional depreciation must be reported under the special rule for involuntary conversions discussed earlier.

The basis of the replacement property is its cost of \$90,000 less the \$17,000 gain on which tax is postponed, or \$73,000. The \$10,000 of ordinary income that you would otherwise be required to report is carried over to the replacement property as additional depreciation. The holding period of the newly acquired property includes the period during which you held the converted property.

**Example 2.** John Adams gets a \$90,000 fire insurance payment for depreciable real property (office building) with an adjusted basis of \$30,000. He uses the whole payment to buy property similar in use, of which \$42,000 is for depreciable real property and \$48,000 is for land. He chooses to postpone the tax on the \$60,000 gain realized on the involuntary conversion. Of this gain \$10,000 is ordinary income because of additional depreciation, but is not reported because of the exception for involuntary conversions. The \$30,000 basis of the property bought is allocated as follows:

- 1) The tentative basis of depreciable real property is \$32,000 (cost of \$42,000, less \$10,000 ordinary income not required to be reported).
- 2) The tentative basis of depreciable real property plus the cost of other property (land) is \$80,000 (\$32,000 plus \$48,000).
- 3) Subtract from the \$80,000 figured in (2) the difference between \$60,000, the gain on tax which is postponed without regard to the rules described earlier, and \$10,000, the ordinary income because of additional depreciation that is

not required to be reported. The difference is \$50,000 which, subtracted from \$80,000, leaves \$30,000.

- 4) Allocate the result in (3) to both properties by their costs, as considered in (2).

Depreciable real property

$$\$32,000 \div \$80,000 \times \$30,000 = \$12,000$$

Other property (land)

$$\$48,000 \div \$80,000 \times \$30,000 = \$18,000$$

The ordinary income not required to be reported (\$10,000) is carried over as additional depreciation to the depreciable real property that was bought, and may be taxed on a later disposition. The holding period of the property that was bought includes the holding period of the exchanged or involuntarily converted property, but for figuring the applicable percentage on the property that was bought a new holding period begins when it is bought.

## Depreciable Property and Other Property in One Transaction

If you dispose of both depreciable personal property and other property in one transaction and realize a gain, you must allocate the amount realized between the two types of property disposed of in proportion to their respective fair market values to figure the part of your gain to be reported as ordinary income because of depreciation. In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the depreciable personal property and other property, any arm's length agreement between them will establish the allocation.

In the absence of an agreement, the allocation should be made by taking into account the appropriate facts and circumstances. This would include, but is not limited to, a comparison between the depreciable personal property and all the property disposed of in the transaction. The comparison should take into account:

- 1) The original cost and reproduction cost of construction, erection, or production,
- 2) The remaining economic useful life,
- 3) The state of obsolescence, and
- 4) The anticipated expenditures required to maintain, renovate, or modernize the properties.

In a like-kind exchange or involuntary conversion, if both depreciable personal property and other property are disposed of and both types are also acquired in the transaction, the part realized on the disposition that is allocated to the depreciable personal property is treated as consisting of, first, the fair market value of the depreciable personal property acquired and, second (to the extent of any remaining balance), the fair market value of property other than depreciable personal property acquired. The amount allocated to the other property disposed of is treated as consisting of the fair market value of all property acquired that has not already been taken into account.

If you dispose of depreciable real property and other property in a single transaction, similar rules apply.

**Example.** A fire destroyed your property having a total fair market value of \$50,000, consisting of machinery worth \$30,000 and other property worth \$20,000. You received an insurance payment of \$40,000 and immediately used it plus \$10,000 of your own funds (or a total of \$50,000) to buy machinery with a fair market value of \$15,000 and other property with a fair market value of \$35,000. Assume that your adjusted basis of the machinery was \$5,000 and the depreciation on the machinery was \$35,000. Assume further that you chose to postpone the tax on your gain arising from the involuntary conversion. You must

report \$9,000 as ordinary income because of depreciation arising from this transaction, figured as follows:

**First,** the \$40,000 insurance payment must be allocated between the machinery and the other property destroyed, in proportion to the fair market value of each. Therefore, the amount allocated to the machinery is 30,000/50,000 of \$40,000, or \$24,000, and the amount allocated to the other property is 20,000/50,000 of \$40,000, or \$16,000. Your gain on the involuntary conversion of the machinery is \$24,000 less \$5,000 adjusted basis, or \$19,000.

**Second,** the \$24,000 allocated to the machinery disposed of is treated as consisting of the \$15,000 fair market value of the replacement machinery bought and \$9,000 of the fair market value of other property bought in the transaction. All of the \$16,000 allocated to the other property disposed of is treated as consisting of the fair market value of the other property that was bought.

**Third,** you must report as ordinary income because of depreciation the smaller of items (1) or (2) under *Like-Kind Exchanges and Involuntary Conversions* (for depreciable personal property), explained earlier. The amounts to be taken into account are: under item (1), your \$19,000 gain on the machinery (because it is less than the \$35,000 depreciation) and, under item (2), the gain included in income (none, because you chose to postpone the tax on your gain), plus the \$9,000 of the fair market value of property other than the depreciable property that was bought, which is treated as being included in the payment for the machinery disposed of. The smaller of the amounts under (1) or (2), \$9,000, is the amount you must report as ordinary income because of depreciation.

## Corporations and Partnerships

Corporations and partnerships figure ordinary income because of depreciation on the disposition of either depreciable personal or depreciable real property as described earlier for individuals. Although the computations differ for each type of property in arriving at the gain to be reported as ordinary income, once the gain is figured, the treatment of the transaction is generally the same. For information on depreciable property distributed by corporations or S corporations, see Publication 542, *Tax Information on Corporations*, or Publication 589, *Tax Information on S Corporations*. For information on distributions of depreciable property by a partnership, see Publication 541, *Tax Information on Partnerships*.

## Part V Reporting Gains and Losses

Capital gains and losses are reported on Schedule D (Form 1040). This schedule is also used to figure the limit on capital losses, to figure capital gains, and any capital loss carryovers from 1987 to 1988.

Any net section 1231 gain from Part I, Form 4797, is also reported on Schedule D (Form 1040). This amount is any net gain resulting from sales, exchanges, and involuntary conversions of real or depreciable property used in your trade or business (or held for the production of rents or royalties), and from involuntary conversions of capital assets held in connection with a trade or business or a transaction entered into for profit, held for more than 6 months. See Section 1231 *Property* discussed earlier. Losses from involuntary conversions of property are discussed later under Form 4797.

Note that although references in this discussion are to Schedule D (Form 1040), the rules

discussed apply also to taxpayers other than individuals. The rules for property held for personal use usually will not apply to taxpayers other than individuals. Also note that Form 4797 is used along with Form 1040, as well as with such Forms as 1065, 1120, and 1120S.

**Form 1099-B.** If you sold stocks, bonds, commodities, etc., through a broker, you should receive Form 1099-B, *Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions*, or an equivalent statement from your broker. Use Form 1099-B or equivalent statement to fill in line 1 of Schedule D (Form 1040).

Whether or not you receive Form 1099-B, you must report all taxable sales of stocks, bonds, commodities, etc., on Schedule D.

**Real estate transactions.** Information reporting is now required on certain real estate transactions. For closings in 1987, the real estate broker—generally the person responsible for closing the transaction—must report to IRS on Form 1099-B, *Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions*, sales or exchanges of the following:

- 1) A single-family residence, such as a house, townhouse or condominium unit,
- 2) A multi-family residence with four or fewer units, or
- 3) Stock in a cooperative housing corporation.

If you have sold or exchanged the above type of property, the broker must give you a copy of Form 1099-B or a statement containing the same information as the Form 1099-B. Also use Form 1099-B to fill in the gross proceeds requested on line 1 of Form 4797 or the form you are using to report the sale or exchange.

**Form 1099-S.** For closings after 1987, transactions must be reported on new Form 1099-S, *Statement for Recipients of Proceeds From Real Estate Transactions*.

## Schedule D (Form 1040)

**Short-term gains and losses.** Gain or loss on the sale or exchange of capital assets held 6 months or less is a short-term capital gain or loss and is reported in Part I.

**Gain on the sale or exchange of property held for personal use** (such as your residence) and held for 6 months or less is a short-term capital gain. **Loss on the sale or exchange of property held for personal use** is not deductible.

Your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries and any short-term capital loss carryover are combined with other short-term gains and losses to figure net short-term capital gain or loss.

**Long-term gains and losses.** A gain or loss on the sale or exchange of capital assets held more than 6 months is a long-term capital gain or loss and is reported in Part II.

**Gain on the sale or exchange of property held for personal use** (such as your residence) and held more than 6 months is a long-term capital gain. **Loss on the sale or exchange of property held for personal use** is not deductible.

**Net section 1231 gain** from Part I, Form 4797, after adjustment for nonrecaptured section 1231 losses from prior tax years, if applicable, is a long-term capital gain that is reported in Part II.

The following are also reported in Part II:

- 1) Capital gain distributions from regulated investment companies, mutual funds, and real estate investment trusts.
- 2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
- 3) Long-term capital loss carryovers.

The result from combining these items is your net long-term capital gain or loss.

**Capital gain distributions.** You report capital gain distributions on line 13, Part II. However, if you do not need Schedule D to report any other capital gains or losses, enter your capital gain distributions for 1987 on line 14, Form 1040.

The total net gain or loss is then figured by combining your net short-term capital gain or loss with the net long-term capital gain or loss. The result is entered on line 18, Part III. If losses are more than gains, see *Treatment of Capital Losses*, in Part III of this publication.

**Total net gain.** If the amount on line 18 is a gain, the gain should also be entered on Form 1040, line 14. In addition, if lines 17 and 18 are net gains and your taxable income in 1987 is taxed above the 28% tax rate, you should use Part IV to figure the tax on your net gain.

**Total net loss.** If the amount on line 18 is a loss, enter on line 19 and as a loss on line 14, Form 1040, the smaller of:

- a) The amount on line 18, or
- b) \$3,000 (\$1,500 if married filing a separate return).

Next, you determine if you have a capital loss carryover. You have a capital loss carryover if the loss on line 18 is more than the loss on line 19. Use Part V to figure your short-term and/or your long-term capital loss carryover(s).

**Part IV.** Long-term capital gains that exceed short-term capital losses (net capital gain) are taxed at a maximum tax rate of 28%. If, in 1987, your taxable income is taxed above the 28% tax rate, you must use Part IV of Schedule D to figure your tax on your net capital gain. If both the amounts on lines 17 and 18 of Schedule D are net gains and your taxable income is taxed above the 28% tax rate, complete Form 1040 through line 36, and then complete Part IV of Schedule D.

Part V of Schedule D is used to figure your short-term capital loss carryover and/or your long-term capital loss carryover from 1987 to 1988. See the discussion of how to compute your capital loss carryover under *Treatment of Capital Losses* in Part III.

## Form 4797

A sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties sometimes results in a capital gain or loss and sometimes in an ordinary gain or loss. All or part of any gain from the disposition of such property may be ordinary gain from depreciation under the rules described in Part IV of this publication.

Gains and losses from involuntary conversions of capital assets held for more than 6 months, in connection with a transaction entered into for profit, may be treated as capital or ordinary gains and losses, depending on the circumstances. Sometimes, however, you may choose to postpone tax on gains from involuntary conversions by acquiring qualified replacement property within a specified period. For information on casualties and thefts, see Publication 547. For information on condemnations, see Publication 549.

Form 4797 is used to report these transactions and to figure the amount of ordinary or capital gain or loss.

Part III should be completed first if property subject to depreciation and held more than 6 months is disposed of at a gain. The part of that gain that must be reported as ordinary gain from depreciation is entered on line 13, Part II. Any remaining gain (any gain in excess of ordinary gain from depreciation) is carried to line 5, Part I.

Part I is used to report sales or exchanges of trade or business property, and some kinds of involuntary conversions (condemnations), other

than casualty and theft, of trade or business property and capital assets held in connection with a trade or business or a transaction entered into for profit and held more than 6 months. Part I is also used to recapture certain prior year's net section 1231 losses as ordinary income.

Part II is used to report ordinary gains or losses on the sale, exchange, or involuntary or compulsory conversions of noncapital assets (trade or business property).

**Business and rental property held 6 months or less.** A gain or loss on the sale, exchange, or involuntary conversion of property used in your business or held for the production of rents or royalties and held 6 months or less is an ordinary gain or loss and is reported in Part II.

**Installment method.** The long-term gain you recognize each year under the installment method of accounting from a taxable sale of business real or depreciable property may be a long-term capital gain in one year and an ordinary gain in another because of section 1231 treatment. After figuring the amount of gain on Form 6252, *Computation of Installment Sale Income*, it must be included in Part I of Form 4797.

For information on the treatment of gain attributable to depreciation for a transaction reported by the installment method, see Part IV.

**Gain on repossession.** If the original sale was reported on the installment method of accounting, the taxable gain on repossession would keep the same classification as the gain on the original sale. Thus, if the sale initially resulted in a capital gain, the repossession gain would be a capital gain also.

**Loss on repossession.** The treatment of losses on repossession depends upon whether the property being repossessed is real or personal property. See Publication 537.

## Example

Jane Smith is single and at the beginning of 1987, she owned and operated Jane's Dress Shop. During the year she traded the land and building where she operated her dress shop for land and a building and opened the J. Smith Hardware Store. For the 1987 tax year, she had the following transactions, which are reported as shown in the accompanying filled-in Form 4797.

### Form 4797

In March of 1987, Jane decided to quit the dress shop and go into the hardware business. She made an even exchange of the land and building where she operated her dress shop for land and a building suitable for use as a hardware store. This was a nontaxable exchange. The basis of the new land and building is the same as the basis of the old land and building that was traded. She must allocate this basis between the new land and building in order to figure the depreciation and other deductions on the new building.

Jane was also able to sell all of the equipment she had used in her dress shop for \$4,000 on March 19, 1987. She had originally paid \$6,000 for it on May 21, 1980, and had deducted \$4,000 in depreciation since then. Therefore, she realized a gain of \$2,000. Because the gain was less than the depreciation taken, all of the gain is ordinary income from depreciation. This amount is reported in Part III of Form 4797 and entered in Part II, line 13.

Jane sold a small vacant lot located across the street from the dress shop, which had been used as parking for her customers. Her adjusted basis was \$6,000 and she received \$8,000 on the sale, realizing a gain of \$2,000. Jane also has a net section 1231 loss from a 1984 sale of section 1250 property. She did not have any net section 1231 losses in other tax years since 1981, nor did Jane have any net section 1231 gains in 1985 or 1986. Jane enters her net section 1231 loss of

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\$1,200 as a nonrecaptured loss on line 8, Part I. The loss is treated as ordinary income in 1987 and is subtracted from Jane's \$2,000 gain on the sale of the parking lot. The \$800 balance on line 9 is a long-term capital gain entered on Schedule D. From Part I, Jane's \$1,200 recaptured loss is entered on line 12, Part II.

**Summary.** The entries in Part II, Form 4797, show an ordinary gain of \$3,200, which is carried to line 15, Form 1040.

The entries in Part I, Form 4797, result in a gain of \$800 from section 1231 transactions. This is

treated as a long-term capital gain and is carried to line 14, Schedule D (Form 1040).

**Gains and Losses From Sales or Exchanges of Assets Used In a Trade or Business and Involuntary Conversions**  
 (And Computation of Recapture Amounts Under Sections 179 and 280F)

▶ Attach to your tax return. See Separate Instructions.

Name(s) as shown on return  
**JANE SMITH**

Identifying number  
**458-00-0327**

**Part I Sales or Exchanges of Property Used In a Trade or Business and Involuntary Conversions From Other Than Casualty and Theft—Property Held More Than 6 Months (More Than 1 Year If Acquired After 12/31/87)**

- Notes:
- Use Form 4684 to report involuntary conversions from casualty and theft.
  - If you sold property that you claimed investment credit on, get Form 4255 to see if you are liable for recapture of the credit.
  - File Form 6198 if you are reporting a loss and have amounts invested in the activity for which you are not at risk. (See instructions under "Special Rules.")
  - Complete Form 8582 before you complete Form 4797 if you are reporting a loss from a passive activity. (See instructions under Passive Loss Limitations.)

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1987 on Form(s) 1099-B (or an equivalent statement) that you will be including on lines 2 or 10 (Column d), or on line 20. (Form 1099-B is a Statement for Recipients of Proceeds From Real Estate, Broker, and Barter Exchange Transactions.) 11

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed (or allowable) since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2 Store PARKING LOT	10/1/73	3/14/87	8,000	-0-	6,000	-	2,000
Land and building	6/1/85	3/1/87	Like-kind exchange	4,652	50,000	-0-	-0-

- 3 Gain, if any, from Form 4684, Section B, line 21
- 4 Section 1231 gain from installment sales from Form 6252, line 23 or 31
- 5 Gain, if any, from Part III, line 32, from other than casualty and theft.
- 6 Add lines 2 through 5 in columns (g) and (h). 2,000
- 7 Combine columns (g) and (h) of line 6. Enter gain or (loss) here, and on the appropriate line as follows (partnerships see the instructions for your line references): 2,000
- If line 7 is zero or a loss, enter the amount on line 11 below and skip lines 8 and 9. (S corporations, enter the loss on Schedule K (Form 1120S), line 5.) If line 7 is a gain and you did not have any prior year section 1231 losses or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.
- 8 Nonrecaptured net section 1231 losses from prior years. (See instructions.) 1,200
- 9 Subtract line 8 from line 7. If zero or less, enter zero 800
- If line 9 is zero, enter the amount from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the amount from line 9 as a long-term capital gain on Schedule D. See specific instructions for line 9.

**Part II Ordinary Gains and Losses**

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed (or allowable) since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
10 Ordinary gains and losses not included on lines 11 through 16 (include property held 6 months or less) (1 year or less if acquired after 12/31/87):							

- 11 Loss, if any, from line 7
- 12 Gain, if any, from line 7, or amount from line 8 if applicable. 1,200
- 13 Gain, if any, from line 31, Part III 2,000
- 14 Net gain or (loss) from Form 4684, Section B, lines 13 and 20a
- 15 Ordinary gain from installment sales from Form 6252, line(s) 22 and/or 30
- 16 Recapture of section 179 deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations. (see instructions)
- 17 Add lines 10 through 16 in columns (g) and (h) 3,200
- 18 Combine columns (g) and (h) of line 17. Enter gain or (loss) here, and on the appropriate line as follows:
- a For all except individual returns: Enter the gain or (loss) from line 18, on the return being filed.
- b For individual returns:
- (1) If the loss on line 11 includes a loss from Form 4684, Section B, Part II, column (b)(ii), enter that part of the loss here and on line 18 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)"
- (2) Redetermine the gain or (loss) on line 18, excluding the loss (if any) on line 18b(1). Enter here and on Form 1040, line 15 3,200

**Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**

Skip section 1252 on line 27 and in the instructions if you did not dispose of farmland or if you are a partnership.

19 Description of sections 1245, 1250, 1252, 1254, and 1255 property	Date acquired (mo., day, yr.)	Date sold (mo., day, yr.)
A STORE EQUIPMENT	5/21/80	3/19/87
B		
C		
D		

Relate lines 19A through 19D to these columns	Property A	Property B	Property C	Property D
	20 Gross sales price	4,000		
21 Cost or other basis plus expense of sale	6,000			
22 Depreciation (or depletion) allowed (or allowable)	4,000			
23 Adjusted basis, subtract line 22 from line 21	2,000			
24 Total gain, subtract line 23 from line 20	2,000			
25 If section 1245 property:				
a Depreciation allowed (or allowable) (see instructions)	4,000			
b Enter smaller of line 24 or 25a	2,000			
26 If section 1250 property: (If straight line depreciation was used, enter zero on line 26g unless you are a corporation subject to section 291)				
a Additional depreciation after 12/31/75				
b Applicable percentage times the smaller of line 24 or line 26a (see instructions)				
c Subtract line 26a from line 24. If line 24 is not more than line 26a, skip lines 26d and 26e.				
d Additional depreciation after 12/31/69 and before 1/1/76				
e Applicable percentage times the smaller of line 26c or 26d (see instructions)				
f Section 291 amount (for corporations only)				
g Add lines 26b, 26e, and 26f				
27 If section 1252 property:				
a Soil, water, and land clearing expenses				
b Line 27a times applicable percentage (see instructions)				
c Enter smaller of line 24 or 27b				
28 If section 1254 property:				
a Intangible drilling and development costs deducted after 12/31/75 (see instructions)				
b Enter smaller of line 24 or 28a				
29 If section 1255 property:				
a Applicable percentage of payments excluded from income under section 126 (see instructions)				
b Enter the smaller of line 24 or 29a				

**Summary of Part III Gains (Complete property columns A through D through line 29b before going to line 30.)**

30 Total gains for all properties (add columns A through D, line 24)	2,000
31 Add columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and in Part II, line 13. (See the instructions to Part IV if this is an installment sale.)	2,000
32 Subtract line 31 from line 30. Enter the portion from casualty and theft on Form 4684, Section B, line 15; enter the portion from other than casualty and theft on Form 4797, Part I, line 5.	-0-

**Part IV Complete This Part Only if You Elect Out of the Installment Method and Report a Note or Other Obligation at Less Than Full Face Value**

33 Check here if you elect out of the installment method	
34 Enter the face amount of the note or other obligation	
35 Enter the percentage of valuation of the note or other obligation	

**Part V Computation of Recapture Amounts Under Sections 179 and 280F When Business Use Drops to 50% or Less (See instructions for Part V.)**

	(a) Section 179	(b) Section 280F
1 Section 179 expense deduction or section 280F recovery deductions		
2 Depreciation or recovery deductions (see instructions)		
3 Recapture amount (Subtract line 2 from line 1. See instructions for where to report)		

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## Other Helpful Publications

Information on other topics related to the sale or exchange of assets may be found in the following publications, all available free.

Publication	Title
225	Farmor's Tax Guide
334	Tax Guide for Small Business
504	Tax Information for Divorced or Separated Individuals
523	Tax Information on Selling Your Home
526	Charitable Contributions
527	Rental Property
530	Tax Information for Owners of Homes, Condominiums, and Cooperative Apartments

534	Depreciation
535	Business Expenses
537	Installment Sales
541	Tax Information on Partnerships
542	Tax Information on Corporations
547	Nonbusiness Disasters, Casualties, and Thefts
549	Condemnations and Business Casualties and Thefts
550	Investment Income and Expenses
551	Basis of Assets
555	Community Property and the Federal Income Tax
559	Tax Information for Survivors, Executors, and Administrators

561	Value of Donated Property, Determining the
572	General Business Credit
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# Installment Sales

For use in preparing  
1987 Returns

## Highlights

**Allocable Installment Indebtedness (deemed payment).** If you are owed money on an installment sale for a tax year ending after 1986, you may have to treat part of certain business debts that you owe at the end of the tax year as if it was a payment received by you on that installment sale. The amount treated as a payment is referred to as the allocable installment indebtedness. This amount is treated as a payment on the installment sale even though you have received no actual payment on the installment sale during the tax year. This rule applies to:

- 1) Sales after February 28, 1986, by dealers in personal or real property, and
- 2) Sales after August 16, 1986, of business or rental real property if the selling price is more than \$150,000.

**Exceptions.** This rule does not apply to the installment sale of:

- 1) Property used substantially for personal purposes, or
- 2) Property used or produced on a farm.

## Introduction

Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your property yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale.

The buyer's "installment obligation" to make future payments to you might be in the form of a deed of trust, a note, a land contract, a mortgage, or some other evidence of the buyer's indebtedness to you. The rules discussed in this publication apply no matter what form the installment obligation takes.

Generally, you report your gain on an installment sale only as you actually receive the payments. It does not matter whether you use the cash or the accrual method of accounting. Each payment you receive is treated as part recovery of your investment and part profit. You are taxed only on the part of each payment that represents your profit on the sale. In this way, the installment method of reporting income relieves you of paying tax on income that you have not yet collected. However, for a sale of depreciable property, you must report in the year of sale any depreciation recapture income up to the amount of the gain. In this case any gain in excess of the recapture amount is taken into account under the installment method.

This publication shows how to figure and report your income from an installment sale each year. It is divided into the following parts:

- Figuring Installment Sale Income
- Electing Out
- Unstated Interest
- Dispositions of Installment Obligations
- Repossessions
- Reporting an Installment Sale (including sample filled-in forms)

This publication provides information on the most common tax situations. It explains the tax law in plain language so that it will be easier to understand. However, the information provided does not cover every situation and is not intended to replace the law or change its meaning.

If you make regular sales. The rules in this publication apply to all installment sales of real or personal property if it is the type of sale you would only make occasionally. Sales of real or personal

property by a dealer or anyone else who regularly sells property on the installment plan are not covered. Neither are sales of personal property that you would have to include in your inventory if it were on hand at the end of your tax year. However, farmers who are not required to maintain inventories can use the installment method for sales of this type of property. Dealers, who regularly sell real or personal property on the installment method, should see section 453C of the Internal Revenue Code.

**Caution:** When this publication went to print Congress was considering legislation that would repeal the installment method for dispositions of property by dealers.

**If you are not the payee or mortgagee.** To use the installment method, you must be the person who is to be paid the installment payments. You may not use this method if the buyer gives a deed of trust or mortgage to a bank or trust company; to finance the purchase and then pays you the purchase price. This is because the outstanding debt is not owed to you. However, you can use this method for a second trust the buyer gives to you after giving a first deed of trust or mortgage to a financial institution.

**If you have a loss.** If your sale results in a loss, you may not use the installment method. If the loss is on an installment sale of business assets, it is deductible only in the tax year in which the sale is made. A loss on the sale of property owned for personal use is not deductible.

If your sale calls for payments in a later year, you may have to figure unstated interest even though you have a loss. See the discussion of unstated interest later in this publication.

**Sale of a passive activity.** If you sell your entire interest in a passive activity on the installment method, special rules apply to the treatment of passive activity losses. For more information, see Publication 925, *Passive Activity and At-Risk Rules*.

**Reporting installment sale income.** Each year, including the year of sale, you must report your income from an installment sale on Form 6252, *Computation of Installment Sale Income*. Attach this form to your tax return.

## Figuring Installment Sale Income

You must allocate the payments you receive each year from an installment sale.

**Interest income.** If interest is included in a payment, you must report separately all the interest as ordinary income on your income tax return. Interest is generally not included in a down payment. However, you may have to treat a part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See the discussion of unstated interest later.

**Gain.** The rest of each payment is treated as if it were made up of two parts. One part is a return of your investment (basis) in the property you sold. The other part is your gain from the sale. The gain will be capital gain if the property you sold was a capital asset. However, if you took depreciation deductions on the asset, part of your gain may be treated as ordinary income. You report depreciation recapture income in the year of sale up to the amount of the gain. See Publication 544, *Sales and Other Dispositions of Assets*, for more information on depreciation recapture.

The first section below discusses how to figure the part of each payment that must be reported as gain. This is done using the gross profit percentage. The second section discusses various types of installment sale payments. In some cases you will be considered to have received a payment, even though the buyer has not paid you anything directly. The next section discusses the allocable installment indebtedness that is treated as a payment for certain sales of business or rental



property. The remaining sections discuss some special rules concerning:

- Escrow accounts.
- Sales to related persons.
- Sales that include a like-kind exchange.
- Contingent sales, and
- Sales of more than one asset at a time.

The final section of this part presents an example of an installment sale.

## Gross Profit Percentage (Gross Profit Ratio)

A certain percentage of each payment (after subtracting out interest) must be reported as gain from the sale. This percentage usually remains the same for each payment you receive. It is called the "gross profit percentage," and is figured by dividing your gross profit from the sale by the contract price.

**Example.** You sell property at a contract price of \$2,000, and your gross profit is \$500. Your gross profit percentage is 25% (\$500 divided by \$2,000). After subtracting out interest, 25% of each payment, including the down payment, is reported as your gain from the sale for the tax year in which you receive the payment.

**Gross profit.** For an installment sale, gross profit is the amount of gain you report on the installment method. It is the total amount of your gain from the sale minus:

- 1) The amount of gain you must report as ordinary income in the year of sale because of *depreciation recapture income* (including the section 179 deduction claimed on the property you sold), and
- 2) The amount of gain you can postpone or exclude on the sale of your home.

**Gain reported in year of sale.** For sales of depreciable property, figure your depreciation recapture income (including the *section 179 deduction* recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. If the amount of your gain equals or is less than the recapture income, you do not have an installment sale. Any gain that is more than the recapture income can be reported on the installment method if the sale is an installment sale. For more information on the section 179 deduction, see Publication 534, *Depreciation*. See Publication 544 for more information on depreciation recapture.

To figure your gross profit, you must know your adjusted basis in the property you sold and the selling price. You add the commissions, other expenses paid in connection with the sale, and the depreciation recapture income reported in the year of sale to your adjusted basis. You then subtract the adjusted basis, as increased, from the selling price to determine gross profit. If the property you sold was your home, subtract from the gross profit any gain you can postpone or exclude. The result is your gross profit from the sale.

**Basis and adjusted basis.** Basis is a way of measuring your investment in the property you are selling. The way you figure basis depends on how you first acquired the property. The basis of property you bought is usually its cost to you. The basis of property you inherited, got as a gift, built yourself, or received in a tax-free exchange must be figured differently.

While you owned the property, various events may have taken place that changed your original basis in the property. Some events, such as additions or permanent improvements, increase basis. Others, such as deductible casualty losses, section 179 deductions, and depreciation deductions, decrease basis. The result is "adjusted basis." The adjusted basis plus selling expenses and depreciation recapture income is referred to in this publication as the *installment sale basis*.

For more information on how to figure basis and adjusted basis, see Publication 551, *Basis of Assets*.

**Selling price.** The selling price for an installment sale is the entire cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. It also includes any debt the buyer pays, assumes, or takes the property subject to. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses for you, that amount is also included in the selling price.

**Selling price reduced.** If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. You cannot go back and refigure the gain you reported in earlier years.

**Sale of home.** If you sell your home, you may be able to postpone or exclude all or part of the gain on the sale. (See Publication 523, *Tax Information on Selling Your Home*.) If the sale is an installment sale, figure the gross profit percentage by including in gross profit only the part of the gain you do not postpone or exclude.

**Example.** You sell your home for \$75,000, under terms that permit you to use the installment method. Your sale agreement provides for payments of interest at an annual rate of 12% in addition to the payments on the sale price. Your adjusted basis in the property is \$54,000 and you have selling expenses of \$4,500 for a total of \$58,500. You, therefore, have a gain of \$16,500 on the sale (\$75,000 - \$58,500). You buy another house, postponing the tax on \$9,000 of your gain. You figure the gross profit using only the taxable part of the gain, \$7,500 (\$16,500 - \$9,000). Your gross profit percentage is 10% (\$7,500 taxable gain divided by \$75,000 contract price). Ten percent of each principal payment you receive should be reported as gain from the installment sale. You must report the interest payments as ordinary income.

**Contract price.** The contract price is the total amount of all the principal payments you are to receive on the installment sale. It includes payments you are considered to receive, even though you are not paid anything directly. See *Payments*, next.

If the selling price is payable partly in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price.

## Payments

You must figure your profit on the payments you receive, or are treated as receiving, each year from an installment sale, including the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you will be considered to have received a payment, even though the buyer does not pay you directly. These situations arise if the buyer takes over or pays off any of your debts, such as a loan, or any of your expenses, such as a sales commission.

**Caution:** When this publication went to print Congress was considering legislation that would provide that if any indebtedness is secured by an installment obligation, the net proceeds of the secured indebtedness will be treated as a payment on the installment obligation.

For certain installment sales of real property used in a trade or business or held for the production of rental income, a percentage of your business debts is treated as a payment at the end of the tax year. The percentage treated as a payment is equal to the percentage of your installment obligations to your investment assets

(including the installment obligations). See *Allocable Installment Indebtedness (Deemed Payment)*, later.

**Buyer's note.** The buyer's note (unless it is payable on demand) is not considered a payment on the sale. Its full face value is included when figuring both selling price and contract price. The payments you receive on the note are reported on the installment method except as discussed under *Allocable Installment Indebtedness (Deemed Payment)*, later.

**Expenses.** If the buyer assumes and pays expenses you have in connection with selling your property, it is considered a payment to you in the year of sale. The expenses are included in both the selling price and contract price when figuring the gross profit percentage.

**Mortgage assumed.** If the buyer assumes (or pays off) your mortgage, or otherwise takes the property subject to it, the following rules apply.

**If the mortgage is less than your basis.** If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. The contract price equals the selling price minus the amount of the mortgage. This difference is all that you will directly collect from the buyer.

**Example.** You sell property with an adjusted basis to you of \$19,000, and you have selling expenses of \$1,000. The buyer assumes your existing mortgage of \$15,000 and, in addition, agrees to pay you a total of \$10,000—a cash down payment of \$2,000 and \$2,000 (plus 12% interest) in each of the next 4 years.

The selling price is \$25,000 (\$15,000 + \$10,000). The contract price is \$10,000 (\$25,000 - \$15,000 mortgage). Your gross profit is \$5,000 (\$25,000 - \$20,000 installment sale basis), and your gross profit percentage is 50% (\$5,000 divided by \$10,000). Therefore, you must report half of each \$2,000 payment you receive as gain from the sale. (You must also report as ordinary income all of the interest you receive.)

**If the mortgage is more than your basis.** If the buyer assumes a mortgage that is more than your installment sale basis in the property, you, in effect, recover your entire basis on the sale. You also receive something in addition. Therefore, the part of the mortgage that is more than your installment sale basis is treated as a payment you receive in the year of the sale. This is in addition to the other payments the buyer will make.

To figure the contract price, subtract the mortgage from the selling price. This is the total of the payments you will actually receive from the buyer. To this amount add back the "payment" you are considered to receive (the difference between the mortgage and your installment sale basis). This makes the contract price the same as your gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than your installment sale basis in the property, the gross profit percentage will always be 100%.

**Example.** The selling price for your property is \$9,000. The buyer will pay you \$3,000 (plus 12% interest) over the next 3 years, and also assumes an existing mortgage of \$6,000. Your adjusted basis in the property is \$4,400 and you have selling expenses of \$600, for a total installment sale basis of \$5,000. The part of the mortgage that is more than your installment sale basis is \$1,000 (\$6,000 - \$5,000). This amount is included in the contract price and is also treated as a payment you receive in the year of sale. The contract price is \$4,000 (\$9,000 - \$6,000 + \$1,000).

Your gross profit on the sale is also \$4,000 (\$9,000 - \$5,000). Therefore, your gross profit percentage is 100%. As the buyer pays you the \$3,000, you must report 100% of each payment as gain from the sale. You must also treat the \$1,000 difference between the mortgage and your installment sale basis as a payment, and report 100% of it as gain in the year of sale.

**Wraparound mortgages.** If your mortgage is not paid off or assumed by the buyer when you sell your property, your installment arrangement with the buyer may be known as a "wraparound mortgage." In a wraparound mortgage, the installment payments you receive are ordinarily large enough to allow you to continue to make your regular mortgage payments on the property. The installment sale "wraps around" the existing mortgage.

For tax purposes, a wraparound mortgage is treated as though the buyer had assumed your mortgage. It does not matter that you are still liable for the mortgage or that title to the property has not actually changed hands.

In the hands of the seller, the wraparound installment obligation has a basis equal to the seller's basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash and the fair market value of other nonqualifying property received in the year of sale. The amount of any indebtedness assumed or taken subject to by the buyer (other than the wrapped indebtedness) is treated as cash received by the seller in the year of sale. Therefore, except when there is not adequate stated interest as discussed later, the gross profit ratio for the wraparound installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

**Example 1.** In 1987, George sold to Henry, a house and land, which was encumbered by a first mortgage with a principal amount of \$50,000 and a second mortgage with a principal amount of \$40,000, for a selling price of \$200,000. George's basis in the property is \$70,000. Under the agreement between George and Henry, passage of title is deferred and Henry does not assume and purportedly does not take subject to either mortgage in the year of sale. Henry pays George \$20,000 in cash and issues a wraparound mortgage note with a principal amount of \$180,000 bearing adequate stated interest. Henry is deemed to have acquired the property subject to the first and second mortgages (wrapped indebtedness) totaling \$90,000. The contract price is \$130,000 (selling price of \$200,000 less \$70,000 mortgage within the seller's basis assumed or taken subject to). Gross profit is also \$130,000 (selling price of \$200,000 less \$70,000 basis). In the year of sale, the gross profit ratio is 100% (\$130,000/\$130,000). Payment in the year of sale is \$40,000 (\$20,000 cash received plus \$20,000 mortgage in excess of basis (\$90,000 - \$70,000)). Therefore, George recognizes \$40,000 gain in the year of sale (\$40,000 × 100%). In the hands of George the wraparound installment obligation has a basis of \$90,000, equal to George's basis in the property (\$70,000) increased by the gain recognized by George in the year of sale (\$40,000) reduced by the cash received by George in the year of sale (\$20,000). George's gross profit for the note is \$90,000 (\$180,000 face amount less \$90,000 basis in the note) and George's contract price for the note is its face amount of \$180,000. Therefore, the gross profit ratio for the note is 50% (\$90,000/\$180,000).

**Example 2.** Assume the same facts as in Example (1) except that under the terms of the agreement Henry assumes the \$50,000 first mortgage on the property. Henry does not assume and purportedly does not take subject to the \$40,000 second mortgage. The wraparound installment obligation issued by Henry to George has a face amount of \$130,000. The tax results in the year of sale to George are the same (\$40,000 payment received and gain recognized). In the hands of George, basis in the wraparound installment obligation is \$40,000 (\$70,000 basis in the property plus \$40,000 gain recognized in the year of sale

minus \$70,000 (\$20,000 cash received and \$50,000 treated as cash received as a result of Henry's assumption of the first mortgage)). George's gross profit for the note is \$90,000 (\$130,000 face amount of the wraparound installment obligation less \$40,000 basis in the note) and George's contract price for the note is its face value of \$130,000. Therefore, the gross profit ratio for the note is 69.23% (\$90,000/\$130,000).

**Mortgage cancelled.** If the buyer of your property is the person who holds the mortgage on it, your debt is not assumed. It is cancelled. You are considered to receive a payment equal to the outstanding amount of the cancelled debt.

**Example.** Mary Jones loaned you \$4,500 in 1983 in exchange for a note mortgaging a tract of land you owned. On April 4, 1987, she bought the land for \$7,000. At that time, \$3,000 remained outstanding on her loan to you. She agreed to forgive this \$3,000 debt and to pay you \$2,000 (plus interest) on August 1, 1987, and again on August 1, 1988. Mary did not assume an existing mortgage. She cancelled a debt you owed her. The effect is that you received a \$3,000 payment at the time of the sale.

**Debts.** If the buyer pays off any of your debts—such as a loan or back taxes—it may be considered a payment to you in the year of the sale.

If, instead of paying off the debt, the buyer assumes it as his or her own, only a part of it may have to be treated as a payment. Compare the amount of the debt to your installment sale basis in the property being sold. If the debt is less than your installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. (If the buyer assumes more than one debt, any part of the total that is more than your installment sale basis is considered a payment.) This follows the same rules discussed above under *Mortgage assumed*.

However, these rules apply only to two types of debts that the buyer assumes:

- 1) Those that you acquired in connection with your ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes, and
- 2) Those that you acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated the same as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of the sale.

**Payments of property.** If you receive property rather than money from the buyer, it is still considered a payment. (However, see *Like-Kind Exchanges*, later.) The value of the payment is the property's fair market value on the date you receive it.

**Fair market value** is the price at which the property would change hands between a buyer and a seller, neither being required to buy or sell, and both having reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its fair market value.

**Third-party notes.** If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on your installment sale, any payments you later receive on the note from the third party are not considered payments on your sale. If the fair market value of the note was less than its face value, a part of each payment you receive on it must be reported as ordinary income.

**Example.** You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$5,000, 12% note of a third party. The fair market value of the third-party note at the time of your sale was \$3,000. This amount, and not \$5,000, is a payment to you in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value (\$3,000 divided by \$5,000), 60% of each payment of principal you receive on this note is a return of capital. The remaining 40% is ordinary income. The interest you receive is reported in full as ordinary income.

**Bonds.** A bond or other evidence of indebtedness you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received a payment equal to the bond's fair market value.

**Guarantees.** If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered to be a payment.

**Deposits.** Deposits that you receive before the year of sale should be treated as payments in the year of sale if, under the contract, they become part of the down payment.

**Example.** Ten years ago you bought a lot for \$8,000. In the following year, you borrowed money to build a house, which you then lived in. The loan was secured by a 7% first mortgage on the property. The house cost \$26,950 to build, making your total cost \$34,950. Over the years, you spent another \$3,600 on permanent improvements to the house. Your adjusted basis in the property therefore came to \$38,550.

Last year you sold the house to Peter Jones for \$77,500, paying your real estate agent a commission of 6% (\$4,650) on the sale. Peter Jones paid you \$12,000 at the time of the sale, and he also:

- 1) Transferred to you, by endorsement, a short-term note of the Apex Company (fair market value \$5,500),
- 2) Assumed your outstanding mortgage (current balance \$18,000), and
- 3) Gave you his second mortgage note in the amount of \$42,000, payable in annual installments of \$3,000 (plus 12% interest), beginning January 1 of this year.

You figure your gross profit on the sale as follows:

Money received .....	\$12,000
Third-party note (fair market value) .....	5,500
Mortgage assumed (outstanding balance) .....	18,000
Installment note (face value) .....	42,000
Selling price .....	\$77,500
Minus: Adjusted basis in the property .....	\$38,550
Commission paid on sale .....	4,650
<b>Gross profit</b> .....	<b>\$34,300</b>

Because you are not going to replace your house by buying or building another one, you cannot postpone being taxed on any part of the gain. (However, if you are age 55 or older, you may still be able to exclude all of your gain from your income. See Publication 523 for details.)

The contract price is the total of all the payments you are scheduled to receive on the sale. It includes the money (\$12,000) and the fair market value of the third-party note (\$5,500) you received as down payment. It also includes the full face value of the buyer's installment note to you (\$42,000). Of the selling price, only the mortgage the buyer assumed is excluded. Since the assumed mortgage is less than your installment sale basis in the property, none of it is considered a payment to you.

Selling price.....	\$77,500
Minus: Assumed mortgage.....	18,000
Contract price	<u>\$59,500</u>

The percentage of each installment payment that you must report as profit is figured as follows:

$$\frac{\text{Gross profit, \$34,300}}{\text{Contract price, \$59,500}} = 57.65\%$$

Your gross profit percentage is 57.65%. Since you were paid a total of \$17,500 (\$12,000 + \$5,500), on the sale last year, you reported \$10,088.75 (57.65% of \$17,500) as your profit from the sale for the year. This year, your profit is \$1,729.50 (57.65% of \$3,000). Since the house was a capital asset and you owned it for more than 6 months, all your profit is long-term capital gain. Any interest you receive should be reported as ordinary income.

## Allocable Installment Indebtedness (Deemed Payment)

If you sell real property that is either (1) used in your trade or business or (2) held for rental income on the installment method and the selling price of the property is more than \$150,000, you may have to treat part of your business debts as a payment on the installment obligation you receive from the buyer.

The amount treated as a payment is referred as the *allocable installment indebtedness* and is a percentage of your outstanding annual indebtedness at the end of your tax year. The percentage to be used is determined by dividing the face amount of all your "applicable installment obligations" by the sum of the face amount of all outstanding installment obligations plus the adjusted bases of all other business and investment assets.

**Caution:** When this publication went to print Congress was considering legislation that would repeal the allocable installment indebtedness rules for nondealer installment obligations.

**Worksheet.** The following worksheet can be used to determine the allocable installment indebtedness (deemed payment):

1. The face amount of all outstanding applicable installment obligations.....
2. The face amount of all outstanding installment obligations.....
3. The adjusted bases of all other assets at the end of tax year.....
4. Add lines 2 and 3.....
5. Divide line 1 by line 4.....
6. Average quarterly or annual indebtedness.....
7. Multiply line 6 by line 5.....
8. Allocable installment indebtedness included as a payment in a prior tax year.....
9. Allocable installment indebtedness (deemed payment) for current tax year (subtract line 8 from line 7).....

The following paragraphs discuss in detail the lines of the above worksheet. This worksheet is similar to the worksheet found in the instructions to Form 6252.

**Face amount of outstanding applicable installment obligations (line 1).** The face amount of an obligation is the original face amount of an obligation decreased by any actual payments received on the obligation. For example, if an installment obligation was issued with an original face amount of \$1,000 and payments of \$400 were actually received on the obligation:

during the tax year of sale, the outstanding face amount at the end of the tax year would be \$600.

An *applicable installment obligation* includes any installment obligation (except as discussed next) that arises from the sale after August 16, 1986, of real property used in a taxpayer's trade or business or held for the production of rental income, provided the selling price is more than \$150,000.

An applicable installment obligation *does not include* any installment obligation arising from:

- 1) The sale of property used or produced in the trade or business of farming. For example, installment obligations arising from the sale of crops or livestock held for slaughter are not included as applicable installment obligations on line 1 of the worksheet.
- 2) The sale by an individual of personal use property, such as an obligation from the sale of a personal residence.

Farming is cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm. It includes handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated. It also includes the planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market.

A farm includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses, or other structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.

Personal use property is any property substantially all the use of which by an individual is not in connection with a trade or business or in the production of income. For example, an installment obligation arising from the sale of a parcel of undeveloped land that was held for investment only (and not for the production of rental income) is not an applicable installment obligation.

**Face amount of all outstanding installment obligations (line 2).** This includes the face amount (original face amount less any actual payments received) of the installment obligations included on line 1 plus all other outstanding installment obligations, except installment obligations that arise from the sale of personal use property. Although the face amount of obligations from the sale of personal business property (such as business machinery), undeveloped land held for investment, and farm property is not included in outstanding applicable installment obligations on line 1, it would be included as part of all outstanding installment obligations on line 2.

**Adjusted bases of all other assets (line 3).** This includes the taxpayer's bases of all assets, except personal use assets, held at the end of the tax year. For property not depreciated under the modified accelerated cost recovery system (MACRS), you may choose to compute the adjusted bases of your assets for this purpose by using the straight line method of depreciation. For property depreciated under MACRS, you may compute the adjusted bases of your assets under the alternate MACRS. See Publication 534.

If you deducted all or part of the cost of an asset under section 179, the amount of the section 179 deduction is treated as if it were allowed as a deduction ratably over 5 tax years beginning with the tax year for which the section 179 deduction was claimed.

**Average quarterly or annual indebtedness (line 6).** The calculation of your indebtedness is generally made on a quarterly basis and the average of the four quarters is used for the purposes of the worksheet. To calculate your average quarterly indebtedness, add the amounts of all indebtedness outstanding at the end of each of the four quarters of your tax year. Divide this sum by four to get your average quarterly indebtedness. Each quarter should include all indebtedness outstanding at the end of the quarter. However, if you only have applicable installment obligations that arose from the sale of real property used in your trade or business or held for the production of rental income, your indebtedness is computed as of the close of the tax year instead of at the close of each quarter.

In making this calculation, all indebtedness is taken into account including, but not limited to, accounts payable, accrued expenses or liabilities, and any other amounts more commonly considered as indebtedness, such as loans from banks and debts in connection with the purchase of property. Do not include any debt that is substantially secured by personal use property, such as a mortgage on your personal residence or a loan on your personal automobile.

**Allocable installment indebtedness included as a payment in a prior tax year (line 8).** This line does not apply to calendar year taxpayers for 1987. It represents the allocable installment indebtedness treated as a deemed payment in prior tax years. In later tax years as actual payments are received on the installment sale, no gain is recognized on the applicable installment obligation until the payments exceed the amount of the allocable installment indebtedness (deemed payment) of the obligation. On the receipt of actual payments, the deemed payment amount attributable to the obligation for which the payment is received is reduced (but not below zero) by the amount of the payment. Any payments in excess of the deemed payment amount are reported under the ordinary rules for the installment method.

**Example.** For 1987 you report a deemed payment in the amount of \$10,000 on an installment sale of business real property. In 1988 you receive an actual payment of \$4,000 on the 1987 sale. The \$4,000 payment will not be taken into account for installment sale purposes in 1988. In determining the deemed payment, if any, for 1988, the \$10,000 will be reduced by the actual payment of \$4,000 and the amount on line 8 of the worksheet for 1988 will be \$6,000. The face amount of the obligation will also be reduced by the \$4,000 payment.

**Allocable installment obligation (deemed payment) (line 9).** This is the amount of the allocable installment indebtedness for the current year. This amount is reported on Line 18 of Form 6252. If there is more than one installment sale involved for a tax year, the deemed payment for the tax year must be allocated based on the outstanding face amount of the applicable installment obligations arising in the tax year.

**Example.** On July 1, 1987, John Ship sells a rental house for \$220,000. The buyer assumes the \$20,000 mortgage on the property. John receives a down payment of \$10,000 and the buyer's note for \$190,000. The first payment on the note is due July 1, 1988. John uses the calendar year as his tax year. John's only business or investment asset is a second rental house which has an adjusted basis of \$60,000 figured using the straight line method of depreciation. His only indebtedness other than personal loans is a mortgage of \$50,000 on the

second rental property. He has no other outstanding installment obligations.

Using the worksheet John figures his deemed payment for 1987 as follows:

1. The face amount of all outstanding applicable installment obligations.....	\$ 100,000
2. The face amount of all outstanding installment obligations.....	\$ 100,000
3. The adjusted bases of all other assets at the end of tax year.....	80,000
4. Add lines 2 and 3.....	250,000
5. Divide line 1 by line 4.....	76%
6. Average quarterly or annual indebtedness.....	\$ 50,000
7. Multiply line 6 by line 5.....	\$ 38,000
8. Allocable installment indebtedness included as a payment in a prior tax year.....	-0-
9. Allocable installment indebtedness (deemed payment) for current tax year (subtract line 8 from line 7).....	\$ 38,000

John fills out Part 1 of Form 6252 as for any other installment sale and determines the gross profit percentage on the sale (line 15 of the form). On line 17 of the form he includes the \$10,000 down payment received in 1987 and on line 18 he includes the deemed payment of \$38,000. He enters the total of \$48,000 on line 19 and applies the gross profit percentage from line 15 to determine the taxable part of the installment sale on line 21 of the form.

## Escrow Accounts

In some cases, the sales agreement, or a later agreement, may call for the buyer to establish an irrevocable escrow account out of which the remaining installment payments (including interest) are to be made. Generally, these sales may not be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

**Example.** You sell property for \$10,000. The sales agreement calls for a down payment of \$1,000 and payment of \$1,500 in each of the next 6 years to be made from an irrevocable escrow account containing the balance of the purchase price plus interest. You may not report the sale on the installment method because the full purchase price is considered to have been received in the year of sale. You must report all your gain in the year of sale.

**Escrow in a later year.** If you make an installment sale and in a later year an irrevocable escrow account is established to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation. Therefore, you cannot use the installment method to report any payments you receive from the escrow account. This is because a disposition has occurred. See *Dispositions of Installment Obligations*, later.

**Substantial restriction.** If an escrow arrangement imposes a substantial restriction on your right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. In order for an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer.

**Example.** You sell your business including all of its assets for \$50,000. The sales agreement provides for a down payment of \$8,000 and payments of \$7,000 in each of the next 6 years to be made from an irrevocable escrow account. The sales agreement also provides that you, the seller, will not enter a competing business for a period of 6 years. If at any time during this period you enter

a competing business, you will forfeit all rights to the amounts then held in escrow. In this situation, the escrow arrangement imposes a substantial restriction and you can use the installment method.

## Installment Sales to Related Persons

Two special rules apply to installment sales between related persons. Test your sale against rule 1 first. If rule 1 does not apply, test your sale against rule 2.

- 1) Depreciable property.** If you sell depreciable property to a related person, you cannot use the installment method to report your gain from the sale. All of the gain must be reported in the year of sale.
- 2) Sale and resale.** If you make an installment sale to a related person who then sells or otherwise disposes of the property, you may have to accelerate reporting your gain on the first sale. The second sale can, in effect, cancel the installment method of reporting for the first sale.

The definition of a "related person" is not the same for both rules. Other conditions differ as well. Each rule is explained below.

**Rule 1: Sale of depreciable property.** If you sell depreciable property to certain related persons, you may not report the sale using the installment method. Instead, all payments to be received are considered to be received in the year of sale. Depreciable property for this rule is any property that can be depreciated by the person or entity to whom you transfer it.

**For sales after October 22, 1986,** payments to be received include the total amount of all payments which are not contingent and the fair market value of any payment that is contingent as to amount.

For any payments which are contingent as to amount but for which the fair market value is not reasonably ascertainable, the basis is recovered ratably and the purchaser may not increase the basis of any property acquired in the sale by any amount before the time the seller includes the amount in income.

**Related persons.** There are two sets of related party rules, one for sales before October 23, 1986, and another for sales after October 22, 1986.

**Sales before October 23, 1986.** The term "related persons" for this purpose includes:

- 1) You and an 80% owned entity,
- 2) Two 80% owned entities, and
- 3) You and any trust in which you or your spouse is a beneficiary unless your interest in the trust is a remote contingent interest (described later).

An 80% owned entity is a partnership in which you own, directly or indirectly, an 80% or more interest in its capital or profits, or a corporation in which you own, directly or indirectly, 80% or more in value of the outstanding stock.

Use the following rules to determine if you own 80% or more of a partnership's capital or profits, or 80% or more of the value of a corporation's outstanding stock.

- 1) Stock or an interest owned directly or indirectly by or for your spouse is considered owned by you.
- 2) Stock or an interest owned directly or indirectly by or for a partnership or estate in which you are a partner or beneficiary, by a trust (except for certain employees' trusts) of which you are treated as owner or are a beneficiary, or by a corporation in which you are a shareholder is considered owned by you in proportion to your ownership interest in the partnership, estate, trust, or corporation.

- 3) Options to get stock, or options to get such options, make you the indirect owner of the stock on which you hold the option.
- 4) Stock or an interest considered owned by a person under rules (1), (2), and (3) for applying those rules, is treated as actually owned by that person. Stock that may be considered owned by a person under either rule (1) or rule (3) is considered owned under rule (3).

**Remote contingent interest.** A beneficiary's contingent interest in a trust is considered remote if, under the maximum exercise of discretion by the trustee for the beneficiary, the value of the interest computed actuarially, is 5% or less of the value of the trust property.

**Sales after October 22, 1986.** The term "related persons" for this purpose includes:

- 1) You and a controlled entity,
- 2) You and any trust in which you or your spouse is a beneficiary unless your interest in the trust is a remote contingent interest (described earlier),
- 3) Two corporations that are members of the same controlled group,
- 4) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
- 5) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation, and
- 6) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

A controlled entity is a partnership in which you own, directly or indirectly, more than 50% of interest in its capital or profits, or a corporation in which you own, directly or indirectly, more than 50% of the value of the outstanding stock.

**Constructive ownership of stock.** To determine whether an individual constructively owns (indirectly owns) any of the outstanding stock of a corporation, apply the following rules:

- 1) Stock owned by or for a corporation, partnership, estate, or trust is constructively owned proportionately by or for its shareholders, partners, or beneficiaries, or
- 2) An individual constructively owns the stock owned by or for the individual's spouse, brothers and sisters (whether by the whole or half blood), lineal descendants, and ancestors.

For purposes of applying rules (1) and (2), a person is considered to actually own stock that he or she constructively owns by applying rule (1). But if an individual constructively owns stock by applying rule (2), he or she does not own the stock for the purpose of again applying rule (2) to make another person the constructive owner of the same stock.

Sales after October 22, 1986, made under a binding contract in effect on August 14, 1986, and at all times thereafter, are treated as sales before October 23, 1986.

**Exceptions.** Rule 1 will not apply to your sale if no significant tax deferral benefits will be derived from the sale or you can show, to the satisfaction of the Internal Revenue Service, that avoidance of federal income taxes was not one of the principal purposes of your sale.

**Rule 2: Sale and resale.** Generally, if you make a first disposition of property under the installment method to a related person who then makes a second disposition, within 2 years of the first disposition, and before all payments are made under the first disposition, a special rule may come into effect. Under this rule, part or all of the amount

the related person realizes as a result of the second disposition is treated by you as if you had received it from the first disposition at the time of the second disposition.

**First disposition.** The term "first disposition" generally means a sale or exchange you make to a related person under the installment method. However, if a corporation reacquires its own stock (treasury stock), this is not treated as a first disposition.

**Second disposition.** The term "second disposition" generally means a disposition of the property by the related person. The term includes a sale, exchange, gift, or cancellation of the installment note. If the property is transferred after the death of the person making the first disposition or the related person's death, whichever is earlier, the transfer and any later transfer is not a second disposition. This exception will apply after the death of either spouse when the spouses hold their interest in the installment obligation or the purchased property as community property or as equal undivided joint interests. An involuntary exchange is not a second disposition if you made the first disposition before you had any knowledge that there was a possibility that the property would be subject to an involuntary exchange. Also see *Exception if tax avoidance is not a principal purpose*, later.

**Related person.** There are two sets of related party rules, one for any sale under rule 2 before October 23, 1986, and another which applies to any sale under rule 2 after October 22, 1986.

**Sales before October 23, 1986.** For the purpose of a second disposition, the term "related person" includes:

- 1) Your spouse, children (including a legally adopted child), grandchildren, or parents.
- 2) A partnership in which you are a partner.
- 3) An estate of which you are a beneficiary.
- 4) A trust which you are a beneficiary of or are treated as an owner of.
- 5) A corporation (other than an S corporation) in which you own 50% or more in value of the stock.
- 6) An S corporation of which you are a shareholder.

**Sales after October 22, 1986.** The term "related person" for sales after October 22, 1986, includes the same relationships just discussed for sales before October 23, 1986, plus the following additional relationships:

- 1) An individual and a member of his or her immediate family, including a spouse, brother, sister, half-brother, half-sister, or any ancestor or lineal descendant.
- 2) A corporation and an individual who owns directly or indirectly more than 50% of the value of the outstanding stock of that corporation.
- 3) Two corporations that are members of the same controlled group.
- 4) A fiduciary of a trust and a corporation, if more than 50% of the value of the outstanding stock is owned directly or indirectly by or for the trust or by or for the grantor of the trust.
- 5) The grantor and fiduciary of any trust, and the fiduciary and beneficiary of any trust.
- 6) The fiduciaries of two different trusts, and the fiduciaries and beneficiaries of two different trusts, if the same person is the grantor of both trusts.
- 7) Certain education and charitable organizations and any person (if an individual, including the members of the individual's family) who directly or indirectly controls the organization.
- 8) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.

- 9) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 10) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

The constructive ownership rules discussed under rule 1 are also applicable to rule 2.

**Limit on amount treated as received.** There is a limit on the amount you are considered to have received in a tax year as a result of a second disposition by a related person. To figure this limit:

- 1) Compare the total contract price of the first disposition with the total amount realized from the second disposition. Use the smaller amount.
- 2) To the sum of all the payments you received by the end of the tax year from the first disposition, add the sum of all amounts that you had to treat as if you had received them in earlier tax years as the result of a second disposition.
- 3) Your limit is the amount in (1) minus the amount in (2). If this is zero or less, you do not treat any amounts realized from a second disposition by a related person as if they were received from a first disposition.

The total amount realized from a second disposition will be reduced by the amount attributable to any improvements made by the related person while the related person held the property.

**Two-year cutoff for property other than marketable securities.** Except for marketable securities, the rules that apply to second dispositions by related persons apply only if the date of the second disposition is not more than 2 years after the date of the first disposition. This 2-year period will be extended for any property in which the related person's risk of loss is substantially reduced by:

- 1) The holding of a "put" on the property (or similar property),
- 2) Another person having the right to acquire the property, or
- 3) A short sale or any other transaction which has the effect of substantially reducing the risk of loss.

A "put" is the right to sell property at a certain price at any time before a specified future date.

A typical closely held corporation's shareholder agreement is not considered to substantially reduce the risk of loss for this purpose. Also, the holding of an option on the property is not considered to substantially reduce the risk of loss if the option purchase price is to be determined by the fair market value of the property at the time the option is exercised.

**Marketable securities.** In the case of marketable securities, there is no 2-year cut off. The related person rules will apply until the person making the first disposition receives all the payments under the first installment sale.

The term "marketable securities" means any security for which, as of the date of disposition, there was an established securities market. This includes securities that are listed on the New York Stock Exchange, and the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis. This includes:

- 1) Foreign securities listed on a recognized foreign national or regional exchange,
- 2) Securities regularly traded in a national or regional over-the-counter market, for which published quotations are available,
- 3) Securities locally traded for which quotations can be readily obtained from established brokerage firms,

- 4) Units in a common trust fund, and
- 5) Mutual funds for which redemption prices are published.

**If the second disposition is not a sale or exchange,** the amount realized is equal to the fair market value of the property disposed of at the time of the second disposition.

**Later payments treated as amounts already paid.** If you have to recognize gain because of a second disposition, any later payments you receive are tax-free until they total more than the amount realized from the second disposition which caused you to recognize gain. Therefore you exclude later payments to the extent of the amount treated as received due to the second disposition when you figure your income from the installment sale.

**Example.** In 1986 Harvey Green sold farmland to his son Bob for \$500,000, which was to be paid in five equal payments over 5 years, plus adequate stated interest on the balance due. Harvey installment sale basis for the farmland was \$250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50% (his gross profit of \$250,000 divided by the contract price of \$500,000). Harvey received \$100,000 in 1986 and included in his income for that year \$50,000 ( $\$100,000 \times .50$ ). Bob made no improvements to the property and in 1987 sold it to the Alfalfa Corporation for \$600,000. This is the amount realized from the second disposition. Harvey figures his installment sale income for 1987 as follows:

Amount realized on property sold by Bob or contract price, whichever is smaller .....	\$500,000
Minus: Sum of payments from Bob in 1986 and 1987 .....	200,000
Amount treated as payment because of second disposition .....	\$300,000
Add: Payment from Bob in 1987 .....	100,000
Total payment received and treated as if received for 1987 .....	\$400,000
Multiply by gross profit percentage .....	.50
Installment sale income for 1987 .....	<u>\$200,000</u>

Harvey will not include in his income from installment sales any principal payments he receives on the installment obligation for 1988, 1989, and 1990 because he has already reported the entire amount of the payments from the first disposition of \$500,000 (\$100,000 in 1986 and \$400,000 in 1987).

**Entire gain not recognized on second disposition.** If, on the second disposition, you still have not recognized the entire gain from the first disposition, then you will recognize gain on later payments at the point that the sum of all payments received are more than the sum of the prior payments already received on which you recognized gain plus any amount you were considered to have received as the result of the second disposition on which you recognized gain.

**Example.** The facts are the same as in the previous example except that Bob sells the property for only \$400,000. The gain for 1987 is figured as follows:

Amount realized on second disposition or contract price on first disposition, whichever is less .....	\$400,000
Minus: Sum of payments from 1986 and 1987 .....	200,000
Amount treated as payment because of second disposition in 1987 .....	\$200,000
Add: Payment from Bob in 1987 .....	100,000
Total payments received and treated as received in 1987 .....	\$300,000
Multiply by gross profit percentage .....	.50
Installment sale income for 1987 .....	<u>\$150,000</u>

In 1988 Harvey receives a payment of \$100,000 from Bob which is not taxed. It is considered to be recovered tax free, because Harvey has already reported the payment and gain in 1987 as the result of the \$200,000 which he treated as a payment even though he did not actually receive that payment. Harvey would apply the \$100,000 payment in 1988 against this amount. He is also not taxed on the payment he receives in 1989 and he would apply the payment against the \$200,000 amount he treated as a payment in 1987. In 1990 Harvey receives the final \$100,000 payment. He would figure the amount of gain he must recognize in 1990 from the installment sale as follows:

Sum of payments actually received as of the end of 1990 from the first disposition.....	\$500,000
Minus the sum of:	
Payment from 1986.....	\$100,000
Payment from 1987.....	100,000
Amount treated as payment in 1987.....	200,000
Total of amounts on which gain was previously recognized.....	400,000
Amount of payment on which gain is to be recognized for 1990.....	\$100,000
Multiply by gross profit percentage...	.50
Installment sale income for 1990	<u>\$ 50,000</u>

**Exception if tax avoidance is not a principal purpose.** These rules do not apply to a second disposition, and any later transfer, if you can show, to the satisfaction of the Internal Revenue Service, that neither the first disposition (to the related person) nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, the second disposition will qualify under the nontax avoidance exception in situations when it is involuntary, such as a creditor of the related person foreclosing on the property or the related person declaring bankruptcy.

The nontax avoidance exception will also apply to a second disposition that is also an installment sale if the terms of payment under the installment resale are substantially equal to or longer than those for the first installment sale. However, the exception would not apply if the resale terms would permit significant deferral of recognition of gain from the first sale, for example, if amounts from the resale are being collected sooner.

**Extending the period for assessing tax.** If you make an installment sale to a related person, the period for assessing any tax you owe as the result of a second disposition does not expire until the day which is 2 years after the day you first notify the Internal Revenue Service that a second disposition, to which the rules for sales to related persons may apply, took place. To notify the Internal Revenue Service that a second disposition took place, answer questions G and H of Form 6252. Attach Form 6252 to your tax return for the tax year in which the second disposition took place.

## Like-Kind Exchanges

If you trade your property for other property of the same kind, you can often postpone reporting part of your gain. These trades are known as "like-kind exchanges." The property you receive in a like-kind exchange is treated as if it were a continuation of the property you give up.

In a like-kind exchange, you do not have to report any part of your gain that comes from the like-kind property you receive. But if you also receive money or other property, you must report as income the part of your gain that comes from these sources.

**Installment payments.** If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply:

- 1) The contract price does not include the fair market value of the like-kind property you receive in the trade.
- 2) The gross profit is reduced by any gain on the trade that can be postponed.
- 3) Like-kind property received in the trade is not considered a payment on the installment obligation. The property is only considered a payment on the sale for the purpose of determining whether the sale qualifies as an installment sale.

**Example.** In 1987 George Brown trades personal property with an installment sale basis of \$400,000 for like-kind property having a fair market value of \$200,000. He also receives an installment note for \$800,000 in the trade. Under the terms of the note, he is to receive \$100,000 (plus interest) in 1988 and the balance of \$700,000 (plus interest) in 1989.

George's gross profit is \$600,000 (selling price of \$1,000,000 minus \$400,000 installment sale basis), and the contract price is \$800,000 (\$1,000,000 minus the fair market value of the like-kind property received, \$200,000). The gross profit percentage is 75% (\$600,000 divided by \$800,000). George reports no gain in 1987 because the like-kind property he receives is not treated as a payment for the purpose of figuring gain. He reports \$75,000 gain for 1988 (75% of \$100,000) and \$525,000 gain for 1989 (75% of \$700,000).

For more information on like-kind exchanges, see Publication 544.

## Contingent Sales

For installment sales, a contingent sale is a sale for which the total selling price cannot be determined by the end of the tax year in which the sale took place.

If the selling price cannot be determined by the end of the tax year, the contract price and the gross profit percentage also cannot be determined (using the same rules that apply to an installment sale that has a fixed selling price). This happens, for example, if you sell your business and the selling price includes a percentage of its profits in future years.

For rules permitting use of the installment method to report a contingent sale and for contingent sales with unstated interest, see the regulations under section 453 of the Internal Revenue Code.

## Single Sale of Several Assets

If you sell two or more assets in a single sale to one buyer and there is more than one class of asset, you must allocate all payments among the different classes of assets in proportion to their respective selling prices.

The arm's-length allocation of the selling price and of the payments received in the year of sale will be acceptable if substantiated by all the facts and circumstances. However, allocation of the selling price and of the payments received in the year of sale to the assets sold not based on the respective selling prices is not acceptable.

If any asset is encumbered by debts that are assumed by the buyer, or the asset is taken subject to a debt and an arm's-length allocation of the down payment or other payments to be received was not made, the down payment and the payments received from installment obligations should be allocated on the basis of the proportionate net fair market values of the assets. The net fair market value of any asset is its fair market value reduced by any debt on the asset that the buyer assumes or takes the asset subject to.

**Allocation of selling price and down payment.** In determining how you report on the installment method any of the gain on the sale of several

assets when you sell your business, you must allocate the selling price and the payments you received in the year of sale to:

- 1) Inventory assets, the gain on which you may not report on the installment method,
- 2) Assets sold at a loss, which you must report in full in the year of sale,
- 3) Depreciable assets sold at a gain, part or all of which you must report in the year of sale because of depreciation recapture income,
- 4) Real property, any gain on which you can report on the installment method, and
- 5) Personal property, any gain on which you can report on the installment method.

Since some gains reported on the installment method may be ordinary income and others may be capital gains, you may be required to make separate computations to report the gain properly for each asset.

**Example.** The total selling price of a business in an arm's-length transaction is \$350,000 and the down payment is \$100,000. There are no other payments in the year of sale. The selling price of the inventory included in the sale is 40% of the total selling price, or \$140,000, leaving \$210,000 for noninventory property.

In the absence of a bona fide allocation of the down payment, it will be ratably allocated to the inventory and noninventory property. Forty percent of the down payment (\$40,000) is allocable to inventory property and 60% (\$60,000) to noninventory property. Gain from the sale of the noninventory property, except any part allocable to depreciation recapture income, can be reported on the installment method.

**A sale of separate and unrelated assets of the same type under a single contract** is reported as one transaction for the installment method. However, if an asset is sold at a loss, the disposition of that asset may not be reported on the installment method but must be reported separately. The remaining assets sold at a gain are reported together.

**Example.** You sold three separate and unrelated parcels of real property, A, B, and C, under a single contract calling for a total selling price of \$130,000. The total selling price of \$130,000 consisted of a cash payment of \$20,000, the buyer's assumption of a \$30,000 mortgage on parcel B, and an installment obligation of \$80,000 payable in eight installments, plus interest at 12% a year.

Your installment sale basis for each parcel was \$15,000. Thus, your net gain was \$85,000 (\$130,000 minus \$45,000). You report the gain on the installment method.

The sales contract did not allocate the selling price or the cash payment received in the year of sale among the individual parcels. The fair market values of parcel A, B, and C were \$60,000, \$60,000, and \$10,000, respectively. Since the installment sale basis for parcel C was more than its fair market value, it was sold at a loss and it must be treated separately.

You must allocate the total selling price and the amounts received in the year of sale between parcel C, sold at a loss, and the remaining parcels.

The total selling price of \$130,000 is allocated \$120,000 for parcels A and B together and \$10,000 for parcel C. The cash payment of \$20,000 received in the year of sale and the note receivable should be allocated on the basis of the proportionate net fair market value. The net fair market value is the fair market value minus any debt assumed or which the property is taken subject to. The allocation is as follows:

	Parcels A and B	Parcel C
Net fair market value		
Fair market value	\$120,000	\$10,000
Minus: Mortgage assumed	30,000	-0-

Net fair market value.....	\$ 90,000	\$10,000
<b>Proportionate net fair market value</b>		
Percentage of total.....	90%	10%
<b>Payments in year of sale</b>		
\$20,000 × 90% = .....	\$ 18,000	
\$20,000 × 10% = .....		\$ 2,000
Excess of mortgage on parcel B over its installment sale basis .....	15,000	
<b>Allocation of payments received in year of sale</b>		
	\$ 33,000	\$ 2,000

The sale of parcel C may not be reported on the installment method because the sale results in a loss. This loss of \$5,000 (\$10,000 selling price minus \$15,000 installment sale basis) is reported in the year of sale. However, if parcel C was held for personal use, the loss is not deductible.

The installment obligation of \$80,000 is allocated to the property sold based on the proportionate net fair market value. Ninety percent of each payment received is from parcels A and B, and 10% of each payment is a return of capital from parcel C. If any payments on the obligation are received in the year of sale, they are included with the other payments received in the year of sale.

## Installment Sale Example

The installment sale of an entire business operated as a sole proprietorship for one overall price under a single contract is not the sale of a single asset. The sale generally includes the sale of real and personal property that may be reported on the installment method, and inventory items that are not reported on the installment method. The sale of depreciable property cannot be reported on the installment method to the extent the gain is reported in the year of sale because it is depreciation recapture income. Assets sold at a loss are not reported on the installment method. The selling price must be broken down into separate amounts for each class of asset.

The tax treatment of the gain or loss on the sale of each class of asset is determined by its classification as capital asset, property used in the business, or inventory and, for capital assets and property used in the business, by the length of time held. Therefore, separate computations may be required to determine the gain or loss for each asset sold.

**Example.** On January 2, 1987, you sold the machine shop you had operated since 1979. You received a \$50,000 down payment and the buyer's note for \$120,000. The note payments are \$15,000 each, plus 12% interest, due every July 1 and January 1. In addition, the buyer assumed an outstanding \$50,000 mortgage on machine A, but the mortgage was not more than your installment sale basis in the machine. The total selling price is \$220,000. Your selling expenses are \$11,000. You have no outstanding business or investment indebtedness at the end of your tax year; therefore, you have no allocable installment indebtedness as discussed earlier.

Of the \$220,000 total selling price, \$10,000 is for assets included in inventory. Because gain on the sale of inventory items cannot be reported on the installment method, the selling price for your installment sale is \$210,000 (\$220,000 - \$10,000). The sales contract specifies that the inventory items and the truck are to be paid for out of the \$50,000 down payment, so the down payment for the installment sale is \$32,839 (\$50,000 - (\$10,000 + \$7,161)). The \$7,161 is the selling price of the truck. The selling expenses of \$11,000 are divided among all the assets sold, including inventory.

The adjusted basis and depreciation claimed on each asset sold are as follows:

Asset	Depreciation Claimed	Adjusted Basis
Land.....	—	\$15,000
Building.....	\$ 8,000	37,000
Machine A .....	20,800	70,200
Truck.....	8,820	5,180
Machine B .....	9,412	25,000

The truck and machine B are 3-year and 5-year recovery property and were depreciated under the accelerated cost recovery system (ACRS). No depreciation is allowed in the year of sale for 3-year and 5-year recovery property under ACRS. (See Publication 534, *Depreciation*.) A \$5,000 section 179 deduction was claimed on machine B. The building and machine A were depreciated on the straight line method.

The assets included in the sale, their selling prices based on their respective values, the selling expense allocated to each asset, the adjusted basis and the gain for each asset are shown in the following chart.

	Selling price	Selling expense	Adjusted basis	Gain
Land.....	\$ 18,522	\$ 926	\$ 15,000	\$ 2,596
Building.....	49,413	2,471	37,000	9,942
Machine A .....	97,839	4,892	70,200	22,747
Truck.....	7,161	358	5,180	1,623
Machine B .....	37,065	1,853	25,000	10,212
	<u>\$210,000</u>	<u>\$ 10,500</u>	<u>\$152,380</u>	<u>\$47,120</u>

Your selling expense for each asset is 5% of the asset's selling price (\$11,000 selling expense divided by \$220,000 total selling price).

The building which was acquired in 1979, the year the business began, is section 1250 property. There is no depreciation recapture income because the building was depreciated using the straight line method. Machine A is section 1245 property acquired in 1980. All the depreciation of \$20,800 on machine A is depreciation recapture income because it is less than the gain on the machine. The remaining gain of \$1,947 can be reported on the installment method. Both the truck and machine B, which were acquired in July 1985, and September 1986, respectively, are section 1245 recovery property. You claimed a lower investment credit on the truck, instead of a basis reduction. See Publication 572, *General Business Credit*, for a discussion of the investment credit recapture. Since the gain on the truck of \$1,623 is less than the depreciation claimed (\$8,820) on it, the total gain is depreciation recapture income. The gain of \$10,212 on machine B is more than the depreciation claimed (\$9,412). Therefore, the depreciation recapture income for machine B is \$9,412 and the remaining gain of \$800 can be reported on the installment method. See Publication 544 for a discussion of section 1245 and section 1250 property.

The total recapture income reported in Part II of Form 4797 is \$31,835. This is made up of \$20,800 on machine A, \$1,623 on the truck, and \$9,412 on machine B. The gain on the truck is reported in full. Therefore, the truck is not included in the installment sale computation. Also, the part of the gains reported as recapture income on machines A and B (\$20,800 and \$9,412) is added to the installment sale basis of the appropriate machine when making the installment sale computations.

Of the \$220,000 total selling price, \$10,000 is for inventory assets that can not be reported on the installment method. The \$7,161 selling price of the truck is also removed from the total selling price because the gain on the truck is reported in the year of sale. The selling price for the installment sale is \$202,839.

The assets included in the installment sale, their selling price, and their installment sale basis are shown in the following chart.

	Selling price	Installment sale basis
Land.....	\$ 18,522	\$ 15,000
Building.....	49,413	39,471
Machine A .....	97,839	95,892
Machine B .....	37,065	36,265
Total	<u>\$202,839</u>	<u>\$187,554</u>

Since the ordinary income part of the gain on machine A is reported in the year of sale, the remaining \$1,947 gain on machine A and the gain on land and building will be reported as section 179 gain. Since the holding period of machine B is less than 6 months, all of the \$800 gain will be reported as ordinary income.

The contract price is \$152,839 (\$202,839 - \$50,000 (the mortgage assumed)). The gross profit percentage (gross profit divided by the contract price) for the assets are figured as follows:

	Percent
Land—\$2,596 divided by \$152,839.....	1.7%
Building—\$9,942 divided by \$152,839.....	6.5%
Machine A—\$1,947 divided by \$152,839.....	1.3%
Machine B—\$800 divided by \$152,839.....	0.5%
Total	<u>10.0%</u>

Your Installment Income for 1987 for each asset is the gross profit percentage for that asset times the total amount received in 1987 on the installment sale. The sales contract specifies the inventory items and the truck are to be paid out of the \$50,000 down payment, therefore, the down payment is reduced by the \$10,000 selling price of the inventory. The \$7,161 selling price of the truck is also subtracted from the down payment. The truck sale does not qualify as an installment sale because all the gain is reported in the year of sale. The remainder of the down payment of \$32,839 (\$50,000 - (\$10,000 + \$7,161)) is for the installment sale. The total amount received in 1987 on the installment sale is the \$32,839 down payment. The first payment on the note is not due until January 1, 1988.

	Inc
Land—1.6985% of \$32,839.....	\$ 558
Building—6.5049% of \$32,839.....	2,138
Machine A—1.2739% of \$32,839.....	418
Machine B—0.5234% of \$32,839.....	172
Total Installment Income for 1987	<u>\$3,286</u>

**Reporting the installment sale.** The installment sale must be reported on Form 6252. The amounts from Form 6252 are then reported on Form 4797 and Schedule D (Form 1040). The computations shown in this example would be included in schedules, as needed, and attached to Form 6252. See the Form 6252 instructions for information on how to report the gain from Form 6252 on Form 4797 and on Schedule D.

**Figure Installment Income for years after 1** by applying the same gross profit percentages to the payments you receive on the buyer's note you collect \$30,000 during the year, you will realize income for that year as follows:

	Inc
Land—1.6985% of \$30,000.....	\$ 509
Building—6.5049% of \$30,000.....	1,951
Machine A—1.2739% of \$30,000.....	382
Machine B—0.5234% of \$30,000.....	157
Total Installment Income	<u>\$3,000</u>

Treat the gain you realize in each year on assets you used in your business and held more than 6 months and on assets you used in business but held 6 months or less, the same as you treated the gain you realized last year on the same class of asset. In some years you may t

a gain on assets you used in business and held for more than 6 months as capital gain and, in other cases, as ordinary gain, since you must make a separate comparison of certain gains and losses for each year you realize income from payments on the buyer's note to determine whether they are ordinary or capital gains and losses. The interest received with each payment is included in full as ordinary income.

**Summary.** The installment income (rounded to the nearest dollar) from the sale of the machine shop is reported as follows:

Selling price.....	\$202,839
Minus: installment sale basis, as adjusted.....	187,554
Gross profit	<u>\$ 15,285</u>
Gain reported in 1987, year of sale.....	\$ 3,284
Gain reported in 1988, \$30,000 × 10.0007%.....	3,000
Gain reported in 1989, \$30,000 × 10.0007%.....	3,000
Gain reported in 1990, \$30,000 × 10.0007%.....	3,000
Gain reported in 1991, \$30,000 × 10.0007%.....	3,031
Gross profit	<u>\$ 15,285</u>

**Inventory.** If inventory items are included in an installment sale, you may have an agreement with the buyer concerning which payments are for inventory and which are for the other assets being sold. If you do not have an agreement, a part of each payment must be allocated to inventory, just as a part of each payment is allocated to every other asset that is sold.

However, gain on the sale of inventory items cannot be reported on the installment method. All of your gain on their sale must be reported as income in the year of sale, even if you are to be repaid in later years.

The amount you receive (or will receive) on the sale of inventory items is reported as ordinary business income on Schedule C (Form 1040). Your basis in the items is used to figure the cost of goods sold, and the part of the selling expenses allocated to inventory is deducted as an ordinary business expense.

**Notes received.** If inventory items are included in an installment sale, and if the fair market value of the buyer's notes is less than their face value at the time you receive them, you figure gain on the inventory items on the fair market value of the notes rather than on their face value. This is true even though you report gains on other items in the sale on the installment method and figure those gains on the basis of the face value of the notes. The part of the note payments you receive for assets included in inventory is treated the same as the note payments when you elect out. See *Fair market value under Electing Out*, next.

## Electing Out

You can choose not to have the installment sale rules apply to your sale. If you make this choice, you must report your entire gain from the sale on your return for the year of sale, even though you will not be paid all of the selling price until later.

**Selling price.** To figure the selling price under this method, you must figure the buyer's installment obligation to you at its fair market value. Notes, mortgages, and land contracts are examples of obligations that must be included at fair market value in figuring the selling price. If you do not elect out, these obligations would be included at their full face value.

**Example.** You sold a parcel of land to another person for \$50,000, payable \$10,000 down and the balance over a period of 10 years at \$4,000 a year, plus 12% interest. The buyer gave you a note for \$40,000. The note had a fair market value of \$30,000 (75% of its face value). You paid a commission of 6%, or \$3,000, to a broker for negotiating the sale. The land cost you \$25,000 and you owned it for more than 6 months. You decide

to elect out of the installment method, and report the buyer's note at its fair market value.

**Computation of gain:**

Selling price.....		\$50,000
Minus: Adjusted basis of the property.....	\$25,000	
Commission.....	3,000	26,000
Gain realized		<u>\$22,000</u>
Gain recognized in year of sale:		
Cash.....		\$10,000
Market value of note (75% of \$40,000)		<u>\$30,000</u>
Total realized in year of sale.....		\$40,000
Minus: Adjusted basis of the property.....	\$25,000	
Commission.....	3,000	28,000
Gain recognized in year of sale		<u>\$12,000</u>

The \$12,000 is long-term capital gain. However, since you included only the fair market value of the note (75% of face value) to figure the gain recognized in the year of sale, you must report as **ordinary income** 25% of each payment of principal you receive in later years. The interest on the note also is ordinary income and is reported as interest income on Form 1040.

**Fair market value.** If you elect out of the installment method, you must figure the fair market value of the buyer's installment obligation to you, whether or not you would actually be able to sell it. If you use the cash method of accounting, the fair market value of the obligation will never be considered to be less than the fair market value of the property sold (minus any other consideration received). If you use an accrual method of accounting, you must always use the full face value of the installment obligation as its fair market value when you elect out.

**How to elect out.** If you want to make this choice, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever is appropriate.

If you elect out and also value the buyer's installment obligation at less than its face value, you must complete an additional part of Schedule D (Part VI) or Form 4797 (Part IV). Check the box provided in that part of the form, and enter the face amount of the buyer's obligation to you and the percentage of the face amount that you are reporting in the year of sale.

**When to elect out.** You must make the choice not to have the installment sale rules apply by the due date, including extensions, for filing your tax return for the year in which the sale takes place. In general, once you make this choice, you may not change your mind. However, you can apply to the Internal Revenue Service for special permission to make a late choice to elect out or to revoke your earlier election. A revocation will not be permitted when one of its purposes is the avoidance of federal income tax, or when the tax year in which any payment was received has closed.

## Unstated Interest

There are different rules for imputing interest for transactions before 1985 and for transactions after 1984. In either case, both the buyer and the seller must treat a part of the installment sale price as interest. For sales or exchanges before 1985, the unstated (imputed) interest rules require you to treat part of each payment as interest, even though it is not called interest in your agreement with the buyer. This amount is generally referred to as "unstated interest." This will reduce the stated selling price of the property and increase the seller's interest income and the buyer's interest expense.

The imputed interest rule applies even if you have a loss on the sale. It applies even if you can postpone or otherwise not recognize all or part of your gain or loss in the year that the sale takes

place. It even applies if you elect out of the installment method.

**Sales and exchanges before 1985.** If, for a sale or exchange before 1985, you determined that the transaction involved unstated interest, you must continue to treat a part of each principal payment as interest.

**If a change is made in the terms of a contract** for the sale of property, and the change affects the liability for, or the amount or due date of, a payment, including a payment of interest, the total unstated interest must be refigured and reallocated.

**A late or early payment** is considered a change in the terms of the contract if the payment is made more than 90 days before or after the date the payment was due under the contract. Any additional interest paid because of a late payment is considered stated interest in refiguring total unstated interest under the contract.

**A default** in the remaining payments under a contract is also considered a change in the terms of the contract.

**If the refigured total unstated interest** is more than the amount of total unstated interest previously returned as income under the contract before the change, you must allocate the difference proportionally to the remaining payments due under the revised contract.

**Previous amount more than refigured amount.** If the total unstated interest previously reported as income is more than the total unstated interest you refigured under the changed contract, deduct the excess unstated interest on your return for the year of the change in the contract.

**Sales or exchanges after 1984.** For sales or exchanges of property occurring after 1984, a debt instrument must provide for adequate stated interest. If a debt instrument does not provide for adequate stated interest, interest is imputed to the debt instrument. Generally, a debt instrument provides for adequate stated interest if it calls for interest at a rate no lower than the test rate of interest applicable to the debt instrument. For sales or exchanges of property (other than new section 38 property which includes most tangible personal property) involving seller financing of \$2,800,000 or less, the test rate of interest is the lower of the applicable federal rate of interest or 9%, compounded semiannually. If the seller financing is in excess of \$2,800,000, and for all sales or exchanges of new section 38 property, the test rate of interest is 100% of the applicable federal rate.

Section 1274 of the Internal Revenue Code applies to any debt instrument issued for the sale or exchange of property if some or all of the payments due under the debt instrument are due more than 6 months after the date of the sale or exchange. Section 483 of the Code applies to sales or exchanges of property excepted from the provisions of section 1274.

Section 483. The rules of section 483 apply to any payment on account of the sale or exchange of property which constitutes all or part of the selling price and which is due more than 6 months after the date of the sale or exchange under a contract under which:

- 1) Some or all of the payments are due more than 1 year after the date of the sale or exchange, and
- 2) There is total unstated interest (or inadequate stated interest).

**Total unstated interest.** Total unstated interest is an amount equal to the excess of:

- 1) The sum of the payments due under the contract, over
- 2) The sum of the present values of the payments and the present values of any interest payments due under the contract.

**Transactions to which section 483 applies.** The rules of section 483 apply to debt instruments arising from sales or exchanges of:

- 1) A farm for \$1,000,000 or less by an individual, estate, testamentary trust, small business corporation (defined in section 1244(c)(3) of the Internal Revenue Code), or a domestic partnership that meets requirements similar to those of section 1244(c)(3),
- 2) A principal residence by the owner,
- 3) Property with total payments (principal and interest) of \$250,000 or less, or
- 4) Land between related parties.

In addition, the rules of section 483 apply to a "cash method debt instrument." A "cash method debt instrument" is any debt instrument given as consideration for the sale or exchange of property (other than new section 38 property as defined in section 48(b)) with a stated principal amount of \$2,000,000 or less and:

- 1) The lender (holder) does not use an accrual method of accounting and is not a dealer in the type of property sold or exchanged,
- 2) Both the borrower (issuer) and the lender jointly elect to account for the interest under the debt instrument on the cash method of accounting, and
- 3) Section 1274 of the Code would have applied except for the election in (2) above.

**Sale of a farm.** The section 483 rules apply to the sale of a farm if the selling price cannot exceed \$1,000,000. If the selling price can exceed \$1,000,000, the section 1274 rules apply. For purposes of determining the selling price, all sales and exchanges that are part of the same transaction (or a series of transactions) are treated as one sale or exchange.

**Sales with total payments of \$250,000 or less.** If:

- 1) The aggregate amount of the payments (interest and principal) due under the debt instrument and under all other debt instruments received as consideration for the sale or exchange, and
- 2) The aggregate amount of any other consideration to be received for the sale or exchange,

cannot exceed \$250,000, the section 483 rules apply. The section 1274 rules apply if the amount can exceed \$250,000.

Any consideration (other than a debt instrument) is taken into account at its fair market value. All sales and exchanges that are part of the same transaction (or series of related transactions) are treated as one sale or exchange.

**Land sales between related parties.** The rules of section 483 apply to land sales between related parties to the extent that the sales price when added to the aggregate sales price of prior land sales between the individuals during the calendar year does not exceed \$500,000. The rules of section 1274, if otherwise applicable, apply to a sale of land to the extent the sales price is in excess of \$500,000. In addition section 1274 applies to a sale of land if any party to the sale is a nonresident alien individual.

Related parties include an individual and the members of that individual's family. The members of an individual's family include the individual's spouse, brother and sister (whether by the whole or half blood), ancestors and lineal descendants.

**Exceptions to section 483 rules.** The unstated interest rules do not apply to the following types of transactions.

**Sales price of \$3,000 or less.** If it can be determined at the time of the sale or exchange of the property that the selling price cannot exceed \$3,000, the unstated interest rules do not apply to the sale or exchange.

**Carrying charges.** The buyer of personal property need not figure unstated interest if any part of the payments includes separately stated carrying charges deductible in part as interest. If the buyer makes an installment purchase under a plan in which carrying charges are separately stated but the interest cannot be determined, the buyer can deduct, as interest, the lesser of—

- 1) An amount equal to 6% of the average unpaid balance under the contract during the year, or
- 2) The part of the total carrying charges allocable to the year.

**Additional exceptions.** See the discussion of the exceptions that apply to both sections 483 and 1274, later.

**Section 1274.** The section 1274 rules apply to any debt instrument given in consideration for the sale or exchange of property if:

- 1) The stated redemption price at maturity for the debt instrument exceeds:
  - a) The stated principal amount when there is adequate stated interest, or
  - b) The imputed principal amount in all other cases, and
- 2) Some or all of the payments under the debt instrument are due more than 6 months after the date of the sale or exchange.

There is adequate stated interest under section 1274 if the stated principal amount for a debt instrument is less than or equal to the imputed principal amount. The imputed principal amount of any debt instrument is equal to the sum of the present values of all payments under the debt instrument.

**Imputed principal.** In transactions to which these rules apply the issue price of the debt instrument has to be determined. Where there is adequate stated interest, the issue price is the stated principal amount. If the debt instrument does not provide for adequate stated interest, the issue price of the instrument is the imputed principal amount of the debt instrument. The issue price of a debt instrument is generally used to determine the sale price (in whole or in part) of any property acquired for the debt instrument.

**Exceptions to the imputed principal rules.** Section 1274 does not apply to any of the debt instruments involved in transactions listed above under *Transactions to which section 483 applies*.

**Assumptions.** If an existing debt instrument is assumed, or property is acquired subject to a debt instrument, in determining if the imputed interest rules apply to the debt instrument the assumption (or acquisition) is not taken into account unless the terms or conditions of the debt instrument are modified or the nature of the transaction is changed.

**Exceptions to sections 483 and 1274.** The imputed interest rules do not apply in the following circumstances:

- 1) **Publicly traded debt instruments or property.** Transactions involving publicly traded debt instruments or any debt instrument issued in consideration for the sale or exchange of publicly traded property do not include any imputed interest. A publicly traded instrument is one that is traded on an established securities market.
- 2) **Treatment of obligors.** An obligor or borrower (issuer) under a debt instrument given in consideration for the sale or exchange of property that is personal use property in the hands of the issuer. Personal use property is any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an investment activity.

- 3) **Patents.** When all substantial rights to a patent, or an undivided interest in property that includes a part of all substantial rights to a patent, are sold or exchanged, the seller need not figure unstated interest or imputed principal or any amount that is contingent upon the productive use, or disposition of the property transferred. This rule only applies if the seller is the inventor or a buyer who purchased the patent or rights to the patent from the inventor before the invention was reduced to practice.
- 4) **Annuitants.** Payments that depend in whole or in part on the life expectancy of any individual do not require the computation of unstated interest or imputed principal.

**Additional information.** For information on the computation of imputed interest and other special rules, see sections 483 and 1274 of the Code and the regulations thereunder.

## Effects of Unstated Interest

Imputed interest affects the selling price and the contract price. It also affects the amount of gain on the sale, whether you use the installment method or elect out.

**Selling price and contract price.** If you use the installment method for reporting your gain on the sale, both the selling price and the contract price must be reduced by any imputed interest. All the other rules relating to installment sales apply as they would if there were no imputed interest.

**If you elect out.** If you do not report your sale using the installment method, you must report your entire gain in the year of sale. However, if you find that the payments you are to receive will include imputed interest, you must reduce the selling price by the total amount of imputed interest before you can determine the gain or loss.

The amount of interest you must report is the sum of the imputed interest plus any interest specified under the contract.

For more information on reporting imputed interest and stated interest, see sections 483 and 1274 of the Code and the regulations thereunder.

## Dispositions of Installment Obligations

If you dispose of an installment obligation (the buyer's note, mortgage, etc.), you will usually have a gain or loss to report. Generally, a disposition includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation. The gain or loss is considered to be gain or loss on the sale of the property for which you received the installment obligation. If the original installment sale of the property produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss.

Use the following rules to figure your gain or loss from the disposition of an installment obligation.

**If you sell or exchange the obligation, or if you accept less than face value in satisfaction of the obligation,** the gain or loss is the difference between your basis in the obligation and the amount you realize.

**If you dispose of the obligation in any other way,** the gain or loss is the difference between your basis in the obligation and its fair market value at the time of the disposition. This rule applies, for example, when you give the installment obligation to someone else or cancel the buyer's debt to you.

Some situations in which these rules may or may not apply are discussed in the following paragraphs:

**Transfers between spouses or former spouses.** No gain or loss is recognized on the transfer of an installment obligation between a husband and wife or a former husband and wife if incident to a divorce. A transfer is incident to a divorce if it occurs within one year after the date on which the marriage ends, or is related to the end of the marriage. The same tax treatment for the transferred obligation applies to the spouse or former spouse receiving it as would have applied to the transferor spouse or former spouse. The basis of the obligation to the transferee spouse (or former spouse) is the adjusted basis of the transferor spouse.

The nonrecognition rule does not apply if the spouse receiving the obligation is a nonresident alien.

**Gifts.** A gift of an installment obligation is a disposition. The gain or loss is the difference between your basis in the obligation and its fair market value at the time you make the gift.

For gifts between spouses or former spouses, see *Transfers between spouses or former spouses*, earlier.

**Cancellation.** If an installment obligation is cancelled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its fair market value at the time you cancel it. If you and the buyer are related persons, the fair market value of the obligation is considered to be no less than its full face value. "Related person" has the same meaning here as it does for Rule 2 under *Installment Sales to Related Persons*, earlier.

**Forgiving part of the buyer's debt.** If you accept part payment on the balance of the buyer's installment debt to you and forgive the rest of the debt, you treat the settlement as a disposition of the installment obligation. The gain or loss is the difference between your basis in the obligation and the amount you realize on the settlement.

If you reduce the selling price but do not cancel the rest of the buyer's debt to you, it is not considered a disposition of the installment obligation. You must refigure the gross profit percentage and apply it to payments you receive after the reduction.

**Assumptions.** If the buyer of your property sells it to someone else and you agree to let the new buyer assume the original buyer's installment obligation, you have not disposed of the installment obligation. It is not a disposition even if the new buyer must pay you a higher rate of interest than the original buyer.

**Installment obligations transferred because of death.** The transfer of an installment obligation as a result of the death of the seller or other holder of the obligation is not a disposition. Unreported gains from the installment obligations are treated as items of gross income in respect of a decedent. This means that whoever receives the installment obligation as a result of the holder's death is taxed on the installment payments in the same way as the seller or other holder would have been if the holder had lived to receive the payments.

However, if an installment obligation is cancelled, or transferred to the buyer, because of the death of the holder of the obligation, it is a disposition. The estate must figure its gain or loss on the disposition. If the holder and the buyer were related persons, the fair market value of the installment obligation is considered to be no less than its full face value. "Related person" has the same meaning here as it does for Rule 2 under *Installment Sales to Related Persons*, earlier.

**Basis.** Your basis in an installment obligation depends on the amount that is yet to be paid on the obligation (the unpaid balance) and your gross profit percentage. Multiply the unpaid balance by the gross profit percentage. This is the amount of profit on the installment sale that you have not already received in payments from the buyer.

The remainder of the unpaid balance is your basis in the obligation. It represents the part of your adjusted basis in the property you sold that you have not already recovered in payments from the buyer.

**Example.** Several years ago you sold some property on the installment method. The buyer still owes you \$10,000 of the sales price. This is the unpaid balance on the buyer's installment obligation to you. Because your gross profit percentage is 60%, \$6,000 (60% of \$10,000) is the profit still due you on the obligation. The rest of the unpaid balance, \$4,000, is your basis in the obligation.

## Repossessions

If, after making an installment sale, you repossess your property from the buyer, you may have to figure:

- 1) Your gain (or loss) on the repossession, and
- 2) Your basis in the repossessed property.

The rules for doing this depend on the kind of property you repossess. The rules for repossessions of personal property differ from those for real property. In addition, special rules may apply if you repossess property that was your principal residence before the sale.

The repossession rules apply whether or not title to the property was ever transferred to the buyer. It also does not matter how you repossess the property—whether you foreclose or the buyer voluntarily surrenders the property to you. However, it is not a repossession if the buyer puts the property up for sale and you repurchase it.

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to you. The discharged obligation must be one that is secured by the property you repossess. This requirement is met if the property is auctioned off after you foreclose and you apply the installment obligation to your bid price at the auction.

## Personal Property

If you repossess personal property, you may have a gain or a loss on the repossession. In some cases, you may also end up with a bad debt.

To figure your gain or loss, subtract your basis in the installment obligation and any expenses you have in connection with the repossession from the fair market value of the property. If you receive anything from the buyer in addition to the repossessed property, it should be added to the property's fair market value before making this subtraction.

The way you figure your basis in the installment obligation depends on whether or not you reported the original sale using the installment method. The method you used to report the original sale also affects the character of your gain or loss on the repossession.

### Sales not reported on the installment method:

- 1) **Basis.** Your basis in the installment obligation is figured on its full face value or its fair market value at the time of the original sale, whichever you used to figure your gain or loss in the year of sale. From this amount, subtract all the payments of principal you have received on the obligation. The result is your basis in the installment obligation. If only a part of the obligation is discharged by the repossession, figure your basis only in that part.
- 2) **Gain or loss.** To your basis in the obligation, add any expenses you have in connection with the repossession. If the fair market value of the property you repossess is more than this total, you have a gain. Because the gain is gain on the installment obligation, it is all ordinary income, not capital gain. If the fair market value

of the repossessed property is less than the total of basis plus repossession expenses, you have a loss. Because the loss is a loss on the installment obligation, it is a bad debt loss. How you deduct the loss depends on whether you sold business or nonbusiness property in the original sale. See Publication 548, *Deduction for Bad Debts*, for more information on bad debt losses.

### Sales reported on the installment method:

- 1) **Basis.** Your basis in the installment obligation is its face value minus the unreported profit (the amount of gain you would have reported as income in the future if you had held the obligation to maturity). If only a part of the installment obligation is discharged by the repossession, figure your basis only in that part.
- 2) **Gain or loss.** Your gain or loss on the repossession is the same character as your gain on the original sale. If you had a long-term capital gain on the original sale, you will have a long-term capital gain or loss on the repossession. If your original gain was ordinary, your gain or loss on the repossession will also be ordinary.

**Worksheet.** The following worksheet can be used to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

1. Fair market value of property repossessed	_____
2. Selling price	_____
3. Minus: Payments made to time of repossession	_____
4. Face value of obligation at time of repossession	_____
5. Minus: Unrealized profit (line 4 times gross profit percentage) ...	_____
6. Basis of obligation (line 4 minus line 5)	_____
7. Gain or loss on repossession (line 1 minus line 6)	_____
8. Minus: Repossession costs	_____
9. Taxable gain or loss on repossession	=====

**Example.** You sold your piano for \$1,500 in December 1986 for \$300 down and \$100 a month (plus interest). The payments began in January 1987. Your gross profit percentage is 40%. You reported the sale on the installment method on your 1986 income tax return. After the third monthly payment, the buyer defaults on the contract and you are forced to foreclose on the piano. The fair market value of the piano on the date of repossession is \$1,400. The legal costs of foreclosure and the expense of moving the piano back to your home total \$100. You figure your gain on the repossession as follows:

Fair market value of piano repossessed	\$1,400	
Basis of the buyer's obligation at the time of repossession:		
Selling price of piano	\$1,500	
Minus: Payments made on contract	600	
Face value of obligation at time of repossession	\$ 900	
Minus: Unrealized profit (gross profit percentage of 40% × \$900)	360	540
Gain on repossession		\$ 860
Minus: Expenses of repossession		100
Taxable gain on repossession		<u>\$ 760</u>

**Basis.** Your basis in repossessed personal property is its fair market value at the time of the repossession.

**Fair market value.** The fair market value of repossessed property is a question of fact to be established in each case. If you bid for the property at a lawful public auction or judicial sale, its fair market value is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

**Bad debt.** If the installment obligation is not fully satisfied by the repossession, the same circumstances that led you to repossess your property may mean that you cannot collect on the rest of the buyer's debt to you. If you cannot, you may be able to take a bad debt deduction for that part of the installment obligation. See Publication 548 for more information.

## Real Property

The rules for repossessions of real property allow you to keep essentially the same adjusted basis in the repossessed property as you had before the original sale. You will be able to recover this entire adjusted basis when you resell the property. This, in effect, cancels out the tax treatment you had on the original sale, and puts you in the same tax position you were in before that sale.

Therefore, the full amount of any payments you have already received from the buyer on the original sale must be regarded as income to you. You must report, as gain on the repossession, any part of those payments that you did not yet include in your income—that is, the part that had been regarded as a return of your adjusted basis rather than as gross profit.

However, the total gain you must report from the payments you received on the original sale is limited to the amount of gross profit you expected on that sale. If this limit applies, your basis in the repossessed property is adjusted downward, postponing the rest of the gain on repossession until you resell the property.

The rules given below show in detail how to figure your basis in repossessed real property and your gain on the repossession. These rules are **mandatory**. However, they apply only if certain conditions are met:

- First**, the repossession must be to protect your security rights in the property.
- Second**, the installment obligation that is satisfied by the repossession must have been received in the original sale.
- Third**, you cannot pay any additional consideration to the buyer in order to get your property back, unless either:
  - 1) The reacquisition and payment of the additional consideration were provided for in the original contract of sale, or
  - 2) The buyer has defaulted, or default is imminent.

"Additional consideration" includes money and other property you pay or transfer to the buyer. For example, additional consideration is present if you reacquire the property subject to an indebtedness that arose after the original sale.

If any of these three conditions are not met, you cannot figure your gain or loss on the repossession and your basis in the repossessed property according to the rules discussed below. Instead, use the rules discussed under *Personal Property*, earlier, as if the property you repossess is personal rather than real property.

**Figuring gain on repossession.** Your gain on repossession is the difference between the amount of money and the fair market value of property (other than obligations of the buyer arising from the sale) you have received on the sale and the total amount of gain you have already reported as income. See the earlier discussion under *Payments* for the definition of what is considered a payment on the sale.

There is a limit on the amount of gain that is taxable. Taxable gain is limited to an amount equal to your gross profit on the original sale, minus the sum of:

- 1) The gain on the sale you reported as income before the repossession, and
- 2) Your repossession costs.

This method of figuring taxable gain, in essence, treats all of the payments you received on the sale as income, but limits your total taxable gain to the gross profit you originally expected on the sale.

**Repossession costs.** Your repossession costs include money or property you pay for the reacquisition of the real property. This includes amounts paid to the buyer of the property as well as amounts paid to others for such items as court costs and legal fees. Repossession costs do not include the fair market value of the buyer's obligations to you that are secured by the real property.

**Worksheet.** The following worksheet can be used to determine the taxable gain on a repossession of real property reported on the installment method.

1. Payments received to time of repossession.....	_____
2. Minus: Gain reported (line 1 times gross profit percentage)....	_____
3. Gain on repossession.....	=====
4. Gross profit on sale.....	_____
5. Gain reported (line 2).....	_____
6. Plus: Repossession costs.....	_____
7. Subtract line 6 from line 4.....	=====
8. Taxable gain (lesser of line 3 or 7).....	=====

**Example.** You sold a tract of land in January 1985 for \$25,000. You accepted from the buyer a \$5,000 down payment, plus a \$20,000 (9.5%) mortgage, secured by the property and payable at the rate of \$4,000 annually plus interest. The payments began on January 1, 1986. Your adjusted basis in the property was \$19,000 and you reported the transaction as an installment sale. Your selling expenses were \$1,000. You figured your gross profit as follows:

Selling price.....	\$25,000
Minus: Adjusted basis.....	\$19,000
Selling expenses.....	1,000
<b>Gross profit.....</b>	<b>\$ 5,000</b>

For this sale, the contract price equals the selling price. Therefore, the gross profit percentage is 20%, figured as follows:

$$\frac{\text{Gross profit, \$5,000}}{\text{Contract price, \$25,000}} = 20\%$$

In 1985 you included \$1,000 in your income (20% of the \$5,000 down payment). In 1986 you reported profit of \$800 (20% of the \$4,000 annual installment). In 1987 the buyer defaulted and you repossessed the property. You spent \$500 in legal fees to get your property back. Your gain on the repossession is figured as follows:

Payments received (\$5,000 + \$4,000).....	\$9,000
Minus: Gain previously reported as income (\$1,000 + \$800).....	1,800
<b>Gain.....</b>	<b>\$7,200</b>

Not all of this gain is taxable. The limit on taxable gain is figured as follows:

Gross profit on original sale.....	\$5,000
Minus: Gain previously reported as income.....	\$1,800
Cost of repossession.....	500
<b>Taxable gain on repossession.....</b>	<b>\$2,700</b>

**Indefinite selling price.** The limit on taxable gain does not apply if the selling price is indefinite and cannot be determined at the time of repossession as, for example, when it is stated as a percentage of the profits to be realized from the buyer's development of the property.

**Character of gain.** The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale.

**Basis.** Your basis in the repossessed property is determined as of the date of repossession. It is the sum of:

- 1) Your adjusted basis in the installment obligation,
- 2) Your repossession costs, and
- 3) The taxable gain on the repossession.

To figure your adjusted basis on the installment obligation at the time of repossession, subtract any unreported profit (the amount of gain you would have reported as income in the future had you held the obligation to maturity) from its face value at the time of repossession.

**Worksheet.** The following worksheet can be used to determine the basis of real property repossessed.

1. Face value of obligation at time of repossession (selling price minus payments received).....	_____
2. Minus: Unreported profit (line 1 times gross profit percentage).....	_____
3. Adjusted basis on date of repossession.....	=====
4. Plus: Taxable gain on repossession.....	_____
Repossession costs.....	_____
5. Basis of repossessed real property.....	=====

**Example.** Assume the same facts as in the preceding example. The face value of the installment obligation (the \$20,000 note) is \$16,000 at the time of repossession, because the buyer had made a \$4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, \$3,200 (20% of the \$16,000 still due on the note) is unreported profit. You figure your basis in the repossessed property as follows:

Face value of obligation at time of repossession.....	\$16,000
Minus: Unreported profit.....	3,200
Adjusted basis on date of repossession.....	\$12,800
Plus: Taxable gain on repossession.....	\$2,700
Repossession costs.....	500
<b>Basis of repossessed real property.....</b>	<b>\$16,000</b>

**Holding period for resales.** If you resell the property you repossessed, the resale may result in a capital gain or a capital loss. To figure whether it is a long-term or a short-term gain or loss, your holding period includes the period you owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property.

If the reacquired property includes improvements made by the buyer, the holding period for these improvements begins on the day after the date of repossession.

**Bad debt.** If you repossess real property under these rules, you cannot take a bad debt deduction for any part of the buyer's installment obligation. This is so even if the obligation is not fully satisfied by the repossession.

If you had already taken a bad debt deduction before the tax year of repossession, you are considered to have recovered the bad debt when you repossess the property. The amount of the bad debt deduction you took in the earlier year must be reported as income in the year of repossession. However, if any part of the earlier deduction did not serve to lower your tax, you do not have to report that part as income. Your basis in the repossessed property must be increased by the amount you report as income.

## Repossessing Your Former Home

When you sell your home, you may be permitted to postpone paying tax on part or all of your gain if you acquire a replacement residence within a specified period of time. You also may be allowed to exclude some or all of your gain from income if you are age 55 or older.

Special rules apply if, after using one or both of these provisions for your sale, you repossess your former home and sell it once again. Under these rules, you do not have any gain or loss at the time of repossession. Instead, the sale and resale are combined and treated as a single transaction. You then refigure your gain on the combined sale-resale, including how much of the gain you can exclude or postpone paying tax on. These special rules apply only if:

- 1) The resale takes place within one year of the repossession, and
- 2) At least some of your gain on the original sale was not taxed because you acquired a replacement home or because you were age 55 or older. (See Publication 523, for details on these two provisions.)

If the resale does not take place within one year of the repossession, the general rules for repossessions of real property discussed earlier are applicable.

**Refigure gain.** To refigure your gain, you must first refigure both the amount you realize on the combined sale-resale and your adjusted basis in the home. The difference between these two amounts is your gain on the combined sale-resale. You then figure how much of this gain you can exclude or postpone paying tax on, using the same rules that would apply to any sale.

**Refiguring the amount realized.** To refigure the amount you realize on the combined sale-resale of your home, add the selling price on the resale to the selling price on the original sale, and subtract:

- 1) Your selling expenses for both sales,
- 2) The part of the original installment obligation that remains unpaid at the time of repossession, and
- 3) Your repossession costs.

**Example.** You sold your home for \$50,000. After some time, you repossessed your property and resold it within one year for \$55,000. When you repossessed, the first buyer owed you \$46,000 on the original sale, and you paid \$1,000 in connection with the repossession. Your selling expenses were \$2,000 dollars originally and \$3,000 on the resale.

The amount realized on the combined sale-resale is figured as follows:

Selling price on resale.....	\$ 55,000
Plus: Selling price on original sale.....	50,000
<b>Total.....</b>	<b>\$105,000</b>
Minus:	
Selling expenses on resale ....	\$ 3,000
Selling expenses on original sale.....	2,000
Amount unpaid on buyer's note.....	46,000
Repossession costs.....	1,000
	<u>52,000</u>
<b>Amount realized on sale-resale</b>	<b>\$ 53,000</b>

**Refigured adjusted basis.** To refigure your adjusted basis for the combined sale-resale, begin with your adjusted basis in the property at the time of the original sale and make any adjustments for events that take place after you repossess the property. You cannot adjust for events that took place while the buyer owned the property.

You may have to make two other adjustments:

- 1) If the buyer became further in debt to you after the original sale, and this debt was also secured by the property you repossessed, add in

the amount outstanding on this debt when refiguring your adjusted basis. In this way, when you figure gain on the combined sale-resale, you will be able to take into account the full amount that is owed you.

- 2) If, in an earlier year, you took a bad debt deduction for any of the buyer's obligations that were secured by the property you repossess, you must subtract the amount of the deduction when refiguring your adjusted basis. If only part of the deduction served to reduce your tax, you need subtract only that part.

**Excluded or deferred gain on resale.** If you are age 55 or older and are excluding any part of your gain for that reason, you must refigure how much gain you can exclude. Use the refigured gain on the combined sale-resale to see how much gain you can exclude.

If you bought a replacement home and are postponing part of your gain for that reason, you must refigure both:

- 1) The amount of gain you can postpone, and
- 2) Your adjusted basis in the replacement home.

From the amount realized on the combined sale-resale, subtract any "fixing-up" expenses you had in connection with either sale. The result is the adjusted selling price for the sale-resale. Compare this amount to (1) the cost of the replacement home and (2) your gain from the combined sale-resale to figure both the amount of gain you can postpone and your adjusted basis in the replacement home. Publication 523 discusses how to do this.

You are allowed to deduct fixing-up expenses for both the sale and resale. Publication 523 also discusses fixing-up expenses.

**Reporting taxable gain.** If you already reported any gain from the original sale, the amount you reported should be subtracted when reporting your gain from the combined sale-resale. Make any necessary adjustments on your tax return for the year of the resale.

**Bad debt.** If you repossess your home under these rules, you cannot take a bad debt deduction for the original installment obligation, or for any other obligation that was secured by the property you repossess.

## Reporting an Installment Sale

You must use Form 6252, *Computation of Installment Sale Income*, anytime you have a sale of property that you report as an installment sale. The form is used to report the sale in the year it takes place, and to report payments received in later years. In addition, if you made the sale to a related person, you may have to file the form each year until the installment debt is paid off, whether you receive a payment during the year or not.

Form 6252 is made up of three main parts. Part I, *Computation of Gross Profit and Contract Price*, must be completed only for the year of sale. Part II, *Computation of Taxable Part of Installment Sale*, must be completed for the year of sale and for any year in which you receive a payment or are considered to have received a payment. Part III, *Information and Computation for Related Party Installment Sale*, must be completed only if you sold the property to a related person as discussed earlier under *Installment Sales to Related Persons*.

**For the year of sale.** Answer the questions at the beginning of the form and complete Part I and Part II. Question D asks whether you sold the property to a related person. If you answer "Yes" to question D, answer question E and complete Part III.

**For years after the year of sale.** Answer the questions at the top of the form and complete Part II for any year that you receive a payment from the

sale, including a deemed payment as discussed under *Allocable Installment Indebtedness (Deemed Payment)*, earlier. You do not have to complete Part I except in the year of sale.

If your sale is to a related person, you may have to complete Part III and file the form in other years as well:

**If you sell marketable securities to a related person,** complete Part III for each year of the installment agreement, even if you do not receive a payment in that year.

**If you sell property other than marketable securities to a related person,** complete Part III for the year of sale and the 2 years following the year of sale, even if you do not receive a payment. After this 2-year period, you do not have to fill out Part III.

**Later dispositions.** If the related person you sold your property to disposes of the property before the installment debt is paid off, you may have to immediately report the rest of your gain in Part III. See *Rule 2: Sale and resale under Installment Sales to Related Persons*, earlier, for more information.

**Several assets.** If you sell two or more assets in one installment sale, you may have to report the sale of each asset separately. The same is true if you sell all the assets of your business in one installment sale. See *Single Sale of Several Assets*, earlier.

If you do not have too many sales to report separately, you may use a separate Form 6252 for each one. However, if you have to report separately the sales of many assets that you sold together, do not prepare a separate Form 6252 for each one. Instead prepare one Form 6252 and attach a schedule that contains all the information for each asset that is required by Form 6252. You would complete Form 6252 as follows:

- 1) Answer the questions at the top of the form.
- 2) In the year of sale, do not complete Part I. Instead write "See attached schedule" in the margin.
- 3) For Part II, enter the total for all the assets on lines 21, 22, and 23.
- 4) For Part III, answer all the questions that apply. If none of the exceptions under question H apply, enter the totals on lines 29, 30, and 31 for all the assets that were disposed of.

**Payments past due.** Do not report payments of principal that you have not yet received, even if they are past due. However, if you use the accrual method of accounting, you have to accrue the payment that is due even though you have not yet received payment.

**Special situations.** If you are reporting payments from an installment sale as income in respect of a decedent or as a beneficiary of a trust, including a partial interest in such a sale, you may not be able to provide all the information asked for on Form 6252. To the extent possible, follow the instructions given above under *Several assets*, and give as much detail as you can in a statement attached to the Form 6252.

For more information on how to complete Form 6252, see the form instructions.

**Other forms.** The gain from Form 6252 must be carried over and entered on another form. That form may be Schedule D, Form 4797, *Gains and Losses From Sales or Exchanges of Assets Used in a Trade or Business and Involuntary Conversions*, or both. Although the references in this publication are to the Schedule D for Form 1040, the rules discussed also apply to the Schedule D's for Forms 1041 (estates and trusts), 1065 (partnerships), 1120 or 1120-A (corporations), or 1120S (S corporations). Form 4797 is used with partnership, corporation, S corporation, estate, and trust returns, as well as with individual returns.

**Schedule D.** If you sell property that is a capital asset and use the installment method, each year you must include the capital gain part of the installment payments from Form 6252 in your net gain or loss from the sale or exchange of capital assets. This gain or loss is reported on Schedule D (Form 1040).

If your gain from an installment sale qualified for long-term capital gains treatment in the year of sale, it will continue to qualify in later tax years when you receive and report the installment payments. Your gain will be long-term if you owned the asset for more than 6 months when you sold it.

**Form 4797.** An installment sale of property that is used in your business or that earns you rent or royalty income sometimes results in a capital gain and sometimes in an ordinary gain and sometimes both. All or part of any gain from its disposition may be ordinary gain from depreciation. Form 4797 is used to report these transactions and to determine the amount of ordinary gain or loss and the amount of capital gain or loss.

If part of your gain on the sale is ordinary gain from depreciation (including the section 179 deduction) and part is capital gain, you must report the gain to the extent of the depreciation recapture income in the year of sale even if no payment is received.

If you dispose of more than one asset in a single transaction, you must make a separate computation for each asset so that any gain is properly allocated between recapture income and capital gain.

## Sample Forms 6252

The following two examples illustrate how to fill out Form 6252. The first example shows how the form is used in the year of sale. The second example shows how it is used in a later year. The sample filled-in forms follow these examples.

### Example 1

On November 1, 1987, Mark Moore sold a lot that he had bought on February 17, 1975, for \$2,650. Because the lot rapidly appreciated in value, Mark was able to borrow more on it than it had cost him. At the time of the sale, \$6,500 remained outstanding on these loans. In the sales contract, the buyer agreed to assume these loans and to pay Mark \$200 a month (plus 12% interest) for 3 years. In addition, the buyer made a down payment of \$1,000 on the sale.

Mark fills out his 1987 Form 6252 as follows:

**Question A.** Mark writes in a description of the lot he sold.

**Questions B and C.** Mark enters the date he acquired the lot and the date he sold it.

**Question D.** Because Mark sold the lot to Acme Design, a partnership of which he is a member, he checks the "Yes" box.

**Question E.** The property Mark sold was not a marketable security (such as a stock or a bond), so he answers "No" to this question. Because he sold the lot to a related person, he must complete Part III of the form. But because the property he sold was not a marketable security, he must complete Part III only for 1987 and the next 2 years.

**Part I.** Mark uses this part of the form to figure the contract price and his gross profit on the sale.

**Line 1.** On this line, Mark enters the selling price, \$14,700. This includes the \$1,000 down payment, the \$7,200 ( $36 \times \$200$ ) in monthly payments he is to receive, and the \$6,500 in loans the buyer assumes.

**Line 2.** Here Mark enters the \$6,500 the buyer assumes.

**Line 3.** Mark subtracts line 2 from line 1 and enters the difference, \$8,200.

**Line 4.** Because he had not made any improvements to the lot, Mark's basis at the time of the sale was the lot's cost of \$2,650.

**Lines 5 and 6.** Mark did not take depreciation deductions on the lot (land is never depreciable), so the amount on line 4 carries over to line 6.

**Line 7.** Mark's only selling expenses were \$150 in legal fees. If he had advertised the lot for sale or paid a commission on the sale, he would include those amounts.

**Line 8.** No depreciation was claimed on the land therefore Mark has no income recapture.

**Line 9.** The total of Mark's adjusted basis in the property plus his selling expenses is \$2,800.

**Line 10.** Mark subtracts line 9 from line 1 and enters the result, \$11,900.

**Line 12.** The property Mark sold was not his principal residence, therefore, he carries the amount on line 10 to line 12. This is his gross profit on the sale.

**Line 13.** Mark next subtracts line 9, \$2,900, from line 2, \$6,500. The result, \$3,700, is the amount by which the assumed loans are more than Mark's basis in the property plus selling expenses. This amount is treated as a payment in the year of sale on line 16.

**Line 14.** The contract price is the sum of all the payments Mark will receive on the sale. This includes the down payment and all the installment payments he is scheduled to receive (line 3). It also includes the "payment" figured on line 13.

**Part II.** In this part Mark figures the amount of gain from the sale he must report for 1987.

**Line 15.** Mark's gross profit ratio for the sale is the gross profit on line 12, \$11,900, divided by the contract price on line 14, also \$11,900. It is, therefore, 100%.

**Line 16.** Mark carries the amount he treats as a payment on line 13 to this line, so that it will be counted in with the other payments he received in the year of sale.

**Line 17.** At the time of the sale, Mark received a down payment of \$1,000. Then, in December 1987, he received his first monthly installment payment. The total payment was \$272, consisting of \$72 interest (one month's interest on \$7,200 figured at 12% a year) and \$200 principal. This is the only installment payment Mark received in 1987. He enters the total amount paid during 1987, \$1,200 ( $\$1,000 + \$200$ ), on this line. He reports the \$72 interest on line 8 of Form 1040.

**Line 18.** Since this was the sale of an undeveloped lot held for investment, Mark has no allocable installment indebtedness to report.

**Line 19.** Here Mark enters \$4,900, the sum of line 16 plus line 17. This is the total of all the payments he is considered to have received in 1987.

**Line 20.** Since 1987 is the year of sale, Mark makes no entry here.

**Line 21.** The gross profit percentage (line 15) for this sale is 100%. Therefore, the entire amount on line 19, \$4,900, is taxable gain. Mark enters this amount on line 21.

**Lines 22 and 23.** Because the lot Mark sold was not depreciable property, he does not have to recapture any depreciation deductions as ordinary gain. All of his gain on the sale is long-term capital gain. He carries the amount on line 23 to line 11 of Schedule D (Form 1040) where it is included with any other long-term capital gains he may have.

**Part III.** Because Mark sold the lot to his partnership, a "related person," he must fill out this part of the form. But because the property he sold was not a marketable security, he must complete this part only for 1987, 1988, and 1989.

**Question F.** Mark enters the name, address, and employer identification number of the partnership that bought the lot.

**Question G.** The partnership did not sell the lot in 1987, so Mark checks the "No" box. Because he checked the "No" box, he does not have to fill out the rest of Part III.

### Example 2

In December 1986, Cora Blue sold a painting she had inherited a few years before. The buyer paid her \$700 down and gave her an installment note for \$3,800. The note calls for quarterly payments of \$530 until the \$3,800 debt is paid off, in about 2 years. Each \$530 payment includes interest figured at 10% a year on the outstanding debt. Cora received her first 4 payments on the note in 1987. The amount of principal and interest she received in each payment is given in the table below:

Payment	Interest	Principal
First.....	\$ 85.00	\$ 435.00
Second.....	84.13	445.87
Third.....	72.98	457.02
Fourth.....	61.55	468.45
	<u>\$313.66</u>	<u>\$1,806.34</u>

Cora must report the \$313.66 in interest as ordinary income on line 8 of her Form 1040. She reports the \$1,806.34 in principal on Form 6252 as follows:

**Question A.** Cora states that the property she sold was an oil painting.

**Questions B and C.** She then writes in the date she acquired the painting (through inheritance) and the date she sold it.

**Question D.** The buyer was not related to Cora, so she checks the "No" box.

**Question E.** Because she checked "No" to question D, Cora does not have to answer this question or fill out Part III of the form.

**Part I.** Cora completed Part I of her Form 6252 for the year of sale, 1986. She does not fill it out for the remaining years of the installment sale.

**Part II.** This is the only part of Form 6252 that Cora fills out.

**Line 15.** On her 1986 Form 6252, Cora had figured her gross profit percentage to be 22.7%. She uses this same percentage on her 1987 Form 6252.

**Line 16.** Since this is not the year of sale, Cora enters zero on this line.

**Line 17.** Cora enters the total amount (minus interest) that she received on the sale in 1987, \$1,806.34.

**Line 18.** Since the painting is not real property, there is no allocable installment indebtedness to report.

**Line 19.** The amount on line 17 carries over to line 19.

**Line 20.** Before 1987, Cora had received only the \$700 down payment on the sale.

**Line 21.** Cora next multiplies the gross profit percentage of 22.7% (line 15), by the amount she was paid in 1987 (line 19), \$1,806.34. The result, \$410.04, is the amount of gain she had on the sale in 1987.

**Lines 22 and 23.** Cora did not use the painting in a business, so it was not depreciable and the recapture rules do not apply. The amount on line 21 carries over to line 23. Because Cora owned the painting for more than a year when she sold it, her gain is long-term capital gain. She carries the amount on line 23 to line 11 of Schedule D (Form 1040), where it is included with any other long-term capital gains she may have.

6252

## Computation of Installment Sale Income

OMB No. 1545-0048

1987

Attachment  
Requirement No. 79

See separate instructions. Attach to your tax return.

Use a separate form for each sale or other disposition of property on the installment method.

Mark Moore

Identifying number  
123-00-6789

- A Description of property **Real Property, undeveloped lot**
- B Date acquired (month, day, and year) **2-17-75** C Date sold (month, day, and year) **11-1-87**
- D Was property sold to a related party after May 14, 1980? (See instructions.)  Yes  No
- E If the answer to D is "Yes," was the property a marketable security?  Yes  No
- If you checked "Yes" to question E, complete Part III.  
If you checked "No" to question E, complete Part III for the year of sale and for 2 years after the year of sale.

**Part I** Computation of Gross Profit and Contract Price (Complete this part for the year of sale only.)

1 Selling price including nonrecourse and other indebtedness (Do not include stated or unstated interest)	1	14,700
2 Mortgage and other indebtedness buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	2	6,500
3 Subtract line 2 from line 1	3	8,200
4 Cost or other basis of property sold	4	2,650
5 Depreciation allowed or allowable	5	0-
6 Adjusted basis (subtract line 5 from line 4)	6	2,650
7 Commissions and other expenses of sale	7	150
8 Income recapture from Form 4797, Part III (See instructions)	8	0-
9 Add lines 6, 7, and 8	9	2,800
10 Subtract line 9 from line 3. If zero or less, do not complete rest of form	10	11,900
11 If question A above is a principal residence, enter the sum of lines 9 and 15 of Form 2119	11	
12 Gross profit (subtract line 11 from line 10)	12	11,900
13 Subtract line 9 from line 2. If line 9 is more than line 2, enter zero	13	5,700
14 Contract price (add line 3 and line 13)	14	11,900

**Part II** Computation of Taxable Part of Installment Sale (Complete this part for the year of sale and any year you receive a payment or have certain indebtedness you must treat as a payment on installment obligations. See instructions for allocable installment indebtedness.)

15 Gross profit percentage (divide line 12 by line 14) (for years after the year of sale, see instructions)	15	100%
16 For year of sale only - enter amount from line 13 above, otherwise enter zero	16	3,700
17 Payments received during year (see instructions) (Do not include stated or unstated interest)	17	6,200
18 Allocable installment indebtedness from page 2 of the instructions	18	0-
19 Add lines 16, 17, and 18	19	4,900
20 Payments received in prior years (see instructions) (Do not include stated or unstated interest)	20	
21 Taxable part of installment sale (multiply line 19 by line 15)	21	4,900
22 Part of line 21 that is ordinary income under recapture rules (See instructions)	22	
23 Subtract line 22 from line 21. Enter on Schedule D or Form 4797	23	4,900

**Part III** Information and Computation for Related Party Installment Sale

F Name, address, and taxpayer identifying number of related party **Home Design, W. Main St. Smalltown, N.Y. 12889 10-7654321**

- G Did the related party, during this tax year, resell or dispose of the property?  Yes  No
- H If the answer to question G is "Yes," complete lines 24 through 31 below unless one of the following conditions is met (check only the box that applies):
- The first disposition was a sale or exchange of stock to the issuing corporation.
  - The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.
  - The second disposition occurred after the death of the original seller or purchaser.
  - It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. (See instructions.)

24 Selling price of property sold by related party	24	
25 Enter contract price from line 14 for year of first sale	25	
26 Enter the smaller of line 24 or line 25	26	
27 Total payments received by the end of your 1987 tax year. Add lines 19 and 20	27	
28 Subtract line 27 from line 26. If line 27 is more than line 26, enter zero	28	
29 Multiply line 28 by the gross profit percentage on line 15 for year of first sale	29	
30 Part of line 29 that is ordinary income under recapture rules (See instructions)	30	
31 Subtract line 30 from line 29. Enter on Schedule D or Form 4797	31	

For Paperwork Reduction Act Notice, see separate instructions.

Form 6252 (1987)

6252

## Computation of Installment Sale Income

OMB No. 1545-0048

1987

Attachment  
Requirement No. 79

See separate instructions. Attach to your tax return.

Use a separate form for each sale or other disposition of property on the installment method.

Corn Blue

Identifying number  
666-00-2222

- A Description of property **Oil Painting**
- B Date acquired (month, day, and year) **7-31-83** C Date sold (month, day, and year) **12-10-86**
- D Was property sold to a related party after May 14, 1980? (See instructions.)  Yes  No
- E If the answer to D is "Yes," was the property a marketable security?  Yes  No
- If you checked "Yes" to question E, complete Part III.  
If you checked "No" to question E, complete Part III for the year of sale and for 2 years after the year of sale.

**Part I** Computation of Gross Profit and Contract Price (Complete this part for the year of sale only.)

1 Selling price including nonrecourse and other indebtedness (Do not include stated or unstated interest)	1	
2 Mortgage and other indebtedness buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	2	
3 Subtract line 2 from line 1	3	
4 Cost or other basis of property sold	4	
5 Depreciation allowed or allowable	5	
6 Adjusted basis (subtract line 5 from line 4)	6	
7 Commissions and other expenses of sale	7	
8 Income recapture from Form 4797, Part III (See instructions)	8	
9 Add lines 6, 7, and 8	9	
10 Subtract line 9 from line 3. If zero or less, do not complete rest of form	10	
11 If question A above is a principal residence, enter the sum of lines 9 and 15 of Form 2119	11	
12 Gross profit (subtract line 11 from line 10)	12	
13 Subtract line 9 from line 2. If line 9 is more than line 2, enter zero	13	
14 Contract price (add line 3 and line 13)	14	

**Part II** Computation of Taxable Part of Installment Sale (Complete this part for the year of sale and any year you receive a payment or have certain indebtedness you must treat as a payment on installment obligations. See instructions for allocable installment indebtedness.)

15 Gross profit percentage (divide line 12 by line 14) (for years after the year of sale, see instructions)	15	22.7%
16 For year of sale only - enter amount from line 13 above, otherwise enter zero	16	0-
17 Payments received during year (see instructions) (Do not include stated or unstated interest)	17	1,806 34
18 Allocable installment indebtedness from page 2 of the instructions	18	
19 Add lines 16, 17, and 18	19	1,806 34
20 Payments received in prior years (see instructions) (Do not include stated or unstated interest)	20	700 00
21 Taxable part of installment sale (multiply line 19 by line 15)	21	410 04
22 Part of line 21 that is ordinary income under recapture rules (See instructions)	22	
23 Subtract line 22 from line 21. Enter on Schedule D or Form 4797	23	410 04

**Part III** Information and Computation for Related Party Installment Sale

F Name, address, and taxpayer identifying number of related party

- G Did the related party, during this tax year, resell or dispose of the property?  Yes  No
- H If the answer to question G is "Yes," complete lines 24 through 31 below unless one of the following conditions is met (check only the box that applies):
- The first disposition was a sale or exchange of stock to the issuing corporation.
  - The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.
  - The second disposition occurred after the death of the original seller or purchaser.
  - It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. (See instructions.)

24 Selling price of property sold by related party	24	
25 Enter contract price from line 14 for year of first sale	25	
26 Enter the smaller of line 24 or line 25	26	
27 Total payments received by the end of your 1987 tax year. Add lines 19 and 20	27	
28 Subtract line 27 from line 26. If line 27 is more than line 26, enter zero	28	
29 Multiply line 28 by the gross profit percentage on line 15 for year of first sale	29	
30 Part of line 29 that is ordinary income under recapture rules (See instructions)	30	
31 Subtract line 30 from line 29. Enter on Schedule D or Form 4797	31	

For Paperwork Reduction Act Notice, see separate instructions.

Form 6252 (1987)

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### How to Get IRS Forms and Publications

You can order tax forms and publications from the IRS Forms Distribution Center for your state at the address below. Or, if you prefer, you can photocopy tax forms from reproducible copies kept at many participating public libraries. In addition, many of these libraries have reference sets of IRS publications which you can read or copy.

Send to  
"Forms Distribution  
Center"  
for your state

If you are located in:



Alaska, Arizona, California,  
Colorado, Hawaii, Idaho,  
Montana, Nevada, New Mexico,  
Oregon, Utah, Washington, Wyoming

PO Box 12626,  
Fresno, CA 93778

Alabama, Arkansas,  
Illinois, Indiana, Iowa,  
Kansas, Kentucky, Louisiana,  
Michigan, Minnesota, Mississippi,  
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Dakota, Ohio, Oklahoma, South  
Dakota, Tennessee, Texas, Wisconsin

PO Box 9903,  
Bloomington, IL 61799

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**Puerto Rico**—Forms Distribution Center, P.O. Box 25866, Richmond, VA 23260.

**Virgin Islands**—V.I. Bureau of Internal Revenue, P.O. Box 3196, St. Thomas, VI 00801

**S J R**

**41**

SENATE COMMITTEE REPORT

FIRST COMMITTEE OF REFERRAL

Date of 5-DAY NOTICE 4/13/89  
IN ACCORDANCE WITH UNIFORM RULE 23

FURTHER

\*\*FISCAL NOTE(S) MUST BE ATTACHED  
IN ACCORDANCE WITH AS 24.08.035

DATE TURNED INTO OFFICE 4/14/89

4/3/89

Mr. President:

L&C

Committee considered

SJR 41

Supporting the status of the Medical Indemnity Corporation of Alaska as a public corporation and an essential instrumentality of the state and endorsing the corporation's tax exempt status

and recommended:

- replace with CS \_\_\_\_\_  same title
- attached amendment(s) and  new title
- \_\_\_\_\_ letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to \_\_\_\_\_

FISCAL NOTE(S) attached Dept of Commerce 4/4/89  zero  fiscal impact  
 appropriation no FN attached  Gov. FN introduced w/ bill

MEMBERS SIGNING DO PASS

OTHER RECOMMENDATIONS

*[Signature]*  
*[Signature]*  
*[Signature]*  
   
   
 

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

*[Signature]*  
 Chair : signature and recommendation

Committee backup attached

FISCAL NOTE

REQUEST:

Revision Date: \_\_\_\_\_ Agency Affected: Commerce & Economic Dev.  
 Title: Supporting MICA as a public corporation endorsing MICA's tax exempt status Medical Indemnity Corporation  
of Alaska  
 Sponsor: Sturgulewski. Components: \_\_\_\_\_  
 Requester: Senate Labor & Commerce

EXPENDITURES / REVENUES : (Thousands of Dollars)

OPERATING	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0

CAPITAL	0	0	0	0	0	0
---------	---	---	---	---	---	---

REVENUE	0	0	0	0	0	0
---------	---	---	---	---	---	---

FUNDING: (Thousands of dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS:

FULL-TIME	0	0	0	0	0	0
PART-TIME						
TEMPORARY						

ANALYSIS: (Attach a separate page if necessary.)

Prepared by: Paul Roller, Director  
 Division: Insurance

Phone: 465-2515  
 Date: 4-4-89

Approved by Commissioner: Larry Mercurieff  
 Agency: Department of Commerce & Economic Development

Phone: 465-2500  
 Date: 4/4/89

Distribution (by preparer):

- Legislative Finance
- Legislative Sponsor
- Requestor
- Office of Management and Budget
- Impacted Agency(ies)

page \_\_\_\_\_ of \_\_\_\_\_

## MEDICAL INDEMNITY CORPORATION OF ALASKA

### TAX ISSUE--BACKGROUND SUMMARY

March 22, 1989

The Medical Indemnity Corporation of Alaska ("MICA") was established by the Alaska Legislature in 1976 to deal with the medical malpractice insurance crisis that existed in Alaska. See AS 21.88.010-21.88.900. At that time all major providers of medical malpractice insurance had withdrawn from the Alaska market. In order to prevent the shortage of physicians that was anticipated to result from the unavailability of malpractice insurance, the Legislature created MICA as a "public corporation" to make available the necessary insurance coverage.

MICA is governed by a nine-member Board of Governors, whose members are appointed by the Governor and confirmed by the Legislature. Initial funding for MICA was provided by the State through the establishment of a \$6,000,000 revolving loan fund, from which MICA may borrow funds upon certification by the Director of Insurance that such a loan is necessary. MICA currently has two outstanding loans from the fund, and these loans are being repaid on the statutory payment schedules. A \$3,000,000 capital loan has now been reduced to \$2.4 million; a \$2,000,000 loan, obtained in 1986 to compensate for fluctuations in loss experience, has now been reduced to \$1.2 million.

In 1977, shortly after MICA was established, MICA sought and obtained from the Alaska Department of Revenue a ruling that MICA was an instrumentality of the State of Alaska and was therefore exempt from state income tax and exempt from the state business license tax. In 1977, MICA also obtained from its independent auditors a written opinion that, as an instrumentality of the State, MICA was exempt from federal income tax under section 115 of the Internal Revenue Code and was not required to file tax returns. Accordingly, MICA has not paid taxes, has not filed tax returns, and has operated in all respects as a tax-exempt instrumentality of the State of Alaska.

In 1988, MICA's independent auditors raised some questions about MICA's exemption from federal income tax. These questions arose in part as a result of changes that were made in the law by the Tax Reform Act of 1986 and by the discovery of some rulings issued by the Internal Revenue Service with respect to other similar but not identical state-established

insurance corporations. In August 1988, through its auditors, MICA requested a ruling from the Internal Revenue Service "with respect to whether the income of MICA is excludable from gross income under Section 115(1) of the Internal Revenue Code of 1986." MICA has not yet received a ruling. It is MICA's understanding that the ruling has not yet been issued, in part, because at the present time there is a division of opinion within the Internal Revenue Service on whether MICA satisfies the requirements for an exemption under section 115(1).

In order for MICA's income to be exempt under section 115(1), the income (1) must be derived from the exercise of an essential governmental function and (2) must accrue to a state or a political subdivision of a state. It is MICA's understanding that the Internal Revenue Service in this case is principally concerned with whether MICA's income accrues to the State, not with whether MICA is performing an essential governmental function. In fact, MICA does satisfy the requirements of section 115(1). Since MICA is an instrumentality of the State of Alaska, all of MICA's income accrues to the State. MICA's income historically has been used only for the necessary expenses of performing MICA's statutory functions and for making the required loan payments to the State.

An attempt by the Internal Revenue Service to tax MICA would raise serious constitutional questions and would extend the issue beyond merely interpreting section 115(1). Under the constitutional principle of intergovernmental tax immunity, the federal government may not impose an income tax on an instrumentality of a state. A ruling by the Internal Revenue Service that it has the authority to impose an income tax on MICA would have serious implications for the tax status of other public corporations that are instrumentalities of the State of Alaska. For example, even the tax-exempt status of the Alaska Permanent Fund would be subject to question. In order to reinforce its position on this question, MICA therefore is seeking the support of the Governor, the Alaska Congressional Delegation, and the Alaska Legislature.

If MICA were found to be subject to federal income tax, its estimated potential tax liability for 1987 and 1988 would total \$2,045,000 (1987--\$1,585,000; 1988--\$460,000). Those taxes would have to be paid out of MICA's existing cash reserves. The taxes for 1989 and future years would have to be funded by premium increases. For 1989, the exact tax liability is not yet known, but MICA's actuaries have calculated that loss of tax-exempt status would require a 1989 premium increase of 12.6 percent for physicians and 10.5 percent for hospitals.

**S J R**

**47**

SENATE COMMITTEE REPORT

Taken from Rules

FURTHER

5/5/89

DATE TURNED INTO OFFICE 1/23/90

Mr. President:

L&C

Committee considered SJR 47

Urging the Federal Deposit Insurance Corporation to reconsider its liquidation policies for the real property that it controls in the state

and recommended

- replace with \_\_\_\_\_ CS \_\_\_\_\_ )  same title
- or adopt \_\_\_\_\_ CS \_\_\_\_\_ )  new title
- attached amendment(s) and  technical title change (HB only)
- \_\_\_\_\_ letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to \_\_\_\_\_

**FISCAL NOTE(S)**  zero  fiscal impact  appropriation no FN  
 new  updated  previous  
 same as previous fiscal note(s) published \_\_\_\_\_

MEMBERS SIGNING DO PASS

OTHER RECOMMENDATIONS

*Walter Rodney*  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

*W. Ellison* *Do pass*  
 Chair: signature and recommendation

Committee Backup attached

**FISCAL NOTE**

**REQUEST:**

Revision Date:                       
 Title: Repealing the FDIC to reconsider  
its liquidation policies for  
the real property they control  
 Sponsor: Rodey, Halford, Faiks  
 Requestor: Fischer, Kelly

Agency Affected:                       
 BRU: Special Comm. on Banking  
and Economic Development  
 Components:                     

**EXPENDITURES/REVENUES: (Thousands of Dollars)**

OPERATING	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING						
CAPITAL	0	0	0	0	0	0
REVENUE	0	0	0	0	0	0

**FUNDING: (Thousands of Dollars)**

GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

**POSITIONS:**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS :** (Attach a separate page if necessary)

Prepared by: Senator Pat Rodey, Chair Phone:                       
 Division: Special Comm. on Banking and Date: 5/4/89  
Economic Development

Approved by Commissioner: Pat Rodey, Chair Date: 5/4/89  
 Agency:                     

Distribution (by preparer):  
 Legislative Finance  
 Legislative Sponsor  
 Requestor  
 Office of Management and Budget  
 Impacted Agency(ies)

**S J R**

**72**

FIRST COMMITTEE OF REFERENCE

DATE: 2/12/90

FURTHER: Judiciary  
Finance

Date of 5-Day Notice: 2/15/90  
(in accordance with Uniform Rule 23)

DATE TURNED INTO OFFICE: 2/26/90

L & C Committee considered SJR 72

Proposing amendments to the Constitution of the State of Alaska creating an economic development fund.

and recommended:

- replace with \_\_\_\_\_ CS SJR 72  same title
- attached amendment(s)  new title
- \_\_\_\_\_ letter of intent adopted

- do pass
- do not pass
- no recommendation
- individual recommendations
- further referral to \_\_\_\_\_

- ATTACHES NEW FISCAL NOTE(S):
- |  |  |
|--|--|
| Department(s)/Date:                                      | Department(s)/Date:                                    |
| <input checked="" type="checkbox"/> fiscal note(s) _____ | <input type="checkbox"/> zero fiscal note(s) _____     |
| <u>Div of Elections 2/15/90</u>                          | _____  |
| <u>(for SJR CS SJR 72)</u>                               | _____  |
| <input type="checkbox"/> appropriation-no fiscal note    | <input type="checkbox"/> Governor's bill w/fiscal note |

SIGNING DO PASS:

[Signature]

[Signature]

[Signature]

[Signature]

OTHER RECOMMENDATIONS:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

[Signature] M. Sec.

Chair: Signature and Recommendation

**FISCAL NOTE**

**REQUEST:**

Revision Date: 2/15/90  
Title: Relating to the economic development fund.  
Sponsor: Sen. Rodey  
Requestor: Sen. Rodey

Agency Affected: Office of the Governor  
BRU: Elections  
Components: II- Primary & General Elections

**EXPENDITURES/REVENUES: (Thousands of Dollars)**

OPERATING	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL	2.2*	-0-	-0-	-0-	-0-	-0-
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
<b>TOTAL OPERATING</b>	<b>2.2*</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>
<b>CAPITAL</b>						
<b>REVENUE</b>						

**FUNDING: (Thousands of Dollars)**

GENERAL FUND	2.2*	-0-	-0-	-0-	-0-	-0-
FEDERAL FUNDS						
OTHER						
<b>TOTAL</b>	<b>2.2*</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>	<b>-0-</b>

**POSITIONS:**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS :** (Attach a separate page if necessary)

The fiscal impact for FY 90 is -0-

- \* Costs included cover 2 to 3 pages in each Official Election Pamphlet, for printing and typesetting, and costs estimated to cover computer programming requirements for vote counting purposes.

Prepared by: Kinda Edgeworth Phone: 465-4611  
Division: Division of Elections Date: 2/15/90

Approved by Commissioner: [Signature] Date: 2.15.90  
Agency: Division of Elections

**Distribution (by preparer):**

Legislative Finance  
Legislative Sponsor  
Requestor  
Office of Management and Budget  
Impacted Agency(ies)

CONTINUATION OF FISCAL NOTE ANALYSIS

For Bill/Resolution No. SJR 72

However, these costs are based on the assumption that all candidates and issues will fit on three ballot cards, which is the norm. It should be noted, however that should the inclusion of this issue require a 4th ballot to be printed, the cost increase would have to be calculated at 16 cents per ballot x approximately 320,000 voters. The total cost of printing the additional ballot card would be \$51.2

Under these circumstances the fiscal note would be:

53.4

Patrick M. Rodey  
Senator

# Alaska State Legislature



## Senate

3111 C. St., Suite 510  
Anchorage, Alaska 99503  
(907) 561-7618

During Session:  
P.O. Box V  
Juneau, Alaska 99811  
(907) 465-3793

DATE: February 23, 1990  
TO: Senator Dick Eliason, Chair  
Senate Labor and Commerce Committee  
FROM: Senator Pat Rodey  
SUBJECT: SJR 72 - Economic Development Fund

The purpose of this legislation is to expand the opportunities for new development and redevelopment that would have a positive impact on the State of Alaska.

The Economic Development Fund would use one-quarter of one percent of the annual receipts of the State taxes on oil and gas. In fiscal year 1989 the State collected \$950 million in oil and gas taxes which would have translated in to approximately \$2.38 million available to the Fund.

Along with the annual deposits in to the fund any earnings or repayments that the fund receives from its activity would go back into the fund. This will enable the fund to develop a stable and ongoing source of investments dollars.

The Board of Directors would operate similar to the Board of Directors of the Permanent Fund Corporation. They would set up the guidelines for a prudent investment policy with the guidance of the Legislature.

**S J R**

**76**

SENATE COMMITTEE REPORT  
FIRST COMMITTEE OF REFERRAL

DATE: 2/12/90

FURTHER:

Date of 5-Day Notice: 2/15/90  
(in accordance with Uniform Rule 23)

DATE TURNED INTO OFFICE: 2/26/90

L & C Committee considered

SJR 76

Urging a change in the allocation formula for federal grants for alcohol, drug abuse, and mental health services.

and recommended:

- replace with \_\_\_\_\_ CS \_\_\_\_\_  same title
- attached amendment(s)  new title
- \_\_\_\_\_ letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to \_\_\_\_\_

ATTACHES NEW FISCAL NOTE(S):

Department(s)/Date:

Department(s)/Date:

fiscal note(s) \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

zero fiscal note(s) \_\_\_\_\_  
Dept of Health & Social Services 2/23/90

appropriation-no fiscal note

Governor's bill w/fiscal note

SIGNING DO PASS:

[Signature]  
[Signature]  
[Signature]  
[Signature]

OTHER RECOMMENDATIONS:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

[Signature] Do pass  
Chair: Signature and Recommendation

## FISCAL NOTE

**REQUEST:**

Revision Date: \_\_\_\_\_ Agency Affected: Health & Social Services  
 Title: Urging a change in the allocation formula for federal grants for alcohol . . . BRU: Office of Alcohol & Drug Abuse  
 Sponsor: Fahrenkamp/Sturculewski Components: \_\_\_\_\_  
 Requestor: \_\_\_\_\_

**EXPENDITURES/REVENUES:** (Thousands of Dollars)

OPERATING	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
<b>TOTAL OPERATING</b>	-0-	-0-	-0-	-0-	-0-	-0-
<b>CAPITAL</b>	-0-	-0-	-0-	-0-	-0-	
<b>REVENUE</b>						

**FUNDING:** (Thousands of Dollars)

GENERAL FUND	-0-	-0-	-0-	-0-	-0-	-0-
FEDERAL FUNDS						
OTHER						
<b>TOTAL</b>	-0-	-0-	-0-	-0-	-0-	-0-

**POSITIONS:**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS :** (Attach a separate page if necessary)

Fiscal impact for FY90 is "0".

Prepared by: Matthew Relix, Coordinator  
 Division: Office of Alcohol & Drug Abuse

Phone: 586-6201  
 Date: \_\_\_\_\_

Approved by Commissioner: Myra M. Munson  
 Agency: Department of Health & Social Services

Date: 2/23/90

- Distribution (by preparer):**
- Legislative Finance
  - Legislative Sponsor
  - Requestor
  - Office of Management and Budget
  - Impacted Agency(ies)

# Alaska State Legislature



SENATOR BETTYE FAHRENKAMP  
CHAIRMAN, RESOURCES COMMITTEE  
110 N. CUSHMAN STREET, SUITE 201  
FAIRBANKS, ALASKA 99701  
OFFICE (907) 452-4882  
HOME (907) 456-2899

WHILE IN JUNEAU  
PO BOX V  
JUNEAU, ALASKA 99811  
CAPITOL, ROOM 125  
OFFICE (907) 465-3834  
HOME (907) 780-6027

Senate

## MEMORANDUM

TO: Senator Richard Eliason, Chairman  
Senate Labor & Commerce Committee

FROM: Senator Bettye Fahrenkamp *Bettye*

DATE: February 21, 1990

SUBJECT: Senate Joint Resolution 76  
"Urging a change in the allocation formula for federal grants for alcohol, drug abuse, and mental health services."

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The federal government has provided funding for substance abuse and mental health services in the form of block grants since 1981. Last fall, the President requested an addition \$1.65 billion for drug abuse programs, from which \$415 million was to go to the states' block grants for prevention and treatment services.

This block grant money is distributed to the individual states by a formula that favors urban areas. As a result, Alaska and six other rural states are not scheduled to receive *any additional funding* for federal fiscal year 1990.

This resolution requests that the Alaska Congressional delegation seek changes in the funding formula so that Alaska can receive a fair share of federal aid.

Thank you for scheduling this resolution. I urge your support, and would be happy to answer any questions.

# MEMORANDUM

State of Alaska

TO: Kurt Parkan (Rep. Boyer)  
~~James Nordlund (Rep. Ellis)~~  
Geoffrey Bullock (Rep. Davis)

DATE: January 9, 1990

FILE NO:

TELEPHONE NO: 586-6201

THRU: Jay Livey  
Special Assistant  
Office of the Commissioner

SUBJECT: Federal Funding  
Anti Drug Act 1990

FROM: Matthew Felix *MF*  
Coordinator  
Office of Alcoholism/Drug Abuse

Attached is the information on federal funding you requested. I also have included a status report I wrote a month ago.

Attachment

cc: Yvonne Chase

**Federal Funding  
Alcohol, Drug Abuse, Mental Health Block Grant**

Federal funding for substance abuse and mental health services has been coming to Alaska in the form of a block grant since 1981. The allocation formula has been debated every year since. In FY 89 ending in September 1989, Alaska was given a small increase in funding but the formula did not allow any increase in the subsequent three (3) years.

In the fall of '89, the President announced a major initiative against drug abuse with a fiscal note of 1.65 billion additional dollars. Of this funding, \$415 million was to be added to the states block grants. This money is distributed to individual states by a formula with four basic components; population, age of population, number of abusers, and a state's calculated total tariffable resources. Alaska does not fair well under this formula. A new formula would have given Alaska a substantial increase. The Senate concurred with the administration although it moved some funds into treatment from the enforcement allocation. The Senate Bill S.1715 included formula changes that reduced the urban weighting considerably. This would have been very advantageous to Alaska. The FY 89 formula with its 40% urban weighting gave Alaska one of the smallest increases that year and 0 increase for FY 90. Nevertheless, some states (8) received no increases in '89 and a few actually took some reductions. The reduction of the urban weighting was viewed as more equitable and still allowed urban areas substantial funding increases.

The House passed HR 3630 that sought to make a number of changes to the Block Grant, including the reprogramming of \$250 million in block grant funds to 4 categorical programs. Additionally, the House bill would have designated separate allocation formulas for the alcohol and drug portion of the Block and for the mental health portion.

The Senate, which had previously passed S.1735, a bill that included a formula change reducing urban weighting from 40% to 20%, tried to convince the House to adopt a formula change.

However, for a number of reasons, including the fact that Congress was anxious to adjourn before Thanksgiving and that the House and Senate could not agree on transportation employee drug testing provisions, the conferees did not reach a compromise and Congress adjourned without making any changes to either the appropriations level or to the formula.

The attached chart prepared by Federal Funds Information for States (FFIS) provides an estimate of each states FY 1990 allocations under both the ADMS Block Grant and the State and Local Law Enforcement Block Grant.

Please note that while the total FY 1990 ADMS Block Grant appropriations was \$1.2 billion, a 1.4 percent reduction was required by the Gramm-Rudman-Hollings sequester law.

Also, H. R. 3015, the Transportation Appropriations bill that provided an additional \$415 million to the ADMS Block Grant for alcohol and drug abuse services contained language stating that the \$415 million "shall remain available for obligation by the states until March 31, 1991 and such obligated funds shall remain available for expenditure by the states until March 31, 1992." Thus, it appears that for the increased appropriations an additional six months is given to obligate and expend these monies. The current law requirement of one year to obligate block grant funds will apply to states' shares of the basic FY 1990 appropriation level of \$790 million.

Although the Congress did not act to change the allocation formula or to make other Block Grant changes before adjournment, it is anticipated that Congress may consider these issues early in 1990.

It is my estimate that the Senate version of the drug bill with its 20% weighting for population (urban) would increase the Alaska block by approximately \$320,000. A 30% weighting may add \$120,000-\$140,000. Again, the House Bill or the use of last year's formula would add 0 to the block grant formula. Alaska would be one of seven (7) states to receive nothing from a \$415 million (FY 90) drug bill allocation. The months of January and February will be a critical time to let our Legislative delegation know of this inequity. Nothing in the formula allows for the high cost of providing prevention and treatment in Alaska. The seven states will be lobbying for a minimum increase for all states. The final bill may set allocations for three (3) years. We must make our position known this next month.

Matthew Felix

ESTIMATED ALLOCATIONS FROM ANTI-DRUG ABUSE FORMULA GRANTS: 1989 & 1990  
(federal fiscal years; dollars in thousands)

STATE	DRUG LAW ENFORCEMENT			DRUG ABUSE BLOCK GRANT			DRUG FREE SCHOOLS			TOTAL		
	1989	1990	% CHANGE	1989	1990	% CHANGE	1989	1990	% CHANGE	1989	1990	% CHANGE
ALABAMA	\$2,018	\$6,593	226.69%	\$12,953	\$18,006	39.01%	\$4,933	\$8,215	66.52%	\$19,904	\$32,814	64.18%
ALASKA	691	1,704	145.13%	2,734	2,734	0.00%	1,421	2,230	56.92%	4,850	6,668	37.48%
ARIZONA	1,751	5,735	227.17%	12,497	17,519	40.19%	3,793	6,097	60.73%	18,041	29,171	62.75%
ARKANSAS	1,388	4,260	206.93%	7,000	8,380	19.71%	2,851	4,735	66.09%	11,239	17,375	54.60%
CALIFORNIA	10,702	39,616	267.99%	87,351	140,169	60.47%	30,048	48,636	62.01%	128,111	218,481	70.30%
COLORADO	1,725	5,498	218.73%	11,165	16,414	47.01%	3,631	5,358	51.07%	16,521	27,170	64.27%
CONNECTICUT	1,693	5,485	219.27%	10,941	16,027	46.49%	3,299	5,140	57.73%	15,893	26,372	67.20%
DELAWARE	739	1,890	155.69%	2,125	3,073	44.61%	1,421	2,235	57.22%	4,285	7,197	67.95%
DIST OF COL	731	1,831	150.44%	3,444	4,770	38.50%	1,421	2,270	56.21%	5,596	8,821	57.62%
FLORIDA	4,969	17,842	259.07%	39,620	59,657	50.57%	11,335	18,443	63.91%	53,914	76,342	72.21%
GEORGIA	2,813	9,653	243.17%	15,837	23,701	49.66%	7,556	12,457	64.84%	26,206	45,811	74.81%
HAWAII	903	2,488	175.53%	4,095	3,827	42.30%	1,421	2,277	60.27%	6,419	10,392	61.01%
IDAH0	871	2,358	170.75%	2,303	2,600	9.11%	1,421	2,290	61.14%	4,675	7,249	55.01%
ILLINOIS	4,805	16,857	250.83%	35,699	57,509	61.09%	13,047	20,818	59.56%	53,551	95,185	77.74%
INDIANA	2,556	8,500	235.66%	22,522	28,240	25.39%	6,482	9,800	51.17%	31,560	46,619	47.72%
IOWA	1,553	4,860	212.95%	4,809	7,884	62.28%	3,217	4,816	50.64%	9,579	17,511	82.61%
KANSAS	1,420	4,397	209.64%	5,543	7,573	36.62%	2,749	4,212	53.24%	9,712	16,182	66.67%
KENTUCKY	1,885	6,080	222.57%	7,296	11,624	59.32%	4,429	7,214	62.87%	13,610	24,918	81.09%
LOUISIANA	2,158	7,011	224.80%	10,191	16,486	61.77%	5,581	9,241	65.57%	17,910	32,738	82.58%
MAINE	941	2,634	179.94%	4,654	4,654	0.00%	1,421	2,289	61.05%	7,016	9,577	36.50%
MARYLAND	2,186	7,308	234.09%	12,085	21,314	76.37%	4,753	7,714	62.38%	19,024	36,332	90.98%
MASSACHUSETT	2,676	9,035	237.61%	25,271	35,091	38.86%	5,683	9,258	62.94%	33,630	53,184	58.74%
MICHIGAN	3,919	13,613	247.37%	27,271	43,130	58.15%	10,773	17,211	59.76%	41,943	73,954	76.24%
MINNESOTA	2,078	6,873	230.74%	9,134	15,173	66.12%	4,729	7,312	54.61%	15,941	29,358	84.14%
MISSISSIPPI	1,476	4,568	209.47%	6,853	7,972	16.33%	3,481	6,002	74.70%	11,810	18,621	57.61%
MISSOURI	2,397	8,012	234.27%	14,318	21,448	49.80%	5,641	8,028	56.49%	22,336	38,289	71.24%
MONTANA	801	2,088	160.64%	2,964	2,964	0.00%	1,421	2,256	58.76%	5,186	7,308	40.91%
NEBRASKA	1,092	3,177	190.91%	3,949	5,431	37.53%	1,812	2,806	54.80%	6,853	11,413	66.54%
NEVADA	874	2,428	177.80%	3,890	5,404	38.92%	1,421	2,270	59.70%	6,185	10,102	63.32%
NEW HAMPSHIRE	893	2,470	176.83%	4,627	4,627	0.00%	1,421	2,275	60.07%	6,941	9,372	35.02%
NEW JERSEY	3,352	11,538	244.21%	31,449	45,540	44.81%	7,910	12,969	63.96%	42,711	70,047	64.00%
NEW MEXICO	1,958	3,047	187.99%	6,435	6,551	1.80%	1,072	3,132	67.25%	9,365	12,730	35.92%
NEW YORK	7,125	25,459	257.32%	85,794	98,111	14.32%	18,683	37,892	76.06%	91,602	156,462	70.81%
NORTH CAROLI	2,884	9,854	241.69%	14,476	21,069	45.54%	7,136	11,336	58.87%	24,496	42,260	72.52%
NORTH DAKOTA	750	1,899	153.22%	1,630	1,855	13.80%	1,421	2,241	57.71%	3,801	5,996	57.73%
OHIO	4,508	15,820	250.93%	36,561	53,413	46.09%	12,381	19,090	54.19%	53,490	88,323	65.24%
OKLAHOMA	1,716	5,418	215.71%	9,808	12,843	30.94%	3,811	5,836	53.67%	15,335	24,117	57.27%
OREGON	1,512	4,769	215.38%	8,111	11,818	45.70%	2,977	4,605	54.70%	12,600	21,192	68.19%
PENNSYLVANIA	4,936	17,386	252.23%	39,746	58,481	47.14%	12,411	20,225	62.96%	57,093	96,092	68.31%
RHODE ISLAND	866	2,343	170.74%	5,503	7,222	31.24%	1,421	2,239	58.93%	7,790	11,826	51.80%
SOUTH CAROLI	1,773	5,729	223.14%	8,909	12,949	45.35%	4,111	4,738	63.91%	14,793	25,417	71.81%
SOUTH DAKOTA	764	1,962	156.81%	3,759	3,759	0.00%	1,421	2,216	56.05%	5,944	7,967	34.05%
TENNESSEE	2,304	7,678	233.17%	12,898	18,754	45.02%	5,539	9,084	62.55%	19,941	35,435	77.69%
TEXAS	6,740	23,997	256.89%	40,166	65,697	63.56%	20,897	33,091	58.35%	67,803	122,787	81.09%
UTAH	1,124	3,297	193.33%	5,686	8,502	49.53%	2,611	3,910	46.42%	9,481	15,709	65.70%
VERMONT	704	1,747	148.42%	3,918	3,918	0.00%	1,421	2,226	56.59%	6,043	7,892	30.60%
VIRGINIA	2,694	9,207	241.75%	14,757	23,935	62.19%	6,238	9,883	58.64%	23,681	41,024	81.69%
WASHINGTON	2,187	7,339	235.17%	14,549	21,835	50.08%	4,983	7,634	54.22%	21,699	34,828	69.72%
WEST VIRGINI	1,205	3,551	194.70%	5,435	5,900	4.70%	2,239	3,645	62.02%	9,079	13,076	44.25%
WISCONSIN	2,287	7,622	233.26%	10,338	17,451	68.80%	5,479	8,582	55.16%	18,104	33,575	85.45%
WYOMING	482	1,642	140.80%	1,285	1,285	0.00%	1,421	2,226	56.62%	3,388	5,153	52.09%
PUERTO RICO	1,724	5,485	218.18%	9,299	14,298	53.76%	5,283	9,891	87.21%	16,304	29,675	81.98%
TERRITORIES	1,109	3,369	203.75%	2,181	2,701	23.84%	3,475	3,582	3.09%	6,765	9,652	42.67%
UNALLOCATED	31,200	51,621	66.45%	40,280	59,643	48.07%	66,770	75,681	13.35%	138,250	184,915	35.22%
TOTAL	\$150,000	\$416,722	197.81%	\$805,594	\$1,192,851	48.87%	\$354,500	\$530,250	51.85%	\$1,310,094	\$2,177,824	66.23%

**S R**

**6**



Official Business

# Alaska State Legislature

## Senate

P.O. BOX V  
State Capitol  
Juneau, Alaska 99811

January 31, 1989

*Dick,*

TO: Senator Dick Eliason, Chairman  
Senate Labor and Commerce Committee

FROM: Senator Jay Kerttula *thanks*

SUBJECT: SR 6 - Hatcher Pass *Jay*

I would like to request that SR 6 - supporting the development of the Hatcher Pass Ski Area - be scheduled for a hearing in the Senate Labor and Commerce Committee at the earliest possible date.

Mitsui & Co., have submitted a draft Conceptual Development Plan to the Department of Natural Resources and it is hoped that approval will be forthcoming. This project is widely supported in the Mat-Su and will provide recreational and economic development opportunities for the entire state.

Thank you for your consideration of this request.

**S R**

**11**