Publication 544

Sales and Other Dispositions of Assets

For use in preparing
2023 Returns

Volume 4 of 5

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Conversion Transactions

Recognized gain on the disposition or termination of any position held as part of certain conversion transactions is treated as ordinary income. This applies if substantially all of your expected return is attributable to the time value of your net investment (like interest on a loan) and the transaction is any of the following.

- An applicable straddle (generally, any set of offsetting positions with respect to personal property, including stock).
- A transaction in which you acquire property and, at or about the same time, you contract to sell the same or substantially identical property at a specified price.
- Any other transaction that is marketed and sold as producing capital gain from a transaction in which substantially all of

your expected return is due to the time value of your net investment.

For more information, see chapter 4 of Pub. 550.

Digital Assets

Digital assets are any digital representations of value that are recorded on a cryptographically secured distributed ledger or any similar technology. For example, digital assets include non-fungible tokens (NFTs) and virtual currencies, such as cryptocurrencies and stable-coins. If a particular asset has the characteristics of a digital asset, it will be treated as a digital asset for federal income tax purposes.

The general tax principles that apply to property transactions apply to transactions using digital assets. Transactions involving digital assets include, but are not limited to:

- The receipt of digital assets as payment for goods or services provided;

- The receipt or transfer of digital asset for free (without providing any consideration) that does not qualify as a bona fide gift;
- The receipt of new digital assets as a result of mining and staking activities;
- The receipt of digital assets as a result of a hard fork;
- An exchange of digital assets for property, goods, or services;
- An exchange or trade of digital assets for other digital assets;
- A sale of digital assets; and
- Any other disposition of a financial interest in digital assets.

If, in 2023, you engaged in any transaction involving digital assets, check the "Yes" box next to the question on digital assets on page 1 of Form 1040 or 1040-SR. On the left side of Form 1040 or 1040-SR, you will see the heading “Digital Assets.” See the Instructions for Form 1040. Also, if you disposed of any digital assets in 2023 that were held as a capital asset through a sale, exchange, or transfer, use Form 8949 to figure your capital gain or loss and report it on Schedule D (Form 1040). See the Instructions for Form 8949.

If you received digital assets as compensation for your services, you must report the income as wages on Form 1040 or Form 1040-SR, line 1a. If you received digital assets for sales to customers in a trade or business, you generally must report the income on Schedule C (Form 1040) for a sole proprietorship. You should report income from digital assets the same way as you would report similar income.

For additional information on digital assets, see the Instructions for Form 1040. Also, visit *IRS.gov/DigitalAsset*.

3.

Ordinary or Capital Gain or Loss for Business Property

Introduction

When you dispose of business property, your taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary or capital is determined under rules for section 1231 transactions.

When you dispose of depreciable property (section 1245 property or section 1250 property) at a gain, you may have to recognize all or part of the gain as ordinary income under the depreciation recapture rules. Any remaining gain is a section 1231 gain.

Topics

This chapter discusses:

- Section 1231 gains and losses
- Depreciation recapture

Useful Items

You may want to see:

Publication

- ☐ **537** Installment Sales
- ☐ **547** Casualties, Disasters, and Thefts
- ☐ **551** Basis of Assets
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **4797** Sales of Business Property

See *How To Get Tax Help* for information about getting publications and forms.

Section 1231 Gains and Losses

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions (discussed below). Their treatment as ordinary or capital depends on whether you have a net gain or a net loss from all your section 1231 transactions.

If you have a gain from a section 1231 transaction, first determine whether any of the gain is ordinary income under the depreciation recapture rules (explained later). Do not take that gain into account as section 1231 gain.

Only gain in excess of the recapture amount is considered section 1231 gain.

Section 1231 transactions. The following transactions result in gain or loss subject to section 1231 treatment.

- **Sales or exchanges of real property or depreciable personal property.** This property must be used in a trade or business and held longer than 1 year. Generally, property held for the production of rents or royalties is considered to be used in a trade or business. This property must also be either real property or of a kind that is subject to depreciation under section 167 of the Internal Revenue Code. See section 1231 for details. Depreciable personal property includes amortizable section 197 intangibles (described in chapter 2 under *Other Dispositions*).
- **Sales or exchanges of leaseholds.** The leasehold must be used in a trade or business and held longer than 1 year.
- **Sales or exchanges of cattle and horses.** The cattle and horses must be held for draft, breeding, dairy, or sporting purposes and held for 2 years or longer.

- **Sales or exchanges of other livestock.** This livestock does not include poultry. It must be held for draft, breeding, dairy, or sporting purposes and held for 1 year or longer.
- **Sales or exchanges of unharvested crops.** The crop and land must be sold, exchanged, or involuntarily converted at the same time and to the same person and the land must be held longer than 1 year. You cannot keep any right or option to directly or indirectly reacquire the land (other than a right customarily incident to a mortgage or other security transaction). Growing crops sold with a lease on the land, though sold to the same person in the same transaction, are not included.
- **Cutting of timber or disposal of timber, coal, or iron ore.** The cutting or disposal must be treated as a sale, as described in chapter 2 under *Timber* and *Coal and Iron Ore*.

- **Condemnations.** The condemned property must have been held longer than 1 year. It must be business property or a capital asset held in connection with a trade or business or a transaction entered into for profit, such as investment property. It cannot be property held for personal use.
- **Casualties and thefts.**The casualty or theft must have affected business property, property held for the production of rents and royalties, or investment property (such as notes and bonds). You must have held the property longer than 1 year. However, if your casualty or theft losses are more than your casualty or theft gains, neither the gains nor the losses are taken into account in the section 1231 computation. For more information on casualties and thefts, see Pub. 547.

Property for sale to customers. A sale, exchange, or involuntary conversion of property held mainly for sale to customers is not a section 1231 transaction. If you will get back all, or nearly all, of your investment in the property by selling it rather than by using it up in your business, it is property held mainly for sale to customers.

Example. You manufacture and sell steel cable, which you deliver on returnable reels that are depreciable property. Customers make deposits on the reels, which you refund if the reels are returned within a year. If they are not returned, you keep each deposit as the agreed-upon sales price. Most reels are returned within the 1-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 not being returned may be capital or ordinary, depending on your section 1231 trans-

actions.

Patents and copyrights. The sale of a patent; invention; model or design (whether or not patented); a secret formula or process; a copyright; a literary, musical, or artistic composition; or similar property is not a section 1231 transaction if your personal efforts created the property, or if you acquired the property in a way that entitled you to the basis of the previous owner whose personal efforts created it (for example, if you receive the property as a gift). The sale of such property results in ordinary income and is generally reported in Part II of Form 4797.

Property deducted under the de minimis safe harbor for tangible property. If you deducted the costs of a property under the de minimis safe harbor for tangible property (currently $2,500 or less), then upon its sale or disposition, this property is not treated as property used in the trade or business under section 1231. Generally, any gain on the disposition of this property is treated as ordinary income and is reported on Part II of Form 4797.

Example. In 2023, you paid $1,000 for a machine that you used in your business. You deducted the $1,000 cost of the machine on your 2023 income tax return under the de minimis safe harbor for tangible property. In 2025, you sold the machine for $1,500. Because you deducted the cost of the machine under the de minimis safe harbor, this property is not treated as property used in the trade or business under section 1231. Upon sale of the machine, you must report the $1,500 as ordinary gain on line 10 of Form 4797.

Treatment as ordinary or capital. To determine the treatment of section 1231 gains and losses, combine all of your section 1231 gains and losses for the year.

- If you have a net section 1231 loss, it is ordinary loss.
- If you have a net section 1231 gain, it is ordinary income up to the amount of your nonrecaptured section 1231 losses from previous years. The rest, if any, is long-term capital gain.

Nonrecaptured section 1231 losses. Your nonrecaptured section 1231 losses are your net section 1231 losses for the previous 5 years that have not been applied against a net section 1231 gain. Therefore, if in any of your 5 preceding tax years you had section 1231 losses, a net gain for the current year from the sale of section 1231 assets is ordinary gain to the extent of your prior losses. These losses are applied against your net section 1231 gain beginning with the earliest loss in the 5-year period.

Example. In 2023, you have a $2,000 net section 1231 gain. To figure how much you have to report as ordinary income and long-term capital gain, you must first determine your section 1231 gains and losses from the previous 5-year period. From 2018 through 2022, you had the following section 1231 gains and losses.

Year	**Amount**
2018	-0-
2019	-0-
2020	($2,500)
2021	-0-
2022	$1,800

You use this information to figure how to report your section 1231 gain for 2023 as shown below.

1)	Net section 1231 gain (2023)....		$2,000
2)	Net section 1231 loss (2020)........	($2,500)	
3)	Net section 1231 gain (2022)........	1,800	
4)	Remaining net section1231 loss fromprior 5 years.......	($700)	
5)	Gain treated as ordinary income.		$700
6)	**Gain treated as long-term capital gain**..........................		**$1,300**

Depreciation Recapture

If you dispose of depreciable or amortizable property at a gain, you may have to treat all or part of the gain (even if otherwise nontaxable) as ordinary income.

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

On property you acquired in a nontaxable exchange or as a gift, your records must also indicate the following information.

- Whether the adjusted basis was figured using depreciation or amortization you claimed on other property.
- Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Corporate distributions. For information on property distributed by corporations, see *Distributions to Shareholders* in Pub. 542, Corporations.

General asset accounts. Different rules apply to dispositions of property you depreciated using a general asset account. For information on these rules, see Pub. 946.

Special rules for certain qualified section 179 real property. If you sold or otherwise disposed of qualified real property for which you elected under section 179 of the Internal Revenue Code to treat the cost of such property as an expense, special rules apply. This includes special rules for determining gain or loss and determining if the basis of the property is treated as section 1245 or section 1250 property.

Section 1245 Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property. See *Gain Treated as* *Ordinary Income*, later.

Any gain recognized that is more than the part that is ordinary income from depreciation is a section 1231 gain. See *Treatment as ordinary or capital* under *Section 1231 Gains and Losses,* earlier.

Section 1245 property defined. Section 1245 property includes any property that is or has been subject to an allowance for depreciation or amortization and that is any of the following types of property.

1. Personal property (either tangible or intangible).
2. Other tangible property (except buildings and their structural components, discussed later) used as any of the following.
   a. An integral part of manufacturing, production, or

extraction, or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.

b. A research facility in any of the activities in (a).

c. A facility in any of the activities in (a) for the bulk storage of fungible commodities (discussed later).

3. Where applicable, that part of real property (not included in (2)) with an adjusted basis reduced by (but not limited to) the following.

   a. Amortization of certified pollution control facilities.

   b. The section 179 expense deduction.

   c. Deduction for qualified clean-fuel vehicles and certain refueling property (as in effect before repeal by Public Law 113-295).

d. Deduction for capital costs incurred in complying with Environmental Protection Agency sulfur regulations.

e. Deduction for certain qualified refinery property if in effect before the repeal by the Tax Increase Prevention Act of 2014. (Repealed by P.L. 113-295, section 221(a)(34)(A), except with regards to deductions made prior to December 19, 2014.)

f. Any applicable deduction for qualified energy efficient commercial building property. See section 179D of the Internal Revenue Code.

g. Amortization of railroad grading and tunnel bores, if in effect before the repeal by the Revenue Reconciliation Act of 1990. (Repealed by Public Law 99-514, Tax Reform Act of 1986, section 242(a).)

h. Certain expenditures for childcare facilities if in effect before repeal by the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508, section 11801(a)(13) (except with regards to deductions made prior to November 5, 1990).

i. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.

j. Deduction for qualified tertiary injectant expenses.

k. Certain reforestation expenditures.

l. Deduction for election to expense qualified advanced mine safety equipment property.

m. Any deduction for qualified film, television, or live theatrical productions allowed under section 181 of the Internal Revenue Code.

4. Single purpose agricultural (livestock) or horticultural structures.

5. Storage facilities (except buildings and their structural components) used in distributing petroleum or any primary product of petroleum.

6. Any railroad grading or tunnel bore.

Buildings and structural components. Section 1245 property does not include buildings and structural components. The term “building” includes a house, barn, warehouse, or garage. The term “structural component” includes walls, floors, windows, doors, central air conditioning systems, light fixtures, etc.

Do not treat a structure that is essentially machinery or equipment as a building or structural component. Also, do not treat a structure that houses property used as an integral part of an activity as a building or structural component if the structure's use is so closely related to the property's use that the structure 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 cannot be used economically for other purposes indicates it is closely related to the use of the property it houses. Structures such 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, but as section 1245 property.

Facility for bulk storage of fungible commodities. This term includes oil or gas storage tanks and grain storage bins. Bulk storage means the storage of a commodity in a large mass before it is used. For example, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage. To be fungible, a commodity must be such that each of its parts are essentially interchangeable, and each of its parts are indistinguishable from another part.

Stored materials that vary in composition, size, and weight are not fungible. Materials are not fungible if one part cannot be used in place of another part and the materials cannot be estimated and replaced by simple reference to weight, measure, and number. For example, the storage of different grades and forms of aluminum scrap is not storage of fungible commodities.

Gain Treated as Ordinary Income

The gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and leaseback transaction, is the lesser of the following amounts.

1. The depreciation and amortization allowed or allowable on the property.
2. The gain realized on the disposition (the amount realized from the disposition minus the adjusted basis of the property).

A limit on this amount for gain on like-kind exchanges and involuntary conversions is explained later.

For any other disposition of section 1245 property, ordinary income is the lesser of (1), earlier, or the amount by which its fair market value is more than its adjusted basis. See *Gifts* and *Transfers at Death*, later.

Use Part III of Form 4797 to figure the ordinary income part of the gain.

Depreciation taken on other property or taken by other taxpayers. Depreciation and amortization include the amounts you claimed on the section 1245 property as well as the following depreciation and amortization amounts.

- Amounts you claimed on property you exchanged for, or converted to, your section 1245 property in a like-kind exchange or involuntary conversion.
- Amounts a previous owner of the section 1245 property claimed if your basis is determined with reference to that person's adjusted basis (for example, the donor's depreciation deductions on property you received as a gift).

Depreciation and amortization. Depreciation and amortization that must be recaptured as ordinary income include (but are not limited to) the following items.

1. Ordinary depreciation deductions.
2. Any special depreciation allowance you claimed.
3. Amortization deductions for any of the following costs.
    a. Acquiring a lease.
    b. Lessee improvements.
    c. Certified pollution control facilities.
    d. Certain reforestation expenses.
    e. Section 197 intangibles.
4. The section 179 deduction.
5. Deductions for all of the following costs.

a. Removing barriers to the disabled and the elderly.

b. Tertiary injectant expenses.

c. Qualified depreciable clean-fuel vehicles and refueling property (minus the amount of any recaptured deduction).

d. Environmental cleanup costs.

e. Certain reforestation expenses.

f. Qualified disaster expenses.

6. Any basis reduction for the investment credit (minus any basis increase for credit recapture).

7. Any basis reduction for the qualified electric vehicle credit (minus any basis increase for credit recapture).

Example. You file your returns on a calendar-year basis. In February 2021, you bought and placed in service for 100% use in your business a light-duty truck (5-year property) that cost $10,000. You used the half-year convention, and your MACRS deductions for the truck were $2,000 in 2021 and $3,200 in 2022. You did not take the section 179 deduction. You sold the truck in May 2023 for $7,000. The MACRS deduction in 2023, the year of sale, is $960 ($^1/2$ of $1,920). Figure the gain treated as ordinary income as follows.

1) Amount realized...............		$7,000
2) Cost (February 2021)..	$10,000	
3) Depreciation allowed or allowable (MACRS deductions: $2,000 + $3,200 + $960).....	6,160	
4) Adjusted basis (subtract line 3 from line 2).		$3,840

5) Gain realized (subtract line 4 from line 1).................... <u>$3,160</u>

6) Gain treated as ordinary income(*lesser* of line 3 or line 5)................. **<u>$3,160</u>**

Depreciation on other tangible 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, under *<u>Section 1245 Property</u>*.

For example, if depreciation deductions taken on certain storage facilities amounted to $10,000, of which $6,000 is from the periods before their use in a prescribed business activity, you must use the entire $10,000 in determining ordinary income from depreciation.

Depreciation allowed or allowable. The greater of the depreciation allowed or allowable is generally the amount to use in figuring the part of gain to report as ordinary income. However, 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 any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight-line method.

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

Multiple asset accounts. In figuring ordinary income from depreciation, you can treat any number of units of section 1245 property in a single depreciation account as one item if the total ordinary income from 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 can figure the ordinary income from depreciation as if the 50 machines and 25 trucks were one item.

However, if five 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 from depreciation.

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

Section 1250 Property

Gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. To determine the additional depreciation on section 1250 property, see *Additional Depreciation*, later.

Section 1250 property defined. This includes all real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property. It includes a leasehold of land or section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable.

If your section 1250 property becomes section 1245 property because you change its use, you can never again treat it as section 1250 property.

Additional Depreciation

If you hold section 1250 property longer than 1 year, the additional depreciation is the actual depreciation adjustments that are more than the depreciation figured using the straight-line method. For a list of items treated as depreciation adjustments, see *Depreciation and amortization* under *Gain Treated as Ordinary Income,* earlier. For the treatment of unrecaptured section 1250 gain, see *Capital Gains Tax Rates*, later.

If you hold section 1250 property for 1 year or less, all the depreciation is additional depreciation. You will not have additional depreciation if any of the following conditions apply to the property disposed of.

- You figured depreciation for the property using the straight-line method or any other method that does not result in depreciation that is more than the amount figured by the straight-line method; you held the property longer than 1 year; and, if the property was qualified property, you made a timely election not to claim any special depreciation allowance. In addition, if the property was in a renewal community, you must not have elected to claim a commercial revitalization deduction for property placed in service before January 1, 2010.
- The property was residential low-income rental property you held for $16^2/3$ years or longer. For low-income rental housing on which the special 60-month depreciation for rehabilitation expenses was allowed, the $16^2/3$ years start when the rehabilitated property is placed in service.

- You chose the alternate ACRS method for the property, which was a type of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- The property was residential rental property or nonresidential real property placed in service after 1986 (or after July 31, 1986, if the choice to use MACRS was made); you held it longer than 1 year; and, if the property was qualified property, you made a timely election not to claim any special depreciation allowance. These properties are depreciated using the straight-line method. In addition, if the property was in a renewal community, you must not have elected to claim a commercial revitalization deduction.

Depreciation taken by other taxpayers or on other property. Additional depreciation includes all depreciation adjustments to the basis of section 1250 property whether allowed to you or another person (as carryover basis property).

Example. You give your child section 1250 property on which you took $2,000 in depreciation deductions, of which $500 is additional depreciation. Immediately after the gift, your child’s adjusted basis in the property is the same as yours 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, your child sells the property. At the time of sale, the additional depreciation is $700 ($500 allowed to you plus $200 allowed to your child).

Depreciation 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. If you can show that the deduction allowed for any tax year was less than the amount allowable, the lesser figure will be the depreciation adjustment for figuring additional depreciation.

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. A wing of your 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 it is replaced and the adjustments for depreciation on it are reflected in the basis of the replacement property.

Figuring straight-line depreciation. The useful life and salvage value you would have used to figure straight-line depreciation are the same as those 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 and useful life are not used for the ACRS method of depreciation. Figure straight-line depreciation for ACRS real property by using its 15-, 18-, or 19-year recovery period as the property's useful life.

The straight-line method is applied without any basis reduction for the investment credit.

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 includes all renewal periods. This inclusion of the renewal periods cannot extend the lease period taken into account to a period that is longer than the remaining useful life of the improvement. The same rule applies to the cost of acquiring a lease.

The term “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 on which the actual depreciation adjustments were allowed.

Applicable Percentage

The applicable percentage used to figure the ordinary income because of additional depreciation depends on whether the real property you disposed of is nonresidential real property, residential rental property, or low-income housing. The percentages for these types of real property are as follows.

Nonresidential real property. For real property that is not residential rental property, the applicable percentage for periods after 1969 is 100%. For periods before 1970, the percentage is zero and no ordinary income because of additional depreciation before 1970 will result from its disposition.

Residential rental property. For residential rental property (80% or more of the gross income is from dwelling units) other than low-income housing, the applicable percentage for periods after 1975 is 100%. The percentage for periods before 1976 is zero. Therefore, no ordinary income because of additional depreciation before 1976 will result from a disposition of residential rental property.

Low-income housing. Low-income housing includes all of the following types of residential rental property.

- Federally assisted housing projects if the mortgage is insured under section 221(d)(3) or 236 of the National Housing Act or housing financed or assisted by direct loan or tax abatement under similar provisions of state or local laws.
- Low-income rental housing for which a depreciation deduction for rehabilitation expenses was allowed.
- Low-income rental housing held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under provisions of

state or local laws that authorize similar subsidies for low-income families.

- Housing financed or assisted by direct loan or insured under Title V of the Housing Act of 1949.

The applicable percentage for low-income housing is 100% minus 1% for each full month the property was held over 100 full months. If you have held low-income housing for at least 16 years and 8 months, the percentage is zero and no ordinary income will result from its disposition.

Foreclosure. If low-income housing is disposed of because of foreclosure or similar proceedings, the monthly applicable percentage reduction is figured as if you disposed of the property on the starting date of the proceedings.

Example. On June 1, 2023, you acquired low-income housing property. On April 3, 2022 (130 months after the property was acquired), foreclosure proceedings were started on the property, and on December 3, 2022 (150 months after the property was acquired), the property was disposed of as a result of the foreclosure proceedings. The property qualifies for a reduced applicable percentage because it was held more than 100 full months. The applicable percentage reduction is 30% (130 months minus 100 months) rather than 50% (150 months minus 100 months) because it does not apply after April 3, 2022, the starting date of the foreclosure proceedings. Therefore, 70% of the additional depreciation is treated as ordinary income.

Holding period. The holding period used to figure the applicable percentage for low-income housing generally starts on the day after you acquired it. For example, if you bought low-income housing on January 1, 2007, the holding period starts on January 2, 2007. If you sold it on January 2, 2023, the holding period is exactly 192 full months. The applicable percentage for additional depreciation is 8%, or 100% minus 1% for each full month the property was held over 100 full months.

Holding period for constructed, reconstructed, or erected property. The holding period used to figure the applicable percentage for low-income housing you constructed, reconstructed, or erected starts on the first day of the month it is placed in service in a trade or business, in an activity for the production of income, or in a personal activity.

Property acquired by gift or received in a tax-free transfer. For low-income housing you acquired by gift or in a tax-free transfer the basis of which is figured by reference to the basis in the hands of the transferor, the holding period for the applicable percentage includes the holding period of the transferor.

If the adjusted basis of the property in your hands just after acquiring it is more than its adjusted basis to the transferor just before transferring it, the holding period of the difference is figured as if it were a separate improvement. See *Low-Income Housing With Two or More Elements* next.

Low-Income Housing With Two or More Elements

If you dispose of low-income housing property that has two or more separate elements, the applicable percentage used to figure ordinary income because of additional depreciation may be different for each element. The gain to be reported as ordinary income is the sum of the ordinary income figured for each element.

The following are the types of separate elements.

- A separate improvement (defined below).

- The basic section 1250 property plus improvements not qualifying as separate improvements.
- 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 building of 100 units and places 30 units in service (available for renting) on January 4, 2020; 50 on July 18, 2020; and the remaining 20 on January 18, 2021. As a result, the apartment house consists of three separate elements.

The 36-month test for separate improvements. A separate improvement is any improvement (qualifying under *The 1-year test* below) added to the capital account of the property, but only if the total of the improvements during the 36-month period ending on the last day of any tax year is more than the greatest of the following amounts.

1. 25% 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. 10% of the unadjusted basis (adjusted basis plus depreciation and amortization adjustments) of the property at the start of the period determined in (1).

3. $5,000.

The 1-year test. An addition to the capital account for any tax year (including a short tax year) is treated as an improvement only if the sum of all additions for the year is more than the greater of $2,000 or 1% of the unadjusted basis of the property. The unadjusted basis is figured as of the start of that tax year or the holding period of the property, whichever is later. In applying the 36-month test, improvements in any 1 of the 3 years are omitted entirely if the total improvements in that year do not qualify under the 1-year test.

Example. The unadjusted basis of a calendar year taxpayer's property was $300,000 on January 1 of this year. During the year, the taxpayer made improvements A, B, and C, which cost $1,000, $600, and $700, respectively. The sum of the improvements, $2,300, is less than 1% of the unadjusted basis ($3,000), so the improvements do not satisfy the 1-year test and are not treated as improvements for the 36-month test. However, if improvement C had cost $1,500, the sum of these improvements would have been $3,100. Then, it would be necessary to apply the 36-month test to figure if the improvements must be treated as separate improvements.

Addition to the capital account. Any addition to the capital account made after the initial acquisition or completion of the property by you or any 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. For example, 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. The status of an addition to the capital account is not affected by whether it is treated as a separate property for determining depreciation deductions.

Whether an expense is treated as an addition to the capital account may depend on the final disposition of the entire property. If the expense item property and the basic property are sold in two separate transactions, the entire section 1250 property is treated as consisting of two distinct properties.

Unadjusted basis. In figuring the unadjusted basis as of a certain date, include the actual cost of all previous additions to the capital account plus those that did not qualify as separate improvements. However, the cost of components retired before that date is not included in the unadjusted basis.

Holding period. Use the following guidelines for figuring the applicable percentage for property with two or more elements.

- 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.
- The holding period for each separate improvement qualifying as a separate element starts on the day after the

improvement is acquired or, for improvements constructed, reconstructed, or erected, the first day of the month that the improvement is placed in service.

- The holding period for each improvement not qualifying as a separate element takes the holding period of the basic property.

If an improvement by itself does not meet the 1-year test (greater of $2,000 or 1% of the unadjusted basis), but it does qualify as a separate improvement that is a separate element (when grouped with other improvements made during the tax year), determine the start of its holding period as follows. Use the first day of a calendar month that is closest to the middle of the tax year. If there are two first days of a month that are equally close to the middle of the year, use the earlier date.

Figuring ordinary income attributable to each separate element. Figure ordinary income attributable to each separate element as follows.

Step 1. Divide the element's additional depreciation after 1975 by the sum of all the elements' additional depreciation after 1975 to determine the percentage used in Step 2.

Step 2. Multiply the percentage 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.

Example. You sold at a gain of $25,000 low-income housing property subject to the ordinary income rules of section 1250. The property consisted of four elements (W, X, Y, and Z).

Step 1. The additional depreciation for each element is W—$12,000; X—None; Y—$6,000; and Z—$6,000. The sum of the additional depreciation for all the elements is $24,000.

Step 2. The depreciation deducted on element X was $4,000 less than it would have been under the straight-line method. Additional depreciation on the property as a whole is $20,000 ($24,000 − $4,000). $20,000 is lower than the $25,000 gain on the sale, so $20,000 is used in Step 2.

Step 3. The applicable percentages to be used in Step 3 for the elements are W—68%; X—85%; Y—92%; and Z—100%.

From these facts, the sum of the ordinary income for each element is figured as follows.

	Step 1	Step 2	Step 3	Ordinary Income
W...	0.50	$10,000	68%	$ 6,800
X....	-0-	-0-	85%	-0-
Y....	0.25	5,000	92%	4,600
Z....	0.25	5,000	100%	5,000
Sum of ordinary incomeof separate elements..................				**$16,400**

Gain Treated as Ordinary Income

To find what part of the gain from the disposition of section 1250 property is treated as ordinary income, follow these steps.

1. In a sale, exchange, or involuntary conversion of the property, figure the amount realized that is more than the adjusted basis of the property. In any

other disposition of the property, figure the fair market value that is more than the adjusted basis.

2. Figure the additional depreciation for the periods after 1975.
3. Multiply the lesser of (1) or (2) by the applicable percentage, discussed earlier under *Applicable Percentage*. Stop here if this is residential rental property or if (2) is equal to or more than (1). This is the gain treated as ordinary income because of additional depreciation.
4. Subtract (2) from (1).
5. Figure the additional depreciation for periods after 1969 but before 1976.
6. Add the lesser of (4) or (5) to the result in (3). This is the gain treated as ordinary income because of additional depreciation.

A limit on the amount treated as ordinary income for gain on like-kind exchanges and involuntary conversions is explained later.

Use Form 4797, Part III, to figure the ordinary income part of the gain.

Corporations. Corporations, other than S corporations, must recognize an additional amount as ordinary income on the sale or other disposition of section 1250 property. The additional amount treated as ordinary income is 20% of the excess of the amount that would have been ordinary income if the property were section 1245 property over the amount treated as ordinary income under section 1250. Report this additional ordinary income on Form 4797, Part III, line 26(f).

Installment Sales

If you report the sale of property under the installment method, any depreciation recapture under section 1245 or 1250 is taxable as ordinary income in the year of sale. This applies even if no payments are received in that year. If the gain is more than the depreciation recapture income, report the rest of the gain using the rules of the installment method. For this purpose, include the recapture income in your installment sale basis to determine your gross profit on the installment sale.

If you dispose of more than one asset in a single transaction, you must figure the gain on each asset separately so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to each asset. Report any depreciation recapture income in the year of sale before using the installment method for any remaining gain.

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

Gifts

If you make a gift of depreciable personal property or real property, you do not have to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property in a disposition subject to recapture, the donee must take into account the depreciation you deducted in figuring the gain to be reported as ordinary income.

For low-income housing, the donee must take into account the donor's holding period to figure the applicable percentage. See *Applicable Percentage* and its discussion *Holding period* under *Section 1250 Property*, earlier.

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 you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain) to recapture depreciation. If the depreciation (additional depreciation, if section 1250 property) is more than the gain, the balance is carried over to the transferee to be taken into account on any later disposition of the property. However, see *Bargain sale to charity*, later.

Example. You transferred 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. You took depreciation of $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 minus $10,000 adjusted basis) that must be reported as ordinary income from depreciation. You report $10,000 of your $30,000 depreciation as ordinary income on the transfer of the property, so the remaining $20,000 depreciation is carried over to your son for him to take into account on any later disposition of the property.

Gift to charitable organization. If you give property to a charitable organization, you figure your deduction for your charitable contribution by reducing the fair market value of the property by the ordinary income and short-term capital gain that would have resulted had you sold the property at its fair market value at the time of the contribution. Thus, your deduction for depreciable real or personal property given to a charitable organization does not include the potential ordinary gain from depreciation.

You may also have to reduce the fair market value of the contributed property by the long-term capital gain (including any section 1231 gain) that would have resulted had the property been sold. For more information, see

Giving Property That Has Increased in Value in Pub. 526.

Bargain sale to charity. If you transfer section 1245 or section 1250 property to a charitable organization for less than its fair market value and a deduction for the contribution part of the transfer is allowable, your ordinary income from depreciation is figured under different rules. First, figure the ordinary income as if you had sold the property at its fair market value. Then, allocate that amount between the sale and the contribution parts of the transfer in the same proportion that you allocated your adjusted basis in the property to figure your gain. See *Bargain Sale* under *Gain or Loss From Sales and Exchanges* in chapter 1. Report as ordinary income the lesser of the ordinary income allocated to the sale or your gain from the sale.

Example. You sold section 1245 property in a bargain sale to a charitable organization and are allowed a deduction for your contribution. Your gain on the sale was $1,200, figured by allocating 20% of your adjusted basis in the property to the part sold. If you had sold the property at its fair market value, your ordinary income would have been $5,000. Your ordinary income is $1,000 ($5,000 × 20%) and your section 1231 gain is $200 ($1,200 – $1,000).

Transfers at Death

When a taxpayer dies, no gain is reported on depreciable personal property or real property transferred to his or her estate or beneficiary. For information on the tax liability of a decedent, see Pub. 559, Survivors, Executors, and Administrators.

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

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

Example 1. You owned depreciable property that, upon your death, was inherited by your child. No ordinary income from 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 you when you died. However, if you sold the property before your death and realized a gain and if, because of your method of accounting, the proceeds from the sale are income in respect of a decedent reportable by your child, your child must report ordinary income from depreciation.

Example 2. The trustee of a trust 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 valuation purposes, the $1,000 increase in value to the date of distribution is a gain realized by the trust. Ordinary income from depreciation must be reported by the trust on the transfer.

Like-Kind Exchanges and Involuntary Conversions

A like-kind exchange of your depreciable property or an involuntary conversion of the property into similar or related property will not result in your having to report ordinary income from depreciation unless money or property other than like-kind, similar, or related property is also received in the transaction.

The nonrecognition rules for like-kind exchanges only apply to exchanges of real property held for investment or for productive use in your trade or business and not held primarily for sale.

For more information on like-kind exchanges and involuntary conversions, see chapter 1.

Depreciable personal property. If you have a gain from an involuntary conversion of your depreciable personal property, the amount to be reported as ordinary income from depreciation is the amount figured under the rules explained earlier (see *Section 1245 Property*), limited to the sum of the following amounts.

- The gain that must be included in income under the rules for involuntary conversions.
- The fair market value of the replacement property other than depreciable personal property acquired in the transaction.

Example 1. You bought office machinery for $1,500 two years ago and deducted $780 depreciation. This year a fire destroyed the machinery and you received $1,200 from your fire insurance, realizing a gain of $480 ($1,200 − $720 adjusted basis). You choose to postpone reporting gain, but replacement machinery cost you only $1,000. Your taxable gain under the rules for involuntary conversions is limited to the remaining $200 insurance payment. All your replacement property is depreciable personal property, so your ordinary income from depreciation is limited to $200.

Example 2. A fire destroyed office machinery you bought for $116,000. The depreciation deductions were $91,640 and the machinery had an adjusted basis of $24,360. You received a $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 choose to postpone reporting the gain. $114,000 of the $117,000 insurance payment was used to buy replacement property, so the gain that must be included in income under the rules for involuntary conversions is the part not spent, or $3,000. The part of the insurance payment ($9,000) used to buy the nondepreciable property (the stock) must also be included in figuring the gain from depreciation.

1) Gain realized on the transaction ($92,640) limited to depreciation ($91,640) $91,640

2) Gain includible in income (amount not spent)...................... 3,000

Plus: Fair market value of property other than depreciable personal property (the stock)	9,000	12,000

Amount reportable as ordinary income (lesser of (1) or (2))...	**$12,000**

The amount you must report as ordinary income on the transaction is $12,000, figured as follows.

If, instead of buying $9,000 in stock, you bought $9,000 worth of depreciable personal property 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 either a like-kind exchange or involuntary conversion of your depreciable real property, ordinary income from additional depreciation is figured under the rules explained earlier (see *Section 1250 Property*), limited to the greater of the following amounts.

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

The ordinary income not reported for the year of 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). You also bought stock for $5,000 to get control of a corporation owning property similar in use to the property condemned. You choose to postpone reporting 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 greater of the following amounts.

1. The gain that must be reported under the rules for involuntary conversions, $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.

2. The gain you would have had to report as ordinary income from additional depreciation ($20,000) had this transaction been a cash sale minus the cost of the depreciable real property bought ($15,000), or $5,000.

The ordinary income not reported, $14,000 ($20,000 − $6,000), is carried over to the depreciable real property you bought as additional depreciation.

Basis of property acquired. If the ordinary income you have to report because of additional depreciation is limited, the total basis of the property you acquired is its fair market value (its cost, if bought to replace property involuntarily converted into money) minus the gain postponed.

If you acquired more than one item of property, allocate the total basis among the properties in proportion to their fair market value (their cost, in an involuntary conversion into money). However, if you acquired both depreciable real property and other property, allocate the total basis as follows.

1. Subtract the ordinary income because of additional depreciation that you do not have to report from the fair market value (or cost) of the depreciable real property acquired.
2. Add the fair market value (or cost) of the other property acquired to the result in (1).
3. Divide the result in (1) by the result in (2).
4. Multiply the total basis by the result in (3). This is the basis of the depreciable real property acquired. If you acquired more than one item of depreciable real

property, allocate this basis amount among the properties in proportion to their fair market value (or cost).

5. Subtract the result in (4) from the total basis. This is the basis of the other property acquired. If you acquired more than one item of other property, allocate this basis amount among the properties in proportion to their fair market value (or cost).

Example 1. In 1998, low-income housing property that you acquired and placed in service in 1993 was destroyed by fire and you received a $90,000 insurance payment. The property's adjusted basis was $38,400, with additional depreciation of $14,932. On December 1, 1998, you used the insurance payment to acquire and place in service replacement low-income housing property.

Your realized gain from the involuntary conversion was $51,600 ($90,000 − $38,400). You chose to postpone reporting the gain under the involuntary conversion rules. Under the rules for depreciation recapture on real property, the ordinary gain was $14,932, but you did not have to report any of it because of the limit for involuntary conversions.

The basis of the replacement low-income housing property was its $90,000 cost minus the $51,600 gain you postponed, or $38,400. The $14,932 ordinary gain you did not report is treated as additional depreciation on the replacement property. If you sold the property in 2023, your holding period for figuring the applicable percentage of additional depreciation to report as ordinary income would have begun December 2, 1998, the day after you acquired the property.

Example 2. You received a $90,000 fire insurance payment for depreciable real property (office building) with an adjusted basis of $30,000. You use the whole payment to buy property similar in use, spending

$42,000 for depreciable real property and $48,000 for land. You choose to postpone reporting the $60,000 gain realized on the involuntary conversion. Of this gain, $10,000 is ordinary income from additional depreciation but is not reported because of the limit for involuntary conversions of depreciable real property. The basis of the property bought is $30,000 ($90,000 − $60,000), allocated as follows.

1. The $42,000 cost of depreciable real property minus $10,000 ordinary income not reported is $32,000.
2. The $48,000 cost of other property (land) plus the $32,000 figured in (1) is $80,000.
3. The $32,000 figured in (1) divided by the $80,000 figured in (2) is 0.4.
4. The basis of the depreciable real property is $12,000. This is the

$30,000 total basis multiplied by the 0.4 figured in (3).

5. The basis of the other property (land) is $18,000. This is the $30,000 total basis minus the $12,000 figured in (4).

The ordinary income that is not reported ($10,000) is carried over as additional depreciation to the depreciable real property that was bought and may be taxed as ordinary income on a later disposition.

Multiple Properties

If you dispose of depreciable property and other property in one transaction and realize a gain, you must allocate the amount realized between the two types of property in proportion to their respective fair market values to figure the part of your gain to be reported as ordinary income from depreciation. Different rules may apply to the allocation of the amount realized on the sale of a business that includes a group of assets. See chapter 2.

In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the depreciable 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. These include, but are not limited to, a comparison between the depreciable property and all the other property being disposed of in the transaction. The comparison should take into account all of the following facts and circumstances.

- The original cost and reproduction cost of construction, erection, or production.
- The remaining economic useful life.
- The state of obsolescence.

- The anticipated expenditures required to maintain, renovate, or modernize the properties.

Like-kind exchanges and involuntary conversions. If you dispose of and acquire depreciable personal property and other property (other than depreciable real property) in an involuntary conversion, the amount realized is allocated in the following way. The amount allocated to the depreciable personal property disposed of 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 the other 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.